WHERE ARE WE NOW? EXAMINING THE POST-RECESSION SMALL BUSINESS LENDING ENVIRONMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

OF THE

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CONTENTS

OPENING STATEMENTS

	Page
Hon. Tom Rice	1
Hon. Judy Chu	2

WITNESSES

Ann Marie Wiersch, Policy Analyst, Federal Reserve Bank of Cleveland, Cleveland, OH	4
Jeff Stibel, Chairman and CEO, Dun and Bradstreet Credibility Corp., Malibu, CA	6
Renaud Laplanche, CEO, Lending Club, San Francisco, CA	7
Fred L. Green, III, President and CEO, S.C. Bankers Association, Columbia, SC	9
John Farmakides, President/CEO, Lafayette FCU, Kensington, MD, testifying on behalf of the National Association of Federal Credit Unions	11

APPENDIX

Prepared Statements:	
Ann Marie Wiersch, Policy Analyst, Federal Reserve Bank of Cleveland, Cleveland, OH	27
Jeff Stibel, Chairman and CEO, Dun and Bradstreet Credibility Corp., Malibu, CA	34
Renaud Laplanche, CEO, Lending Club, San Francisco, CA	42
Fred L. Green, III, President and CEO, S.C. Bankers Association, Columbia, SC	45
John Farmakides, President/CEO, Lafayette FCU, Kensington, MD, testifying on behalf of the National Association of Federal Credit Unions	55
Questions for the Record:	
None.	
Answers for the Record:	
None.	
Additional Material for the Record:	
CUNA - Credit Union National Association	67
Lend Academy	72

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THURSDAY, DECEMBER 5, 2013

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:02 a.m., in Room 2360, Rayburn House Office Building, Hon. Tom Rice [chairman of the Subcommittee] presiding.

Present: Representatives Rice, Chabot, Mulvaney, Schweikert, Chu, and Payne.

Chairman RICE. Good morning. The hearing will come to order.

Today we will examine the lending environment for small businesses. Since small businesses create over two-thirds of new jobs, we must make an effort to ensure capital is available for their growth. By comparing pre- and post-recession levels of traditional small business lending, and analyzing the factors affecting these levels, we can gain a better understanding of where we stand and narrow our focus on the policies that will spur economic growth and job creation.

Recent data shows that banks are making more small loans in the past 2 years. Despite this improvement, loan levels are still below where they were before the recession. Economists, bankers, small business owners, and regulators point to different reasons to explain the postrecession drop in small business lending. Some suggest it is reduced demand by small borrowers, while others point to increasing regulatory scrutiny on banks.

In reality, a confluence of forces has led to lower levels of lending. For instance, at the same time banks are being forced by regulators to require more from borrowers in the way of collateral and personal guarantees, home values, a huge source of collateral for borrowers, have dropped. And when the potential borrowers hear that it is hard to obtain bank financing, many do not seek it, thereby decreasing loan demand.

We are fortunate to have with us a group of leaders within the small business financing space, from experts that analyze lending to those that are on the front lines making the loans. We will also hear from a business that offers a new source of financing that is becoming part of the lending environment. I look forward to learn-

ing firsthand what today's witnesses see as the factors shaping the lending landscape.

With that, I would like to thank our distinguished panel of witnesses for being here today, and I now recognize the ranking member for her opening statement.

Ms. CHU. Good morning.

Today's hearing will examine the current state of lending to small businesses. Although in the last 2 years the lending environment has slightly improved, bank loans to small businesses remain below prerecession levels. Multiple factors and economic trends affect small business lending. And today we are going to receive testimony from experts and industry leaders on this very, very important matter.

Evidence suggests that our Nation's economy is slowly but surely on the mend; 7.8 million jobs have been created since the postcrisis low of 2010. The housing and auto industries, which were central to the downturn, have rebounded. The Federal Reserve's monetary policy stance has remained conducive, providing market liquidity and supporting the resurgent stock market. The small business sector is also experiencing an uptick in hiring.

Still, expansion expectations are below the norms seen during the previous economic downturns. For job growth to accelerate and to reach the pace that our economy needs, small businesses must become a bigger part of the equation. In every previous recession, it has been small, nimble firms that have led us back to prosperity by growing quickly and adding new workers.

