

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

To: Members, House Small Business Committee
From: Sam Graves, Chairman
Re: Full Committee Hearing: "The State of Small Business Access to Credit and
Capital: The View from Secretary Geithner"
Date: June 20, 2011

On Wednesday, June 22, 2011, at **10:00 am** in Room 2360 of the Rayburn House Office Building, the Small Business Committee will meet for the purposes of reviewing the current state of small business access to equity capital and debt financing. The hearing will focus on the Department of Treasury's current and future efforts to assist the private sector in providing the needed funds for small businesses to expand and grow. The only witness at the hearing will be the Secretary of the Treasury, the Hon. Timothy Geithner.

I. Definition of a Small Business

Under § 3(a)(1) of the Small Business Act, 15 U.S.C. § 632(a)(1), a small business concern "shall be deemed to be one that is independently owned and operated and which is not dominant in its field of operation." The Act authorizes the Administrator of the Small Business Administration (SBA) to "specify detailed definitions or standards by which a business concern may be determined to be small for the purposes of this Act or any other Act." *Id.* at § 632(a)(2)(A).¹ The Administrator exercised this authority and has denominated 42 separate size standards covering some 1137 business classifications² which may be found at 13 C.F.R. § 121.201. Those standards, except in unusual circumstances, classify small businesses based on the number of employees or the annual gross revenue of the enterprise. Nearly every conceivable business has a small business size standard established by the Administrator be it an advertising agency or a zoological park and anything in between.

¹ The Small Business Act utilizes the term "small business concern." Although statutorily accurate, common parlance substitutes the term "small business" and that usage will be adopted for this memorandum.

² The categories for classifying businesses are established in the North American Industrial Classification System or NAICS. That system is overseen by the Office of Management and Budget with significant input from the Bureau of the Census. A detailed explication of this classification system is beyond the scope of this memorandum and the intricacies, for those who wish to do so, can be explored in OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRIAL CLASSIFICATION SYSTEM (2007).

No federal or private database exists that accurately counts the number of small business concerns in the United States. According to estimates by the SBA's Office of the Chief Counsel for Advocacy (and based on data from the Internal Revenue Service, the Bureau of the Census and the Department of Labor), there are approximately 29.6 million businesses in the United States. Of those, only about six million are small businesses with employees with the remainder being self-employed individuals.

The Small Business Lending Fund and the State Small Business Credit Initiative created by the Small Business Jobs Act of 2010 do not utilize the Small Business Act definition or the size standards developed by the Administrator. Furthermore, banks generally have their own and very different definition of a small businesses.³

II. Financing of Small Businesses

Most small businesses utilize the financial resources of their founder to start a business. While some founders have sufficient savings to start without seeking outside assistance, most entrepreneurs require outside financing.⁴ There are two basic categories of outside funds for small businesses: debt financing and equity investment.

A. 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. The conditions of fund disbursement and terms of repayment are set forth when the business obtains the monies from the lender, almost invariably in loan documents.⁵ Typically, borrowing for the short-term (generally less than a year) are used to finance working capital (to purchase goods or merchandise for resale or to fund current business operations). Terms of repayment that extend beyond one year generally are used to purchase durable assets, such as equipment or land.⁶ Commercial banks and other federally-regulated financial institutions, like thrifts and credit unions, are the largest source of debt financing to small business borrowers.⁷

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

³ See, e.g., Robb Mandelbaum, *Wells Fargo Bankers Answer Criticism of Lending Practices*, N.Y. TIMES, May 26, 2011, at B6; JP MORGAN CHASE, Press Release of April 26, 2011, available at <http://investor.shareholder.com/jpmorganchase/releasedetail.cfm?ReleaseID=571659> (both discussing that small businesses are ones with gross revenue of less than \$20 million).

⁴ S. PRESTON, ANGEL FINANCING FOR ENTREPRENEURS: EARLY STAGE FUNDING FOR LONG-TERM SUCCESS 71 (2007).

⁵ In certain instances, the terms of repayment could be subsumed in a covenant to a bond that is sold to investors. However, the transactions costs (such as registration with federal and state securities regulators) associated with the issuance of bonds would be cost prohibitive for the overwhelming majority of small businesses. Thus, the functioning of the bond or commercial paper market is beyond the scope of this memorandum.

⁶ R. HISRICH, M. PETERS & D. SHEPHERD, *ENTREPRENEURSHIP* 346 (7th ed. 2008).

⁷ *Id.* at 350.

through the sale of the businesses' goods or services.⁸ Term loans are issued in a set amount for a single purpose (but generally not to provide working capital for quotidian business operations) and generally have maturities of five years or more.⁹ Bridge loans are used to cover gaps in financing to cover a specified event and typically have short maturities, but not always.¹⁰ 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.¹¹ Finally, some businesses will lease tangible assets, enabling them to utilize the asset without completely taking ownership of the asset.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

⁸ 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.

⁹ *Id.*

¹⁰ 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.*

¹¹ *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).

¹² 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 who retains title to the vehicle. Leases can be extended to many durable assets, including railroad cars, ships, planes, and even buildings. *Id.*

¹³ R. HISRIC, 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.

Debt financing is absolutely crucial for most small business owners. Without access to credit on reasonable terms, small businesses will not be able to conduct their operations, purchase goods, obtain “plant and equipment,” or hire new employees.

B. Equity Investment

The primary distinction between equity investment and debt financing is debt comes associated with a legal obligation to pay the provider of funds while equity investment does not.²⁰ In return for forgoing the legal obligation to pay, the provider of funds in an equity investment will require a stake in the company.²¹

Both the equity investor and the entrepreneur have major factors to assess with respect to equity financing. The investor must consider whether the potential gain (return on investment) outweighs the risk from the enterprise failing and the funds not being protected by the business owner’s legal obligation to repay the provider of capital.²² While the entrepreneur must weigh certain economic factors in considering debt versus equity,²³ the primary issue is actually psychological – will the entrepreneur be willing to give up part ownership and management to obtain the equity investment?²⁴ Once that decision is made, the entrepreneur then must find a source of equity capital.

