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# Congress of the United States
## U.S. House of Representatives
## Committee on Small Business

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| To: | Members, House Small Business Committee, Subcommittee on Investigations, Oversight and Regulations |
| From: | Small Business Committee Staff |
| Subject: | Subcommittee Hearing: Small Business Committee Field Hearing in Colorado: Local Perspectives on the State of Small Business Lending |
| Date: | August 22, 2011 |

The Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet for a field hearing titled *Small Business Committee Field Hearing in Colorado: Local Perspectives on the State of Small Business Lending.* The hearing is scheduled to begin at **10:00 A.M. on August 25, 2011, in Greenwood Village City Hall, 6060 S. Quebec Street, Greenwood Village, CO**.

The purpose of the hearing is to review the state of small business lending in Colorado. The hearing will focus on Small Business Administration loan programs and the regulatory impediments to small business lending. Witnesses at the hearing will represent the Small Business Administration, community banks and the local small business community.

**Introduction**

For entrepreneurs looking to start or expand a business, one of the most important things they need is financing. Financing for a business can come in many different forms, the business can be self-funded, funded by friends or family, an equity share in the business can be sold, or the business owner can obtain debt capital from a lending institution, generally a commercial bank. For a business choosing to apply for a loan from a bank, it must be prepared to demonstrate how it will repay the loan. Banks, like other businesses, are established to make a profit, which is done through the business of making loans. The number one reason for failure is making bad loans,[1] so banks must manage a wide range of risks if they want to be successful. A small business seeking financing must prove that the loan will be repaid and be profitable for the bank.

Commercial banks accept deposits and in turn pool that money to make loans. Banks are profitable lending money because their cost of funds is less than the rate they charge to

[1] BENTON E. GUP ET AL., COMMERCIAL BANKING: THE MANAGEMENT OF RISK 18 (2007).

borrowers.[2] Of course, this model works if the loan is repaid. Like a traditional business, banks can borrow money to expand. Banks lend more money than they have capital to cover the losses on a dollar-for-dollar basis. This is called leverage.[3] The higher the leverage, the more money the bank can lend, potentially increasing its profits. If loans are being paid off by borrowers, a highly leveraged institution will have sufficient capital to cover deposits. However, if the loans are not repaid, i.e., going into default, a highly leveraged institution is unlikely to have sufficient capital to cover loan losses, putting the institution at a higher risk of failure. To properly manage leverage ratios, banks must navigate numerous risk factors associated with lending.

**Credit Risk**

Each bank loan is an investment in the soundness of a business proposal. To minimize the risk that a loan will default, banks must analyze business proposals by assessing the creditworthiness of the borrower and how they intend to use the money. This process is known as underwriting. Typically, lenders will assess small businesses on five factors before making a loan (called the five C's): character, capacity, capital, collateral, and conditions.[4] Character generally involves an assessment of the borrower's reputation, honesty, integrity, responsibility, and consistency.[5] Capacity refers to the ability of the business owner to pay back the loan and this generally depends on the cash flow and earnings of the business.[6] 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).[7] A lender is more likely to issue a loan if the collateral can be sold for nearly the amount of the loan.[8] Conditions refer to the overall state of the economy or the state of a particular industry.[9] The more successful a bank is at underwriting, the better chance it has of being profitable since fewer loans will default.

**Compliance Risk**

Another form of risk that banks must manage is compliance risk, or the risk to earnings or capital arising from violations of laws, rules, and regulations.[10] When banks fail, depositors who entrust

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[2] Banks provide other functions from which they can earn money from a variety of sources other than lending such as: cash management for small businesses; fiduciary services to trusts; and fees paid by customers for everything from the use of automated teller machines to overdraft protection from checking accounts. Unless otherwise noted, this memorandum will focus on the bank lending function.

[3] NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, THE FINANANCIAL CRISIS INQUIRY REPORT 60 (2011).

[4] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, 352 (2008).

[5] B. GUP & J. KOLARI, COMMERCIAL BANKING: THE MANAGEMENT OF RISK, 263 (2005).

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

[7] *Id.* at 264.

[8] *Id.*

[9] *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.