In order for these firms to play their traditional job-creating role, a number of factors must be in place. Perhaps the most important ingredient is the availability of capital. If, as the saying goes, small businesses are the economy's backbone, then the flow of capital is the lifeblood. Since the great recession, the value of small business loans has remained at less than 80 percent of its pre recession level. The number of loans issued also dropped from over 25 million before the recess to just over 21 million in the second quarter this year.

Although challenges remain, there has been progress. The Thompson Reuters/Pay Net Small Business Lending Index is well off its low, but remains below its highs. This indicates that firms are borrowing again, but are hesitant about the future. Fewer are also falling behind or defaulting on loans, suggesting they are in better shape to take on additional debt, and hopefully expand.

Within this context, it is important to remember that lending through the Small Business Administration is always critical for entrepreneurs seeking affordable capital. However, during periods of economic sluggishness, when credit is tight elsewhere, the SBA's role becomes more important. Last year, the agency made nearly $18 billion in 7(a) loans and made available another $5 billion in financing for projects under the 504 program.

Unfortunately, while this represents a positive trend in the total dollars lent, the number of businesses receiving SBA loans has fallen dramatically. Compared to the agency's high-water mark in 2007 when over 110,000 small businesses received loans through this program, the total number helped has fallen by 51 percent,

meaning that 56,000 fewer small businesses received loan assistance this year.

And understanding what this trend means for entrepreneurs and what is driving it is of great concern to this Subcommittee. All of this is occurring against a regulatory backdrop that is changing. Dodd-Frank resulted in a vast array of new regulations on the financial sector and established several new government entities. These new powers are necessary to address the root causes of the financial crisis, overleverage and deceptive mortgages, to name a few. At the same time, we must be sure our Nation's small banks and credit unions that were not the cause of the downturn are exempted.

While regulations implemented under the act will change many facets of the financial industry, data indicates that the perceived regulatory burden has had no negative effect on small business lending. In fact, a consortium of the Nation's most prolific small business lenders recently announced they made an additional $17 billion in loans in the past 2 years.

At today's hearing, we will take the pulse of the small business lending environment and gain insight about how to expand small businesses' financing options. And as we do so, it is important to remember that what makes sense for one entrepreneur might not work for another, and that there is a broad spectrum of capital options for small firms. Some businesses' needs can be met with conventional loans, and for others a debt-based solution may not make sense at all. Equity investment might make a better fit.

On that note, I would like to thank our witnesses for taking time to be here. Their views and experiences will be very valuable to the Subcommittee as we consider how best to meet small businesses' capital needs.

Thank you, and I yield back.

Chairman RICE. Thank you, Ms. Chu.

Your opening statements will be submitted for the record. If any Committee members have opening statements, theirs will be submitted for the record. I would like to take a moment to explain the timing lights to you. You have lights in front of you. They will start out as green. When they turn yellow, you have 1 minute. When they turn red, your time is up. But within reason, we will give you a certain amount of flexibility to finish your statements.

Our first witness is Ann Marie Wiersch, policy analyst at the Federal Reserve Bank of Cleveland. Ms. Wiersch joined the bank in 1999, and worked in the accounting and financial management departments prior to her transition to a policy role in 2009. She has worked on several Federal Reserve System initiatives, including the projects focused on small business issues and State and local government finance. Ms. Wiersch holds an undergraduate degree in business administration from Bowling Green State University and an MBA from Cleveland State University.

Ms. Wiersch, we look forward to your testimony.

STATEMENTS OF ANN MARIE WIERSCH, POLICY ANALYST, FEDERAL RESERVE BANK OF CLEVELAND, CLEVELAND, OH; JEFF STIBEL, CHAIRMAN AND CEO, DUN AND BRADSTREET CREDIBILITY CORP., MALIBU, CA; RENAUD LAPLANCHE, CEO, LENDING CLUB, SAN FRANCISCO, CA; FRED L. GREEN, III, PRESIDENT AND CEO, S.C. BANKERS ASSOCIATION, COLUMBIA, SC; AND JOHN FARMAKIDES, VICE PRESIDENT OF LEGISLATIVE AFFAIRS, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS, ARLINGTON, VA

STATEMENT OF ANN MARIE WIERSCH

Ms. WIERSCH. Chairman Rice, Ranking Member Chu, and distinguished members of the Subcommittee, it is an honor to testify before you today on the state of small business lending. My statement will focus on the decline in lending to small businesses and the factors that are driving that decline. My remarks represent my own views and are not official views of the Federal Reserve Bank of Cleveland, or any other element of the Federal Reserve System.