There are a number of sources from which the entrepreneur can obtain equity capital. Friends and family members are one source of equity; typically such investment is not as focused on potential investment returns as might be if the investors were completely unaffiliated with the business owner.²⁵ Angels are high-net worth individuals who invest that wealth (usually in the \$25,000 to \$100,000 range but some angels may invest up to \$2 million)²⁶ in companies, generally at a very early stage of the enterprise’s life, and differ from more common types of private equity funding through their interest in imparting business acumen to the entrepreneur and not seeking control over the business.²⁷ Another source of investment is from private venture capital firms (whether as a freestanding enterprise or the subsidiary of a larger corporate parent). Generally, they are limited partnerships in which the venture firm is the general partner raising money from institutional investors (such as university endowments or pension plans) who then provide capital to businesses that will produce significant returns on the investment (generally when the business is either sold or through an initial public offering).²⁸ The business owner could sell shares, rather than to one particular angel investor or venture

²⁰ S. PRESTON, ANGEL FINANCING FOR ENTREPRENEURS: EARLY STAGE FUNDING FOR LONG-TERM SUCCESS 34 (2007).

²¹ *Id.*

²² *Id.*

²³ For example, the entrepreneur has to calculate the effect of debt repayment on cash flow. If cash flow is limited, that militates in favor of seeking equity investment.

²⁴ *Id.*

²⁵ *Id.* at 72.

²⁶ *Id.* at 10.

²⁷ *Id.* at 8, 22-23.

²⁸ R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 380, 386.

capital fund, to multiple private investors. Ultimately, the business could simply share sells to the public through an offering of stock to the general public.

Except for the public offering, all of the sources of equity capital described above are considered part of the informal capital market.²⁹ This informal market, nevertheless, is subject to a number of rules stemming from the Securities Act of 1933 (1933 Act). That statute provides the fundamental tenet of stock sales to the general public in the United States – that certain material information must be disclosed to the public through registration statements filed with the Securities and Exchange Commission (SEC). 15 U.S.C. § 77e. However, § 4 of the 1933 Act exempts certain types of transactions from the registration and disclosure requirements. *Id.* at § 77d. For the purposes of this memorandum, the key exception in § 4 is the one for “transactions by an issuer not involving any public offering....” *Id.* at § 77d(2).³⁰

The SEC has set forth what types of transactions meet the qualifications in its Regulation D.³¹ Regulation D covers the sale of stock in so-called “private offerings”³² sometimes also referred to as “private placements.”³³ Under Regulation D, stocks may be offered only to a limited number of individuals (who must be qualified investors³⁴) or for a limited amount of funds to an unlimited number of investors. For example, Rule 504 authorizes the sale of securities to an unlimited number of investors, accredited or otherwise, if the funds raised are less than \$1 million in any 12-month period.³⁵ 17 U.S.C. § 230.504. While Rule 504 allows an unlimited number of investors, Rule 505 limits the number of unaccredited investors to 35, but permits an unlimited number of accredited investors to purchase stock up to a value of \$5 million. *Id.* at § 230.505. Finally, Rule 506 authorizes the sale of an unlimited value of stock to accredited investors and a very limited number of unaccredited investors as long the unaccredited are so-called sophisticated investors (understand the risks even if they do not meet the qualifications as an accredited investor). *Id.* at § 230.506.

The final mechanism for raising equity investment is to make an offering to the public that is subject to § 5 of the 1933 Act. The primary benefit is the business can access the broadest possible market to obtain funds.³⁶ While this is the primary benefit, there are a number of regulatory costs associated with a public offering. First, the transactions cost

²⁹ *Id.* at 374.

³⁰ Sellers of stock also may be subject to various state laws that regulate the sale of stock within that state. The subject of these so-called “Blue Sky” laws is beyond the scope of this memorandum.

³¹ 17 C.F.R. §§ 230.501-.08. The full breadth of the exemptions to the registration and disclosure requirements of § 5 of the 1933 Act are beyond the scope of this memorandum.

³² The use of the term “private offering” distinguishes it from the more general sale to the public subject to the strictures of § 5 of the 1933 Act.

³³ C. BAGLEY & C. DAUCHY, *THE ENTREPRENEUR’S GUIDE TO BUSINESS LAW* 159 (3d ed. 2008).

³⁴ A qualified investor is an individual or entity that meets certain threshold asset and income levels. Given the risks associated with the purchase of private securities (risk of loss and illiquidity of investment), the qualified investor threshold is some assurance that the investor understands the risk and can bear loss of the investment. *Id.* These qualified investors are called “accredited investors.” *Id.* at 160.

³⁵ The clear presumption is that amounts that can be lost are sufficiently small that the Commission need not worry about the fiscal health of the individuals who make purchases under Rule 504.

³⁶ *Id.* at 662.

associated with going public are well in excess of \$1,000,000 for legal and accounting fees alone.³⁷ After the stock is sold to the public, a host of annual and periodic reporting requirements are mandated by the SEC.³⁸ In addition to those requirements, companies must absorb the costs to comply with the enhanced audit requirements of the Sarbanes-Oxley Act passed in the wake of the Enron and WorldCom scandals.³⁹ Nevertheless, the access to broader financial markets and the ability to make the entrepreneur's wealth liquid (by converting that share of the company into more easily marketable securities) outweigh the regulatory costs of going public.

Private sector sources are the primary avenue by which small businesses obtain capital. However, many worthy small businesses may be turned away from normal commercial markets for capital, especially at the start-up phase due to the firm's or owner's lack of a track record. For these gaps in the market, the federal government offers programs to boost private sector provision of capital to small businesses.

III. SBA Capital Access Programs

There are three primary capital access programs overseen by the SBA. All involve a public-private partnership in which private sources offer capital to small businesses in return for a government guarantee of some portion of the funds provided to the small business. These programs are: the 7(a) guaranteed loan program ("7(a) Loan Program"); the Certified Development Company Program ("CDC Program");⁴⁰ and the Small Business Investment Company Program ("SBIC Program"). The first two programs enhance small business access to credit while the latter provides additional opportunities for such concerns to obtain equity capital.

A. The 7(a) Loan Program

The 7(a) Loan Program (named after § 7(a) of the Small Business Act, 15 U.S.C. § 636(a)) serves as the SBA's primary business loan program to assist small businesses obtain financing when they may not be able to obtain sufficient credit from normal lending channels.⁴¹ Loans are not made directly by the SBA; rather the SBA issues guarantees of repayment of loans made by commercial lenders. The size of the guarantee is related to the size of the loan with guarantees of 85 percent for smaller loans (those under \$150,000) and 75 percent for loans in excess of \$150,000. Maximum loan size used to be set at \$2 million dollars with interest rates depending on the size of the loan with the largest loans having the lowest interest rates (usually 2.25 or 2.75 percent above prime depending on the maturity date of the loan).