[10] BENTON E. GUP ET AL., COMMERCIAL BANKING: THE MANAGEMENT OF RISK 19 (2007).

their savings to a bank lose their money.[11] To minimize bank failure, the government has stepped in to make banking more safe and secure. While government intervention might be justified on public policy grounds,[12] the cost of regulatory compliance and potential limits on business practices must be absorbed by the bank. For instance, laws and regulations that prohibit a certain lending practice or place a cap on the amount a bank can charge for a product or service affect the bank's revenue stream and the bank must find a new way to make money. Also, understanding how to comply with the rules takes time, effort and money. The cost of regulatory compliance is considered part of the overhead expenses that must be recouped through lending.

**Regulation of Banks and the Impact on Lending**

Regulators are responsible for monitoring an institution's compliance with a host of state and federal laws and regulations covering all aspects of the banking business. Accomplishing this mission requires that regulators know the specifics of the bank's operation. To judge the health of a bank, regulators conduct examinations that can occur either on-site or off-site. On-site examinations involve a team of regulators traveling to the bank to examine bank policies and procedures, balance sheets, income statements and loan files to make sure that safeguards are in place. The cost of examinations is paid for by banks on a sliding scale, depending on the type of examination and the time it takes the regulators to conclude their review.[13] Between on-site examinations, regulators may request information from the bank to gain knowledge about the capital available, the loans being made and the money being repaid.[14] As a result of examinations, regulators may take action against a financial institution to make them more secure.

To prevent bank failure, regulators may take several steps. Regulators can require banks to implement policies and procedures to help insure the loans will be repaid or require that there is sufficient collateral for the bank to recover in the event of default. Regulators can also require the bank to increase its capital reserves so they have additional money to cover potential losses. For federally regulated institutions, the general capital reserves are based on international standard developed by the Basel Committee on Banking Supervision, an international committee comprised of 57 countries that develops capital requirements for financial institutions.[15] The

[11] Deposit insurance from the Federal Deposit Insurance Corporation (FDIC) insures that depositors are made whole when a bank fails.
[12] COLO. REV. STAT. § 11-101-102 (2003).
[13] 12 U.S.C. § 1267.
[14] Federal Deposit Insurance Corporation Report of Condition and Income (Call Report) is an example of an off-site examination tool which includes the institution's balance sheet and income statement.
[15] See BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS, (2006), available at http://www.bis.org/publ/bcbs128a.pdf.

general principal of the Basel rules is that capital requirements should be risk-based meaning that the riskier an asset, the more capital a bank must hold against default.[16]

Regulators typically have discretion to determine if the bank is compliant with rules and regulations. Since regulators may second guess bank policies and lending decisions, banks have difficulty anticipating their overhead costs. When regulators force banks to change policies or reclassify loans as requiring additional capital, this affects the profitability of the bank. There are two options for banks to raise capital, they can take on additional investors, or reduce the amount of money at risk through lending. If capital is raised from additional investors,[17] the current investors' share in future profits is diluted. If fewer loans are made, a revenue stream in the bank's business model is diminished and businesses have less access to capital potentially leading to less economic growth.[18]

Banks concerned about regulatory interference and economic conditions generally tighten lending standards so they will not have to retroactively raise capital. When banks tighten lending standards, they require more collateral, demand higher credit scores and are more cautious about other factors linked to repayment. When credit standards are raised, fewer businesses are able to meet the qualifications to secure a loan. This scenario occurred in the aftermath of the 2008 financial crisis. Since that time credit conditions have improved slightly,[19] but small businesses report that they still have trouble gaining access to capital. Further, the Federal Reserve Board's Senior Loan Officer Survey shows that commercial and industrial lending standards since 2007 have tightened and there is overall weaker demand for loans.[20] The Small Business Administration (SBA) Office of the Chief Counsel for 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."[21]

A major overhaul in banking law and regulation was recently made by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[22] This law, written in response to the financial crisis of 2008, provides for a comprehensive reorganization of the regulatory structure

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[16] 12 C.F.R. Part 225 App. A (2011).
[17] Raising money in the capital market can be extremely difficult, particularly during periods of tightened credit due to overall economic conditions.
[18] BENTON E. GUP ET AL., COMMERCIAL BANKING: THE MANAGEMENT OF RISK 16 (2007).
[19] Sundeep Reddy, *Banks Open Loan Spigot Just a Bit,* Wall St. J., Aug. 16, 2011, at A2.
[20] CHAD MOUTRAY ET AL., LINKING FRANCHISE SUCCESS WITH ECONOMIC GROWTH AND NET JOB CREATION 7 (April 2011).
[21] OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, *Small Business Research Summary: Lending by Depository Lenders to Small Businesses 2003 to 2010,* 12 (2011).
[22] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