Recent industry and media reports provide a mix of perspectives on the state of small business lending. Contradictory messages abound and often result from inconsistent definitions of what constitutes a small business and from the absence of comprehensive and reliable data on small business lending.

Banks and government agencies use a wide range of parameters to classify firms as small businesses. One frequently cited definition is so expansive that it includes more than 99 percent of businesses in the U.S. It should not come as a surprise then that we hear so many differing reports about small business conditions when firms of so many different sizes and industries are analyzed together. In addition, the considerable lack of data on small business lending and the variance in the size of firms and loans included leads to inconsistency in reporting among the data that are available.

Nonetheless, we do know that bank lending to small businesses declined since the onset of the great recession. According to FDIC data, the current value of small loans outstanding is about 78 percent of its prerecession level in inflation-adjusted terms. Recent analysis by the Federal Reserve Bank of Cleveland concludes that there are a number of factors driving this trend. Fewer small businesses are interested in borrowing than in past years. And at the same time, small business financials and collateral values remain weak, depressing loan approval rates. Furthermore, increased scrutiny from regulators led some banks to boost their lending standards, resulting in a smaller fraction of creditworthy borrowers.

Finally, shifts within the banking industry have reduced the number of banks focused on the small business sector. Small business lending has become relatively less profitable than other types of lending, dampening some bankers' interest in this market.

Small businesses were hit hard by the economic downturn, and weak earnings and sales mean that fewer businesses are looking to expand. Surveys show that since 2007, fewer businesses plan to seek credit, increase capital investment, and hire additional workers.

Some of the subdued demand for loans may stem from perceptions that credit is not readily available. According to recent surveys, more business owners think that credit has become harder to get and will remain so.

The supply of credit has also declined as lenders are approving fewer small business loan applications, with many firms lacking the cash flow, credit scores, and collateral that banks require. More lending is secured by collateral now than before the recession, and the decline in value of both commercial and residential properties has made it difficult for businesses to meet collateral requirements.

At the same time, bankers have increased their credit standards, meaning that fewer small businesses qualify for loans than before the economic downturn. Banks tightened lending standards significantly during the recession, and while standards have eased somewhat in recent quarters, data show they remain stricter for small businesses than for large firms.

Furthermore, there is evidence that heightened scrutiny by regulators factored into banks' decisions to tighten standards. The research shows that elevated levels of supervisory stringency have a material impact on total loans and loan capacity.

The decline in lending also reflects longer term trends. Banks have been exiting the small business loan market for over a decade, leading to a reduction in the share of small business loans in banks' portfolios. The FDIC reports that the fraction of nonfarm, nonresidential loans of less than a million dollars has declined steadily since 1998, dropping from 51 to 29 percent.

Consolidation of the banking industry has reduced the number of small banks, which are more likely to lend to small businesses. Moreover, increased competition in the banking sector has led some bankers to seek bigger, more profitable loans. The result has been a decline in small business loans, which are less profitable, because they are banker time intensive, are more difficult to automate and securitize, and have higher costs to underwrite and service.

While the decline in small business credit since the great recession is evident, the causes of the decline are less clear. A careful analysis of various data sources suggests that a multitude of factors explain the reduction in credit. The supply and demand forces unleashed by the financial crisis added to longer term trends, as some banks had already been shifting away from the small business credit market.

The confluence of factors makes it unlikely that small business credit will spontaneously increase any time soon. Given the contribution that small businesses make to employment and economic activity, policymakers may be inclined to intervene to promote greater access to credit for small business owners. When considering means of intervention, however it is important to be cognizant that multiple factors are affecting credit demand and supply. Any proposed solution should consider the combined effect of all the factors involved.

This concludes my prepared remarks, and I look forward to your questions.

Chairman RICE. Thank you, ma'am.