³⁷ *Id.* at 663. This excludes fees charged by the investment banks that underwrite the public offering.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ This program is colloquially and incorrectly referred to as the "504 Loan Program" for § 504 of the Small Business Investment Act of 1958. However, that section does not describe what CDCs do but rather the authority of the SBA to securitize and sell on the public markets bonds issued by CDCs. This memorandum will not adopt the incorrect colloquial reference.

⁴¹ K. MARKS, L. ROBBINS, G. FERNANDEZ & J. FUNKHOUSER, *THE HANDBOOK OF FINANCING GROWTH* 146 (2005).

The SBA is authorized to charge an up-front guarantee which will vary depending on the size of the loan with a maximum cap of 3.75 percent of the amount guaranteed. 15 U.S.C. § 636(a)(18(A)). In addition to this up-front guarantee fee, there also is an ongoing guarantee paid by the lender to the SBA and amounts to 0.55 percent of the unpaid balance of the guaranteed portion of the loan. *Id.* at § 636(a)(23).

Any lender is eligible, after receiving approval from the Administrator, to originate loans for which the SBA will issue a guarantee. A subset of these lenders, denoted “preferred lenders,” has substantial expertise with the SBA lending programs and regulations. Preferred lenders are authorized to approve loans using documentation and loan forms developed by the SBA to issue guarantees without first submitting the loan packages to the agency for approval.

In addition, preferred lenders may utilize the Express Loan program, *id.* at § 636(a)(31), in which the preferred lender may use their own forms and documentation but only will be eligible for a 50 percent guarantee of loans up to \$350,000 from the SBA rather than the normal 75 or 85 percent. Even though the guarantee percentage of a loan is lower, the government runs a substantial risk from the Express Loan program because the quality of loan documentation is not as substantial as in the normal 7(a) loan program.

B. The CDC Program

The CDC Program provides long-term fixed-rate financing to small businesses to acquire real estate or machinery or equipment for expansion or modernization as long as the loans⁴² meet certain policy and job creation standards. The program was created by Congress in Title V of the Small Business Investment Act of 1958, 15 U.S.C. §§ 695-97g. In this loan program, the small business contributes 10 percent of the value of the project, a commercial bank contributes 50 percent (colloquially referred to as the “first-lien lender”),⁴³ and a certified development company or CDC contributes 40 percent through the issuance of a debenture whose repayment is guaranteed by the federal government. The maximum size of the debenture that can be issued by a CDC will vary depending upon the purpose of the project and the type of borrower,⁴⁴ one general statement is that CDC lending can finance significantly larger projects than those available under the 7(a) loan program. Interest rates on CDC debentures are pegged to an increment above the interest rate for 5- and 10-year Treasury notes. As with 7(a) loans,

⁴² K. MARKS, L. ROBBINS, G. FERNANDEZ & J. FUNKHOUSER, *THE HANDBOOK OF FINANCING GROWTH* 147 (2005).

⁴³ If the borrower fails to pay and there is a bankruptcy proceeding, the commercial bank lender will be paid back before the federal government. The bank then is considered to hold a first lien on the property.

⁴⁴ The sizes of the debentures are \$1.5 million if the project does not meet certain statutory goals, \$2 million if it meets certain goals, and \$4 million dollars for loans to small manufacturers. The Small Business Jobs Act of 2010 raised these limits to \$5 million for most projects and \$5.5 million for certain projects of small manufacturers. Thus, for a project with a \$2 million dollar debenture, the project size is actually \$5 million (\$2 million debenture, \$2.5 million from a commercial bank lender, and \$500,000 from the borrower).

there is a fee structure but it is a somewhat more complicated calculation of various fees paid by borrowers, first lien lenders, and the CDC. 15 U.S.C. § 697(b)(7), (d).

Historically, CDC loans could not be used for purposes of refinancing existing debt.⁴⁵ The rationale behind the prohibition was that refinancing, while potentially beneficial to the business to reduce debt, was not a key component of economic development that led Congress to create the CDC program.

Unlike the 7(a) loan program, the vast majority of loan packages in the CDC must be approved by the SBA. Of the approximately 270 authorized CDCs in the United States, only a handful are designated as “Premier Certified Lenders” or PCLs which are entitled to approve loan packages without first submitting the loans to the SBA.⁴⁶ These PCLs also have the authority to liquidate (just as preferred lenders do in the 7(a) loan program) loans that go into default without the assistance or approval of the SBA.

C. SBIC Program

Small business investment companies (SBICs) are for-profit enterprises organized under state law as either a corporation or partnership or a variant thereof. SBICs receive a license to operate from the SBA pursuant to authority in Title III of the Small Business Investment Act of 1958. The SBA may not grant a license until it is satisfied that the licensee has: a) sufficient capital to operate soundly and profitably; and b) has qualified management. 15 U.S.C. § 681(c)(3)(A). If the SBA is satisfied with these aforementioned determinations, then the agency, prior to issuing a license, must consider whether: a) there is a need for investment in the area in which the applicant will operate; b) the reputation of the owners of the applicant; and c) the prospect that the ownership will manage the business in a profitable manner. Once the SBA is satisfied, it will then issue a license. Thus, the licensing process requires the SBA to consider the business plan of the SBIC before issuing a license. *See* 13 C.F.R. § 107.130.

The SBA licenses two types of SBICs – debenture SBICs and participating security SBICs. The primary difference between debenture SBICs and participating security SBICs is in how the entities repay the federal government for their leverage. The divergent repayment schedules lead the SBICs to invest at different stages of a company’s development. The basic philosophy of the debenture SBIC is to invest in companies in which the return on the investment will be split between an increase in the value of the company and monetary payments back to the SBIC. In contradistinction,

⁴⁵ For businesses seeking to refinance existing debt, they would have to utilize the 7(a) loan program.

⁴⁶ The primary rationale for the establishment of PCLs no longer exists. Historically, it took the SBA up to 3 months of review at a SBA district office to approve a CDC loan package. PCLs avoided these delays because they could approve loans without SBA review of each individual loan. However, the cost of this authority was a requirement that the PCL maintain larger loan loss reserves than other CDCs. The SBA, after intercession and complaints by the Committee on Small Business in 2003-04, centralized review of CDC loans in its Citrus Heights, CA loan processing facility. The time frame for processing such loans has now dropped to anywhere from 2 to 5 business days. Without significant delay and no requirement for additional loan loss reserves, very few CDCs have sought the authority to be a PCL.

participating security SBICs receive the bulk of their investment payback in the growth of the value of the companies in which they invest.