surrounding the financial services industry.[23] To fully implement the provisions of the Dodd-Frank Act, federal agencies are required to conduct 243 new rulemaking actions.[24] Because of the scope of the revised regulatory structure, both the cost of compliance with the new law and the overall economic impact remain unknown.[25] In general, large banks have an easier time complying with new regulations than do small banks. Large businesses with larger staff can focus on compliance, whereas smaller banks with fewer employees have more difficulty complying with regulations and reporting requirements.[26] With respect to capital levels, Dodd-Frank prohibits federal banking regulators from lowering minimum leverage capital requirements that were in place prior to passage of the Act.[27] For additional capital requirements imposed by regulators, the law sets phase-in periods for smaller financial institutions and requires that a study be done on the impact of the capital requirements on small institution access to capital.[28] One way that a financial institution can lend to small businesses without increasing its capital reserves is through the use of a government guaranteed lending program.

**SBA Loans**

The U. S. Small Business Administration 7(a) loan program is an option for banks wanting to take advantage of a government guarantee. This program guarantees a percentage of a loan from a participating lender in case of default by the borrowers, which are small businesses that cannot obtain credit elsewhere.[29] The public policy goal for risking taxpayer dollars in this way is that the government should aid small businesses in obtaining access long-term capital.[30] 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.[31] Maximum loan size has recently been increased to $5 million.[32]

The 7(a) program benefits both small businesses and banks. Small businesses are able to obtain long-term, fixed-rate financing, while banks have the security of the government guarantee should the borrower not be able to repay the loan. On the regulatory front, since the bank is only

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[23] *The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic: Hearing Before the Subcomm. on Oversight and Investigations of the House Committee on Financial Services*, 112th Cong. (2011) (statement of Douglas W. Elmendorf, Director, Congressional Budget Office).
[24] *The Uncertainty Principle*, WALL ST. J., July 14, 2010 available at http://online.wsj.com/article/SB10001424052748704288204575363162664835780.html.
[25] *One Year Into Dodd-Frank, Uncertainty Reigns*, U.S. Chamber Magazine, June 26, 2011, available at http://www.uschambermagazine.com/article/one-year-into-dodd-frank-still-no-fix-for-financial-ills
[26] According to SBA's Office of Advocacy, in 2008 small businesses faced an annual regulatory cost of $10,585 per employee, which is 36 percent higher than the per employee regulatory cost for larger businesses.
[27] Pub. L. No. 111-203 § 171, 124 Stat. 1376, 1435 (2010).
[28] *Id.* at § 171(b)(6), 124 Stat. at 1437-38.
[29] 15 U.S.C. § 636(a)(1)(A).
[30] 15 U.S.C. § 631.
[31] Pub. L. No. 111-240 § 1111, 124 Stat. 2507 (2010).
[32] This change was made permanent in the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

risking a certain percentage of the loan, they are required to hold less capital in reserves than for a traditional loan. Small business borrowers, on the other hand, are able to receive access to funding that they would not otherwise have access to and more favorable loan terms, including longer repayment terms and fixed interest and fees.

**Hearing Purpose**

From 2003 to 2010, many small banks increased their small business lending despite massive declines in small business lending from their larger counterparts. [33] Because of the importance of small banks as a lender to small business and thus to economic growth, a proper regulatory balance should exist between protecting depositors and protecting a financial institution's ability to lend. Anecdotally, many small business lenders claim that federal regulators have increased the capital requirement imposed on banks.[34]

This hearing will provide attendees the opportunity to hear from the Small Business Administration about the government-backed lending programs available to help small businesses access capital. Small banks will also have the opportunity to explain how regulators have responded to the financial crisis of 2008 and how regulations have affected their small business lending. Finally, a witness representing small businesses will explain how small firms have weathered the financial crisis, including their ability to access capital through bank loans and the factors that would give them the confidence to expand their business or create new jobs.

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[33] Gregory W. Haynes and Victoria Williams, *Lending by Depository Lenders to Small Businesses, 2003 to 2010*, SBA Office of Advocacy, (March 2011).

[34] *Access to Capital: Can Small Business Access the Credit Necessary to Grow and Create Jobs: Hearing Before the House Committee on Small Business*, 112th Cong. (2011) (testimony of Lynn Ozer, Executive Vice President, Susquehanna Bank, Pottstown, PA on behalf of the National Association of Government Guaranteed Lenders).