Our next witness is Jeff Stibel, chairman, chief executive officer, and president of Dun & Bradstreet Credibility Corporation. Mr.

Stibel was previously president and CEO of Web.com, Inc., and currently sits on the boards of numerous private and public companies, as well as academic boards of Tufts University and Brown University. He is the author of academic and business articles, the book "Wired for Thought," and is the named inventor of the U.S. patent for search engine interfaces. Additionally, he was the recipient of the Brain and Behavior Fellowship while studying for his Ph.D. at Brown University.

Mr. Stibel, we look forward to your testimony.

STATEMENT OF JEFF STIBEL

Mr. STIBEL. Thank you, Chairman Rice, Ranking Member Chu, the Committee, and its wonderful staff for having me here today to discuss what I believe is one of the most important topics in regards to the economy today.

As you mentioned, Chairman Rice, I am the CEO of Dun & Bradstreet Credibility Corp. We are one of the largest business credit monitoring companies in the United States. So I believe I have a unique perspective into the topic of small business lending. My written testimony is full of statistics that demonstrate in short that small businesses today are finally doing well again. Yet despite that fact, they are not adding jobs.

The reason is because they need access to capital to grow their businesses, yet they are not able to secure sufficient loans. It is a small business paradox, one in which small businesses are growing revenues but not payroll, and that is hurting our economy and society as a whole. What we are seeing, in effect, is the smaller the business, the greater the revenue growth. And we are seeing this throughout this year.

This is a good thing. It also means that the smaller the business, the greater the productivity as measured in terms of revenue output per employee. However, what we are not seeing is that the smaller businesses are adding jobs. And it is the jobs that really drive our economy forward in the long run.

Rather than regurgitate these statistics, I would like to tell a story about a small business owner that I met only a few days ago. I believe his story, better than any statistics, will encapsulate the problems that we are facing.

I met Mike Banfield on Monday of this week. He founded SpringStar in 1998 in Seattle, Washington, to offer organic pest control products. It was a huge success story almost right from the beginning. He grew revenues, he grew employees. He eventually got a bank loan, and that fueled his growth even further. Throughout the recession, Mike's business actually thrived, and he continued to grow.

However, as we have all seen, banks didn't fare as well. So the bank ended up calling his loan. Despite the fact that this was an SBA-backed loan, Mike had to give a personal guarantee because that is still required. And when he pulled that loan, Mike's successful business went under, and he almost went bankrupt himself, ruining his family.

The good news is that Mike is an entrepreneur and he persevered and he ended up finding an alternative source of capital,

rebuilt his business, was able to grow that business. And that business is now thriving today, with record revenues.

However, he hasn't added any jobs. To add jobs, he needs greater access to capital. The problem is that Mike has been trying for years and can't get a bank loan. Now, he is just plain discouraged. He needs a loan, but no longer wants a loan.

A little known fact in business is that jobs are added for future growth, not current demand. For current demand, people in business just work harder. Job growth is an investment, just like computers, equipment, tools, manufacturing. Investments require capital, but many companies like Mike's aren't willing or able to secure loans anymore. And the stats are, frankly, alarming. The smallest businesses have less access to capital, and the smallest business owners have less desire for that capital.

We have a small business paradox, and there is an even greater need than there ever has before. This personally is a painful story to hear as a business person. A company poised for success that just needs access to capital. I suspect it is a painful story to hear for government. A company poised to impact the economy and society, but can't unless it gets access to capital.

But most of all, this is a painful story to hear for the unemployed. We have people who desire to contribute to society, who see a desperate need from a company, but a need and desire that cannot be fulfilled without access to capital. I believe that is why we are all here today. And working together, business, banks, and the government, we can all work to make a difference. So thank you.

Chairman RICE. Thank you, Mr. Stibel.

Our next witness is Renaud Laplanche, founder and CEO of Lending Club. Prior to starting Lending Club in 2006 Mr. Laplanche was the founder and CEO of TripleHop Technologies, an enterprise software company eventually acquired by Oracle. He was named the 2013 Ernst & Young entrepreneur of the year award winner for northern California and 2012 entrepreneur of the year at the BFM awards. Mr. Laplanche has a master's of business administration from HEC and London Business School, and a J.D. from Montpelier University, and is a frequent guest lecturer at Columbia Business School.