Once licensed, the SBIC is able to draw leverage in tiers. For every dollar of private investment, an SBIC is entitled to draw up to three dollars in government funding (but is not required to draw that maximum amount). The leverage derives from securities that are sold in the private market (essentially a loan by private investors to the SBIC) and the federal government guarantees that the "lenders" to the SBIC are repaid with interest. The SBICs must repay the federal government for the leverage. In essence, there are two separate "loan" transactions; a loan of leverage by the SBA to the SBIC and a loan of private funds by investors to the SBIC who receive either a debenture or participating security (depending on the type of SBIC) for the total value of funds provided by the private investors as "collateral." The SBA guarantees the repayment of the funds provided to the SBIC by the private investors who purchased the leverage. As with the 7(a) and CDC loan programs, there are fees paid upfront by the investment company (a fee up to 3 percent of the value of the leverage to purchase a commitment of leverage), 15 U.S.C. § 683(i), and an ongoing fee for the SBA's guarantee which is paid as additional interest charge on the amount owed to the government by the SBIC for the issuance of the leverage. *Id.* at § 683(b).

The SBA also imposes significant oversight and control on the operations of SBICs primarily through its control on the issuance of leverage. The SBA only will issue leverage (even if the SBIC has purchased a commitment for leverage) when the SBIC demonstrates that it needs the leverage. *Id.* at § 107.1120(a). Nor will the agency issue leverage if it determines that the issuance of the leverage will unduly place the government at risk of loss. *Id.* at § 107.1120(c)(2)(ii). The SBA also conducts examinations of licensees to ensure they are in compliance with all applicable regulations and ensure that they are not placing the government at undue risk. *Id.* at § 107.690. SBICs are limited in the amount of funds that may be invested in anyone company. *Id.* at § 107.740. Finally, the SBA can stop the SBIC from making investments if the investment losses are sufficiently severe to place the company in "capital impairment." *Id.* at § 107.1830-50.

The commercial markets, supplemented by the programs at the SBA, were working reasonably well in providing needed funds to small businesses. This smooth functioning of the credit and equity capital markets would be upended by the financial crisis in the latter half of 2008.

IV. The Financial Crisis⁴⁷

A volatile mix existed in the middle part of the last decade. Low interest rates maintained by the Federal Reserve led American consumers to conclude that consumption was a more logical choice than savings, especially given the low interest available on such savings. But the question became what to consume; the answer, given the low interest rates was real estate. As people purchased homes, the price of real estate began to rise. The boom spilled over to commercial real estate as investors sought gains unavailable in the equities or bond markets. As the value of the real estate increased (at least on paper), Americans and corporations could purchase based not on available cash, but on the value of the real estate they held.⁴⁸

Rather than holding on to loans for real estate and receiving interest payments on the loans, lenders, through investment bankers, could bundle hundreds or thousands of such loans into securities and sell the securities to investors (termed “securitization”). The investors would receive payments based on the payment of interest on loans from the borrowers who purchased the real estate.⁴⁹ In essence, the value of the security was derived from the value not of the security owned by the investor but the value of the loans that made up the security. This was the genesis of the term “derivative.” Using sophisticated mathematical modeling, investment banks developed ever more exotic types of derivatives, primarily credit default swaps, as a way to eliminate the risks associated with failures of the underlying loans in the securitization⁵⁰ while making spectacular profits.⁵¹

The problem with all of this is the fact that the banks that made the loans, the packagers of the securitized loans, and the sellers of the derivatives forgot that the value of all of these things ultimately related back to the underlying loan. And the people who created the derivatives forgot what Professor Robert Shiller so cogently pointed out – what goes up always comes down and vice versa.⁵²

⁴⁷ The literature on the financial crisis is voluminous and growing. Good synopses can be found in R. LOWENSTEIN, *THE END OF WALL STREET* (2010) and C. MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS AND THE GREAT CREDIT CRASH* (2009). Morris’s book also provides an excellent summary of the various exotic financial instruments created by investment banking houses starting in the late 1990s.

⁴⁸ For example, Kmart purchased Sears in 2005 by using the value of Sears real estate to back debt needed for the purchase. See Sandra Jones & David Greising, *Sears Turnaround Plan Short on Detail, Long on Odds*, CHICAGO TRIB., Feb. 3, 2008, available at <http://www.gvvcapital.com/chicagotrib6.html>.

⁴⁹ B. GUP & J. KOLARI, *COMMERCIAL BANKING: THE MANAGEMENT OF RISK* 17-18, 421-22 (2005).

⁵⁰ R. McDONALD, *FUNDAMENTALS OF DERIVATIVES MARKETS* 373-76 (2009).

⁵¹ Until the advent of exotic financial derivatives, the basic thinking in the financial markets was that higher risk led to greater returns. B. JORDAN & T. MILLER, JR., *FUNDAMENTALS OF INVESTMENTS: VALUATION AND MANAGEMENT* 16 (5th ed. 2009).

⁵² R. SHILLER, *IRRATIONAL EXUBERANCE* 142 (2d ed. 2005). In essence, what the investment banking houses forgot (and despite the sophisticated mathematics) was a basic principle of differential calculus – that to determine the slope of a curve, you first need a curve. And once you have a curve, there will be ups and downs in the curve.

That is exactly what happened beginning in 2007 – the price of homes underlying the securities and their mushrooming web of exotic derivatives started going down. In turn, that made payment on the various instruments suspect and, like a house of cards, if you remove one or two cards, the whole house (pun clearly intended) collapses. Another way of looking at it (and one way that Professor Shiller does)⁵³ is to consider the fact that all of this was a naturally occurring Ponzi process in which risk of holding the debt kept being transferred. As long as there was someone to assume the risk, the market had no problem. Once someone rejected the purchasing of the risk, the entire enterprise was likely to collapse. And collapse it did in spectacular fashion.

The first hits were in 2007 when the subprime real estate mortgage lenders began shutting.⁵⁴ Then in March of 2008, Bear Stearns (an investment bank highly leveraged with enormous exposure in securitized real estate loans) was facing imminent collapse but was saved by JP Morgan's purchase of the company at \$2 a share when one week earlier its stock had been trading at \$62.⁵⁵ Resolution of the problems at Bear Stearns only exposed the fact that derivatives created an interconnectedness and interdependence in the financial markets in which the collapse of one firm could trigger a mass collapse of commercial and investment banks.⁵⁶

Those fears were put off for a while, until late summer of 2008 because banks, both commercial and investment, still were able to raise capital.⁵⁷ However, the additional capital raised was being overwhelmed by losses in the loans underpinning the securities and the inability to find purchasers for troubled residential and commercial real estate. In turn, this hampered the ability of firms to obtain needed capital to protect against the losses.⁵⁸ The investment bank with the greatest exposure, Lehman Brothers, filed for bankruptcy, early on September 15, 2008.⁵⁹ That created a chain reaction which affected numerous holders of derivatives (notably the insurer, AIG, that had issued hundreds of billions of dollars of a type of insurance – a credit default swap – for which it did not have the financial resources to pay on the claims of holders), hedge funds, bondholders, and the stock market.