Mr. Laplanche, we look forward to your testimony.

STATEMENT OF RENAUD LAPLANCHE

Mr. LAPLANCHE. Thank you. Good morning. Thank you for having me. My name is Renaud Laplanche, and I am the founder and CEO of Lending Club, a credit platform that employs over 300 people in San Francisco and has facilitated over $2 billion in consumer loans this year, funded by both individual and institutional investors. And we will be launching a dedicated small business lending platform in the next quarter.

My father was a small business owner. He owned a grocery store in a small town in France. And I spent every day of my teenage years, from 5 to 8 in the morning before class, helping him in the store.

After having started two companies in New York and San Francisco, residing in the U.S. for over 14 years, and starting a family here, I recently passed my citizenship test and will soon be a U.S.

citizen. Testifying before this Committee on the state of small business lending in America is a very special moment for me.

Small businesses are not only a driving force in the U.S. economy, they are an essential part of the American dream. I believe it is our shared responsibility to ensure that these businesses and their owners have sufficient access to capital on fair terms.

I have two points I hope to convey to you today. First, small businesses have insufficient access to credit, and the situation is not getting any better. Second, their credit performance as a group suggests that they should be getting more credit.

A survey released by the Federal Reserve Bank of New York in August of this year was the latest to paint a grim picture of availability of credit to small businesses. Access to capital was reported as by far the biggest barrier to growth. Out of every 100 small businesses, 70 wanted financing. Of those 70, 29 were too discouraged to even apply. Of the 41 that did apply for credit, only 5 received the amount they wanted. Substantially, all of these businesses were looking for $1 million or less in capital.

The situation has not gotten any better lately. While the overall volume of loans of more than a million dollars has risen slightly since 2008, loans of less than 1 million have fallen by 19 percent. The number of small businesses with a business loan fell by 33 percent from 2008 to 2011.

The problem is worse for the smallest businesses. While businesses with 20-plus employees reported an increase in bank loans from 2009 to 2011, the majority of small businesses, which have fewer than 20 employees, reported a decline, with the smallest businesses suffering the steepest decline. Businesses with two to four employees reported a 46 percent reduction in bank loans over that same period.

While traditional sources of capital have pulled back, alternatives are on the rise. Alternative lenders, such as online lenders and merchant cash advance providers, are the fastest growing segment of the SMB loan market, reporting a 64 percent growth in originations over the last 4 years. Many of these alternative lenders, however, charge fees and rates that result in annual percentage rates generally in excess of 40 percent. And without always full transparency, business owners don't always understand the true cost of these loans. This lack of understanding can be very harmful to small businesses, which could find themselves in a spiral of inescapable debt service.

Small business credit performance and loan performance, however, is doing just fine. Charge-off rates on small business loans have been below 1 percent since March 2012, down from a peak of nearly 3 percent in 2009. In contrast, charge-off rates on consumer credit cards peaked above 10 percent in the financial crisis. These figures show that absolute loan performance is not the main issue of declining SMB loan issuance. We believe a larger part of the issue lies in high underwriting costs and generally high operating costs for the lenders.

SMBs are a very heterogeneous group, and therefore the underwriting and processing of these loans is not as cost efficient as underwriting consumers, a more homogenous group. Business loan underwriting requires an understanding of the business plan and

financials and interviews with management that result in higher underwriting costs, which make smaller loans, under $1 million, and especially under $250,000, less attractive to lenders. By contrast, larger loans, going mostly to larger businesses, are more attractive, as they allow for underwriting costs to be amortized over a larger amount and longer loan period.

We believe we have solutions to bring underwriting costs down and create the conditions for credit to become more available and more affordable to small businesses in America, and we would be honored to answer the Subcommittee questions in that regard.

Chairman RICE. Thank you, Mr. Laplanche.

Our next witness is Fred Green, III, president and CEO of the South Carolina Bankers Association, based in Columbia, South Carolina. Prior to his current position, Mr. Green served as president and COO of Sunovis Financial Corp, a five-State bank holding company, and before this as president, CEO, and chairman of the National Bank of South Carolina. Mr. Green also previously served on the board of the Fifth District Federal Reserve Bank, based in Richmond, Virginia, and on the Federal Advisory Council for both the Fifth and Sixth Districts. He received his B.S. and MBA from the University of South Carolina. Go Gamecocks.

Mr. Green, we look forward to your testimony.

STATEMENT OF FRED L. GREEN, III

Mr. GREEN. Good morning. Chairman Rice, Ranking Member Chu, members of the Committee, my name is Fred Green. I am the president and CEO of the South Carolina Bankers Association. We are the professional trade association that has represented South Carolina banks for over 110 years. Our members are both large and small banks, and collectively they hold about 99 percent of the deposit market share in our State. I have been a banker for 34 years, mostly in leadership roles in commercial banks, and for the last 2 years I have headed up our State association.

This morning I am pleased to share the banking industry's perspective on the state of the small business lending environment. You all know how important small business is to the national economy. Small businesses account for over half the jobs in the U.S., and as much as 65 percent of new jobs created over the last 15 years.

Banks are the primary lenders to small businesses, and their presence in local communities throughout our Nation is critical to meeting the unique needs of new and developing companies. There is a symbiotic relationship between the health of a community and the health of the banks that are located and operate there. This is why small business lending is an important part of every bank strategy and why banks today provide more than 21 million small business loans.

Loan demand has improved since the recession. However, it remains at relatively weak levels, held back, I think, and we all think, by uncertainty about the future. Concerns over changes to taxes, employment costs, and regulation make small business owners less interested in expanding and incurring new debt to fund that expansion. Another point that reinforces the lower demand is the utilization of borrowings under existing committed lines is at

a relatively low level at 50 percent. These are loans that have already been committed, the borrower can draw down to expand, but have only drawn up to 50 percent.

Despite the low loan demand, banks continue to meet the needs of their customers. In every community, banks are actively lending and continually looking for lending opportunities. After declines in the loan portfolios since prerecession peaks, recent FDIC data shows that outstanding loans have been growing over the last 12 months.

Banks face challenges in providing loans to meet their customers' needs with the most recent wave of regulations as well. The cumulative impact of hundreds of new or revised regulations may be a weight too great for many small banks to bear. Congress must be vigilant in its oversight in implementing the Dodd-Frank Act to ensure that rules are adopted only if they result in a benefit that clearly outweighs the burden. Some rules under Dodd-Frank, if done improperly, will literally drive some banks out of business.

In South Carolina, we recognize this growing concern, and recently held a special conference of our top bank executives to address significantly stricter mortgage regulations and capital standards that will be implemented next year. Some community banks have already told us that they will have to stop offering certain products, like residential mortgages, because of the new lending regulations.

For many, these community banks are the only option in their community, the only source of lending of this type in their community. In fact, community banks are the only physical banking presence in one-fifth of the counties in the United States. And more regulation means more resources devoted to regulatory compliance, and this means fewer resources can be dedicated to doing what banks do best, and that is meeting the credit needs of the local communities, the businesses, and the residents that are there.

Banks are eager to serve the financing needs of small businesses. They understand that they play a critical role in their local economies, and no bank has or wants to stop pursuing small business lending. Yet small businesses remain hesitant to expand due to the economic uncertainty. This does not mean that banks are not making loans. Our economy is growing, although slowly, and banks are addressing the financing needs that exist today.

Healthy, properly financed small businesses are absolutely critical to our communities' economies. Banks understand their role in this and continue to make loans to every creditworthy borrower they can, despite an increasingly difficult lending environment.

Thank you again for the opportunity to testify.

Chairman RICE. Thank you, Mr. Green.

I would now yield to Ms. Chu, who will introduce our final witness.

Ms. CHU. I have the pleasure of introducing B. John Farmakides, president and CEO of Lafayette Federal Credit Union. Mr. Farmakides is the president and CEO of this credit union. He has been an active member of this particular credit union community since 1994 and was named president and CEO in 2007. Prior to that, he worked in investment banking, commercial real estate, and for the Federal Government.

Currently, Mr. Farmakides holds positions on many professional boards and serves on the regulatory committee of the National Association of Federal Credit Unions. Mr. Farmakides received his BBA and MBA degrees from James Madison University and a law degree from the American University.