By Wednesday, September 17, the financial sector was in complete freefall; prices for equities were plummeting; institutions and individuals were pulling money out of money market funds; hedge funds were shuttering as investors demanded repayment. In fact, the rush to purchase the debt of the United States was so rampant that investors were willing to take a zero interest rate in return for lending to the United States rather than risk losing their money at financial firms. Normal credit markets for businesses – large and small – essentially froze.⁶⁰ For example, AT&T, the largest telecommunications company in the

⁵³ *See id.* at 78.

⁵⁴ R. LOWENSTEIN, *THE END OF WALL STREET 90-98* (2010).

⁵⁵ *Id.* at 128. The purchase also was supplemented with a Federal Reserve guarantee to absorb any losses on \$29 billion of Bear Stearns' most problematic loans. *Id.*

⁵⁶ *Id.* at 130.

⁵⁷ *Id.* at 132-38.

⁵⁸ *Id.* at 148.

⁵⁹ *Id.* at 202.

⁶⁰ *Id.* at 221-22.

United States, was forced to borrow daily on an overnight basis promising to repay the next day.⁶¹ If AT&T could not borrow funds for any length of time, it was highly improbable that a struggling small business owner could find credit at any price.

Obviously, the situation as existed in the middle of September 2008 could not continue. With access to credit frozen and equity nearly unattainable with the plunging value of the stock market, businesses, particularly small ones, could not operate. Banks were even refusing to make loans to small businesses through the 7(a) Loan Program despite federal guarantees on the lion share of such loans. Wall Street and the Secretary of the Treasury believed that something had to be done. The response that was developed was the Troubled Asset Relief Program or TARP.

V. TARP

The original concept of TARP, as envisioned by then Secretary of the Treasury, Henry Paulson, was to provide government funds to purchase bad assets held by banks.⁶² However, that would not resolve the problem associated with insufficient capital needed for banks to resume lending. Revisions proposed by Secretary Paulson then incorporated the ability to provide capital injections to banks through the purchase of preferred shares.⁶³ Yet, the first attempt at enacting TARP failed and the reaction on Wall Street was swift with the market plummeting 778 points.⁶⁴ By the time the TARP was reconsidered again in the House, the stock market had lost 9 percent of its value and that loss was sufficient to convince the House to pass TARP.⁶⁵

The legislation creating the TARP was titled the Emergency Economic and Stabilization Act (EESA), Pub. L. No. 110-343, 122 Stat. 3765, *codified at* 12 U.S.C. §§ 5201-61, and signed into law by President Bush on October 3, 2008. Within days of that signature, the Secretary of the Treasury, using the authority granted in § 101 of the EESA, created a Capital Purchase Program to buy preferred stock in banks rather than their troubled mortgages or even their securitized derivative instruments. The expectation was that the funds would provide the banks with sufficient capital to recommence lending. Ultimately, the government provided 707 financial institutions with \$205 billion in capital under the Capital Purchase Program portion of TARP.⁶⁶

Despite the provision of capital to banks, credit markets for small businesses remained frozen even for loans backed by the SBA, which were still trading at a premium over debt directly issued by the Treasury. In November of 2008, Treasury decided to use TARP

⁶¹ *Id.* at 222.

⁶² *Id.* at 223.

⁶³ *Id.* at 236.

⁶⁴ *Id.* at 247.

⁶⁵ *Id.* at 255.

⁶⁶ <http://www.treasury.gov/initiatives/financial-stability/investment-programs/cpp/Pages/capitalpurchaseprogram.aspx> A detailed explanation of all aspects of TARP is beyond the scope of this memorandum. The best source of information about the Secretary's utilization of TARP funds can be found in the periodic reports of the Office of the Special Inspector General for the Troubled Asset Relief Program available at www.sig tarp.gov.

funds to provide \$20 billion in credit protection for the Federal Reserve's Term Asset-Backed Lending Facility or TALF.⁶⁷ One of the assets that could be used as collateral for the TALF were loans issued under the 7(a) Loan Program and then securitized. The Department of Treasury used TARP funds to reimburse the Federal Reserve for any losses absorbed by the Federal Reserve associated with the TALF up to a maximum of \$20 billion.⁶⁸ The concept was to generate liquidity in the marketplace for sound assets that simply could not be sold as a result of the non-existent market for asset-backed securities after Fannie Mae and Freddie Mac were placed into conservatorship, Lehman Brothers went bankrupt, and the federal government purchased 80 percent of the stock of AIG.

While the intervention by the Department of the Treasury and the Federal Reserve stabilized the financial system to some extent, the assistance did not help small businesses obtain needed debt or equity funding. The Small Business Committee received testimony in hearings held late in the 110th Congress that revealed small businesses were having difficulty borrowing, including at least one business that had to shut down in December of 2008 as a result of the loss of its credit line and inability to find a substitute lender. Apparently, the TARP had not stimulated lending to small businesses and some thought additional action was required to make credit available to small businesses.

VI. The American Recovery and Reinvestment Act⁶⁹

The authors of the ARRA recognized at least a modest need to provide direct assistance to small businesses through the SBA Capital Access programs. Changes were made to some of the existing programs and a few new lending programs were created.

Most of the changes in the ARRA focused on improving the ability of small businesses to obtain credit. Section 501 provided for reductions in fees for borrowers under the 7(a) Loan and CDC Programs. Section 502 authorized but did not mandate that the SBA could raise the guarantee percentage to 90 percent for all loans. ARRA provided \$375

⁶⁷ <http://www.treasury.gov/initiatives/financial-stability/investment-programs/cbli/Pages/lendinginitiative.aspx> The TALF was a program created by the Federal Reserve to provide loans to institutions that held certain types of asset-backed securities. Essentially, the owner of the asset-backed securities would obtain a loan from the Federal Reserve Bank of New York (FRBNY) for some value less than the total value of the collateral. These would be securitized loans (similar to the securitization of mortgages) for items like automobiles, student loans, or credit card receipts. As has already been demonstrated, the value of the securitized instrument depends on a large measure on the value of the underlying loans. To take account of potential problems, the TALF required some type of "haircut," i.e., if the value of the asset-backed securities was a face value of \$100 million, the holder would get a loan for \$90 million resulting in a "haircut" of ten percent. OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, INITIAL REPORT TO CONGRESS 82-83 (Feb. 2009).

⁶⁸ *Id.* at 83. Since the loans made under the TALF were non-recourse, the FRBNY would seize the collateral and dispose of it. However, that might not cover the full value of the loan (even after the "haircut" absorbed by the borrower). Treasury used TARP funds to reimburse the Federal Reserve.

⁶⁹ Pub. L. No. 111-5, 123 Stat. 115 (2009) ("ARRA").

million to fund these fee reductions and increases in the guarantee percentage.⁷⁰ The CDC Program was bolstered in § 503 with the temporary creation of a federal guarantee on securitized first lien loans made by banks.⁷¹ The concept was to increase liquidity for holders of these assets similar to the Federal Reserve's effort with the TALF. Additional support for secondary market liquidity was provided in § 509 through a loan guarantee program to key broker-dealers involved in securitizing and reselling pools of 7(a) loans. Section 504 of ARRA modified the longstanding prohibition against the use of CDC loan proceeds to refinance debt if the CDC used the proceeds to pay off existing debt and then expand the business.⁷² Section 506 established a business stabilization program (later renamed as "ARC Loans") that authorized the SBA to give loans of less than \$35,000 to businesses needing a small amount of money to cover expenses while the businesses recovered from the economic dislocations associated with the financial crisis. Interest on loans would be forgiven, i.e., essentially the loans were zero-interest loans. The ARRA provided \$265 million for the cost of the program.

Although the primary focus of the small business provisions in the ARRA (like the TARP) was to stimulate the credit markets, Congress recognized that small businesses were also facing difficulty in accessing equity markets.⁷³ Given this, the ARRA also made modest but important changes to the SBIC program in an effort to stimulate equity investment in small businesses. Section 505 increased the maximum amount of leverage available for a SBIC to obtain to \$150 million for a single SBIC or \$225 million for multiple SBICs if they are commonly controlled by the same licensee or group of licensees. Those limits could go up to \$175 million and \$250 million respectively if the SBIC or commonly controlled SBICs invested at least 50 percent of their funds in small businesses located in low-income geographic areas. Given the difficulty that smaller enterprises have in finding equity, § 505 also required licensees to devote at least 25 percent of their capital to these smaller enterprises.⁷⁴

⁷⁰ Without an appropriation, the lending programs would not have taken in sufficient funds to cover the cost of the program as required by the Federal Credit Reform Act.

⁷¹ As already described, the CDC program requires a commercial lender to provide a first lien (or mortgage) loan on the project for 50 percent of the cost. Like all loans, these first liens can be securitized but did not have a federal guarantee.

⁷² Typically, debt refinancing occurs simply to reduce the debt payments of the business. Given the underlying premise of the CDC Program, the ARRA required some type of economic development associated with refinancing.

⁷³ Two primary problems were occurring in the equity markets. Given the overall volatility downward of the stock market during the latter half of 2008 and first half of 2009, companies would not want to go public only to see their share prices plummet as they were caught up in forces unrelated to the fundamentals of the newly public company. In addition, the ability to find equity capital was constrained by investors seeking the safety of federal government debt or having the inability to withdraw funds from illiquid investments be they commercial real estate, hedge funds, or private equity firms. For example, many wealthy investors were caught with the inability to access capital when the auction rate securities market completely collapsed. See Daisy Maxey, *Still Frozen after all These Years*, WALL ST. J., Oct. 30, 2010, available at <http://online.wsj.com/article/SB10001424052702304879604575582272276490314.html>.

⁷⁴ Smaller enterprises, generally start-ups, are much more reliant on credit for reasons already identified in elsewhere in this memorandum. The provision on smaller enterprises was an effort to use SBICs and the leverage they receive from the government to invest more heavily in newer businesses.

After the changes made by the EESA through the TARP and the ARRA through SBA capital access programs, debt financing and equity capital remained a significant constraint for small businesses. In the early part of the 111th Congress, the Committee on Small Business held a number of hearings (one jointly with the Committee on Financial Services) in which businesses reiterated their inability to access the credit markets. Statistics supported the anecdotal evidence provided by witnesses. Lending guarantees issued by the SBA during 2009 were down significantly (about 43 percent overall) from 2008 and 2007 numbers (although the SBA lending was up in 2009 in comparison to the last quarter of 2008). Additionally, the Treasury Department data showed that the 22 largest recipients of federal financial aid under the TARP reduced their overall small business lending by 4.5 percent during the seven months from February 2009 to November 2009.⁷⁵ The data probably overstated their willingness to lend since almost all of these institutions were preferred SBA lenders that could issue loans with a 90 percent guarantee. These conclusions were buttressed by the Federal Deposit Insurance Corporation's (FDIC) finding in early 2010 that commercial and industrial loans were 17 percent lower than in the first quarter of 2009.⁷⁶

VII. The Small Business Jobs Act of 2010

Given the lackluster results of the TARP and ARRA provisions in opening up the credit markets, the Administration and Congress sought other vehicles to boost small business access to capital and credit. Those efforts came to fruition in the Small Business Jobs Act of 2010.⁷⁷ That Act had three primary small business financing components: a) additional modifications to the SBA capital access programs; b) a State Small Business Credit Initiative ("SSBCI"); and c) creation of the Small Business Lending Fund ("SBLF").

A. SBA Capital Access Programs

Title I supplemented the changes in the SBA capital access programs by providing additional funds for reducing borrower fees and increasing the guarantee percentages through the end of 2010.⁷⁸ Once those funds ran out at the end of December 2010, the borrower fees in both programs and the guarantee percentages in the 7(a) Loan Program would return to the levels prior to the enactment of ARRA.

In an effort to increase lending, the Act permanently raised the loan limit to \$5 million in the 7(a) Loan Program.⁷⁹ In addition to this permanent change, the Act made a number of temporary enhancements to the 7(a) Loan Program: a) increasing the size of loans

⁷⁵ Andrew Martin, *The Places They Go When Banks Say No*, N.Y. TIMES, Jan. 31, 2010, at Business 5.

⁷⁶ H.R. REP. NO. 111-499, at 16 (2010).

⁷⁷ Pub. L. No. 111-240, 124 Stat. 2504 ("Small Business Jobs Act" or "Act").

⁷⁸ *Id.* at § 1704, 124 Stat. at 2553.

⁷⁹ *Id.* at § 1111, 124 Stat. at 2507-08. The increase to a \$5 million dollar loan size does not mean that the federal government is on the hook for that amount. Given the concomitant return to the normal 75 percent guarantee percentage, the government will only be issuing a guarantee for \$3.75 million of the \$5 million loan.

available under the Express Loan Program to \$1 million;⁸⁰ b) providing a statutory authorization for and extending the operation of the SBA's floor plan pilot program to September 30, 2013;⁸¹ (with loan amounts up to \$5 million and a guarantee percentage of between 60 and 75 percent of amount of credit extended); and c) mandating that the SBA develop an alternative net asset and net income size standard for loans issued under the 7(a) Loan Program;⁸²

Changes also were made to the CDC program. The size of debentures that CDCs may offer was permanently raised to \$5 million or \$5.5 million depending on the purpose of the project.⁸³ Temporary changes to the CDC program made by the Act were: a) extending the secondary market pool guarantee under § 503 of the ARRA until two years after the initial sale of securitized first lien loans is made;⁸⁴ and b) authorizing the use of CDC loans to refinance debt without any regard to whether such debt reductions are associated with job creation.⁸⁵

B. SSBCI

Title III of the Act appropriated \$1.5 billion for the creation of the SSBCI.⁸⁶ Under the program, the Secretary of the Treasury allocates the appropriated funds to states and municipalities that support access to credit by businesses. The allocations are based on the level of unemployment in the state in comparison to all other states, i.e., states with higher unemployment levels get a greater percentage of the \$1.5 billion.⁸⁷ Funds are disbursed in one-third tranches for use by the states and only a limited amount of the funds may be used to cover an individual state's administrative costs.⁸⁸ Within the SSBCI, funds can be used by the states either to continue or create a capital access

⁸⁰ *Id.* at § 1135, 124 Stat. at 2520.

⁸¹ *Id.* at § 1133, 124 Stat. at 2514-15. Using inventory that is sold to consumers as collateral for a loan to enable a business to purchase inventory is a common financing technique used by car, boat, recreational vehicle, furniture, and appliance dealers, among others. This is called floor-plan financing because the businesses are purchasing inventory that will be placed on their showroom floor. Historically, the SBA did not permit the use of loan proceeds to purchase inventory, even if the inventory is used as collateral for the loan. *See* 13 C.F.R. § 120.130(c) (2008). In 2009, the SBA created a pilot program (without Congressional authorization or comment from the public) to permit floor plan financing for products that receive titles from states, such as automobiles, boats, manufactured homes, and motorcycles.

⁸² Under the CDC and SBIC Programs, a business is eligible for a loan if it either meets the size standards set forth in 13 C.F.R. § 121.201 or meets standard based on net worth and net income as delineated in 13 C.F.R. § 121.301(b)-(c). For years, the SBA inexplicably resisted authorizing a financial-based standard for loans under the 7(a) Loan Program.

⁸³ *Id.* at § 1112, 124 Stat. at 2508. As a result of these changes, a small manufacturer can obtain a debenture from a CDC for \$5.5 million. If that is 40 percent of the project cost, then the total project cost, given the 50 percent first lien, 40 percent CDC debenture, and 10 percent borrower contribution, would total \$13.75 million.

⁸⁴ Small Business Jobs Act at § 1119, 124 Stat. at 2510.

⁸⁵ *Id.* at § 1122, 124 Stat. at 2510-12.

⁸⁶ *Id.* at §§ 3001-11, 124 Stat. at 2568-82.

⁸⁷ H.R. REP. NO. 111-499, at 17.

⁸⁸ Small Business Jobs Act § 3003(c), 124 Stat. at 2571-72.

program or provide other support for ensuring small businesses have access to needed credit and capital.⁸⁹

The capital access program is designed to provide portfolio insurance for business loans by establishing a reserve fund at each financial institution making loans to businesses with less than 500 employees and for loans of less than \$5 million. Borrowers and lenders make insurance payments to the reserve fund which is matched by the state payment to the reserve fund. States may use the monies allocated by the Secretary to meet their match.⁹⁰

If a state does not have or wish to start a capital access program, the Act permits the states to use the allocated funds to support other initiatives at boosting lending to small businesses and classified generically as “other credit support programs.” These other credit support programs include: collateral support programs (using funds to augment the collateral offered by the borrower thereby giving banks greater confidence in recouping the full value of the loan); loan participation programs in which state governments and lenders share the risk of the loan; state-sponsored venture capital programs in which states partner with private venture capital firms to fund small businesses; state loan guarantee programs in which states guarantee commercial loans similar to the existing SBA programs, or any other program that the Secretary deems eligible for support.⁹¹ The Secretary may not award funds under these other programs unless the Secretary determines that the funds one dollar in public investment by the state results in an increase in one dollar of privately available credit.⁹² No federal support will be given to these other state credit programs unless: a) they target average borrower size of 500 employees or less (and no support may be provided to businesses in excess of 750 employees); and b) target loans with average value of less than \$5 million (and no loan may exceed \$20 million).⁹³

The Secretary calculated the state allocation for the SSBCI on October 8, 2010.⁹⁴ Notices of intent to file for funds were due by November 26, 2010 and 48 states and 5 territories met that deadline.⁹⁵ The first award was made under the SSBCI was made on January 14,

⁸⁹ DEPARTMENT OF THE TREASURY, GUIDELINES FOR STATE SMALL BUSINESS CREDIT INITIATIVE 1 (April 27, 2011), available at <http://www.treasury.gov/resource-center/sb-programs/Documents/SSBCI%20Policy%20Guidelines.pdf>. (“Treasury SSBCI Guidelines”).

⁹⁰ Small Business Jobs Act § 3005(c), 124 Stat. at 2575; see Treasury SSBCI Guidelines at 1.

⁹¹ *Id.*

⁹² Small Business Jobs Act, § 3006(c)(1), 124 Stat. at 2578.

⁹³ *Id.* at § 3006(c)(4), 124 Stat. at 2578.

⁹⁴ DEPARTMENT OF THE TREASURY, PRESS RELEASE, available at <http://www.treasury.gov/press-center/press-releases/Pages/tg896.aspx>.

⁹⁵ DEPARTMENT OF THE TREASURY, FREQUENTLY ASKED QUESTIONS ON STATE SMALL BUSINESS CREDIT INITIATIVE 3 (May 2011), available at http://www.treasury.gov/resource-center/sb-programs/Documents/SSBCI_FAQs_FINAL_052011.pdf. The only states that did not meet the deadline were North Dakota and Wyoming. A state may file an intent to apply but if the application is not received by June 27, 2011, a municipality located in the state may apply. If no municipality in the state applies, the money is returned to the Treasury. *Id.*

2011 according to a Department of Treasury fact sheet.⁹⁶ As of June 17, 2011, seven states have received a total of \$325 million according to the Department of the Treasury.⁹⁷

C. SBLF

Title IV of the Act⁹⁸ created the SBLF. The concept is similar to the Capital Participation Program established under the TARP (*although no TARP funds*⁹⁹ were used in creating the SBLF). The Secretary of the Treasury is authorized to spend up to \$30 billion to purchase preferred shares of banks or savings and loans with assets (including their parent holding companies) of less than \$10 billion.¹⁰⁰ As with the Capital Participation Program in TARP, the concept is that by bolstering their capital, lenders will be able to make more loans, thereby improving small business access to credit.

Under the SBLF, community banks had until May 16, 2011 to apply for funds. Banks with less than \$1 billion in assets may apply for up to 5 percent of their Tier 1 risk-weighted assets.¹⁰¹ Institutions with more than \$1 billion but less than \$10 billion are authorized to apply for up to 3 percent of the Tier 1 risk-weighted assets.¹⁰² Once the SBLF purchases preferred stock, the dividend rate will vary depending on the amount of increased lending that goes to small businesses according to the following rates: a) less than 2.5 percent, dividend rate is 5 percent; b) between 2.5 percent and 5 percent, dividend rate is 4 percent; c) between 5 percent and 7.5 percent, dividend rate is 3 percent; d) between 7.5 percent and 10 percent, dividend rate is 2 percent; and e) above 10 percent, dividend rate is 1 percent.¹⁰³ Any bank applying must provide a lending plan describing how it will address the credit needs of small businesses that it serves.¹⁰⁴

⁹⁶ <http://www.treasury.gov/resource-center/sb-programs/Documents/SSBCI%20Fact%20Sheet-%20March%202011%20v4.pdf>. Interestingly, the Treasury Department website has no data on the number of award allocations made to date, whether the monies are being used for capital access or other credit support programs, and how many dollars private dollars have been loaned under the program.

⁹⁷ Data on file with the Committee staff.

⁹⁸ Small Business Jobs Act, §§ 4101-13, 124 Stat. at 2582-96.

⁹⁹ *Id.* at § 4111(a), 124 Stat. at 2595. To further ensure that the program does not appear to be a TARP-like bailout of smaller institutions, banks that are on the FDIC problem list are prohibited from receiving SBLF funds. *Id.* at §4103(d)(4), 124 Stat. at 2588.

¹⁰⁰ H.R. REP. NO. 111-499, at 17.

¹⁰¹ Small Business Jobs Act, § 4103(d)(1)(A), 124 Stat. at 2586. Tier 1 Capital is the amount of equity available to cover loan losses. Since loans are considered assets (because they generate income), banks need to have a certain amount of equity to cover such loans. However, not all loans are of equal risk to the bank. For example, if the bank lends money to the federal government, its risk is less than if it lends money to a residential real estate developer in Las Vegas, NV. So banks calculate their assets on a risk-weighted basis. See generally T. KOCH & S. SCOTT MACDONALD, BANK MANAGEMENT 312-24 (6th ed. 2006) (discussing risk-based capital requirements in banking industry). The calculation of risk-weighted assets and capital is beyond the scope of this memorandum.

¹⁰² Small Business Jobs Act, § 4103(d)(1)(B).

¹⁰³ DEPARTMENT OF THE TREASURY, SMALL BUSINESS LENDING FUND : GETTING STARTED GUIDE FOR COMMUNITY BANKS 1 (March 28, 2011), available at <http://www.treasury.gov/resource-center/sb-programs/Documents/SBLF%20Getting%20Started%20Guide.pdf>. There are somewhat different guidelines due to the nature of their corporate structure if the lender is organized under Subchapter S of the Internal Revenue Code or organized as a mutual association (such as a mutual bank or credit union).

The Act does not adopt the definition of “small business” limned in Part I of this memorandum. Instead, the Act defines the term small business lending as:

lending as defined by and reported in an eligible institutions’ quarterly call report, where each loan comprising such lending is one of the following types: (i) Commercial and industrial loans. (ii) Owner-occupied nonfarm, nonresidential real estate loans. (iii) Loans to finance agricultural production and other loans to farmers. (iv) Loans secured by farmland.¹⁰⁵

Given this definition, any loan submitted on a bank’s quarterly call report (submitted to its appropriate banking regulator, such as the Federal Reserve or Office of the Comptroller of the Currency, and the FDIC) made in one of the above categories will qualify as small business lending unless the loan exceeds \$10 million or the borrower had more than \$50 million in revenue.¹⁰⁶ The instructions to fill out the call report data only denotes loans of \$1 million or less as small business loans and makes no other categorization of small business loans.¹⁰⁷ As a result, the data used to measure small business lending in the SBLF covers an entirely different set of small businesses than those that fall within the definition set out in the Small Business Act or used by the SBA.

As of the date of this memorandum, 844 banks have submitted applications seeking a total of \$11.6 billion in capital injections. However, there have been no final agreements signed between Treasury and banks although some are expected within the next 30 days.

Given the size of business, the amount of actually lending that must be increased, and the dividend rate, it remains to be seen whether the SBLF will spur additional lending or simply result in loans to businesses that already would have received them without the injection of capital. Audits from the Treasury Inspector General and Governmental Accountability Office (GAO)¹⁰⁸ are expected to focus on that question.

D. Conclusion

The SSBCI and SBLF are too inchoate at this point to fully assess their operations, i.e., whether they will increase lending and create jobs. Although SBA lending continues to increase as a result of the Small Business Jobs Act, it remains unclear how much of such lending actually resulted in new job creation, particularly with respect to the refinancing of existing debt under the CDC program. Finally, the Act does not address mechanisms to increase small business access to equity capital.

Guidelines on the SBLF for those institutions can be found at <http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx>.

¹⁰⁴ Small Business Jobs Act, § 4103(d)(1)(E), 124 Stat. at 2587.

¹⁰⁵ *Id.* at § 4102(18), 124 Stat. at 2584.

¹⁰⁶ *Id.*

¹⁰⁷ FDIC, SCHEDULE RC-C – LOANS AND LOAN LEASE RECEIVABLES, REPORTING INSTRUCTIONS at RC-C-30 (March 2011).

¹⁰⁸ The Department of the Treasury’s Inspector General is required to conduct a semi-annual audit and the GAO an annual audit of the program. Small Business Jobs Act, § 4107, 124 Stat. at 2593-94.