Welcome, Mr. Farmakides.

STATEMENT OF JOHN FARMAKIDES

Mr. FARMAKIDES. Thank you. Good morning Chairman Rice, Ranking Member Chu, and members of the Subcommittee. My name is John Farmakides, and I am testifying today on behalf of the National Association of Federal Credit Unions. I serve as president and CEO of Lafayette Federal Credit Union, headquartered in Kensington, Maryland.

NAFCU and the entire credit union community appreciate the opportunity to discuss the small business lending environment. Credit unions serve over 97 million people from all walks of life, and we are eager to provide our members the best lending opportunities, while helping to spur job creation.

Despite regulatory and statutory obstacles to credit union business lending, a November 2013 survey of NAFCU members found that credit union member business lending is growing over the next 12 months. On a scale that goes from negative 100 to positive 100, where zero indicates flat growth, the median growth expectation for credit unions was 35.6.

Still, credit unions are hampered in their ability to help small businesses by an arbitrary and outdated member business lending cap that hasn't been adjusted in over 15 years. Credit union member business lending is limited to 12.25 percent of total assets, with member business loans over $50,000 counting against the cap. This is counterproductive as the country continues to recover from the financial crisis.

At Lafayette, we have seen increased demand from our members to access business lines of credit, to help meet day-to-day cash flow shortfalls, and manage the needs of their businesses. I have example after example of ways we have been able to help, such as a $125,000 line of credit we extended to a local bike rental and touring company to help manage the cyclical nature of their business.

Unfortunately, any line of credit above the $50,000 threshold counts towards the cap, even if the funds are not actually extended. Consequently, Lafayette is forced to pick and choose which business loans will be funded even though all are creditworthy. Businesses often turn to us when they have denied lines of credit from other lenders. So if we can't extend the line of credit, it is not likely to happen anywhere else.

I am very proud of my staff and the level of expertise we have in member business lending. Just in the last year, we have been able to assist very small traditional companies, such as a specialty bakery with a single owner. At the same time, we have made loans to several consulting firms related to government contracting, in addition to a trucking delivery service, as well as an innovative solar energy appliance company.

We urge members of the Subcommittee to help credit unions by supporting corrective legislation to modernize the cap, such as a bi-

partisan bill introduced by Representative Ed Royce and Carolyn McCarthy, H.R. 688, along with the ideas to assist small businesses, such as adjusting the outdated definition of a member business loan from $50,000 to a new 21st century number of $250,000, indexed for inflation.

The Small Business Administration loan programs also are an important resource that help credit unions provide capital. However, utilizing an SBA loan guarantee program requires meeting stringent government regulations. We are an approved SBA 7(a) lender, but currently have just one SBA 504 loan outstanding and one USDA business and industry loan outstanding.

Part of the challenge for credit unions is determining the overall applicant eligibility to participate in an SBA program, which is nearly as important as determining the applicant's creditworthiness. Failing to meet certain eligibility criteria may preclude the applicant from participating in an SBA guaranteed loan program. Eligibility criteria includes, among other things, size restrictions, type of business, use of proceeds, credit standards, and meeting a credit-elsewhere test.

If Congress and the SBA were to make it easier for credit unions to participate in these programs, small businesses throughout the Nation will have greater access to capital at a time when it is needed most. A 2011 SBA study found that credit unions played an important countercyclical role to meet demands of small business loans while others pulled back during the recent recession.

In conclusion, small businesses are the driving force of our economy. Credit unions play an important role in helping our member small businesses access the funds they need. Congress should do everything they can to ensure credit unions can meet the needs of their members. Thank you for the opportunity to testify today, and I welcome any questions you may have.

Chairman RICE. Thank you, Mr. Farmakides.

I am going to withhold my questions until the end, and work with the panel here.

Ms. Chu, would you like to do the same? Whichever order you prefer is fine with me.

Ms. CHU. Yes. Well, you know what, I would like to defer to the member as well and give him a first shot.

Chairman RICE. Okay. I am going to start with Mr. Mulvaney then. Thank you.

Mr. MULVANEY. Thank you, Mr. Chairman.

Folks, thanks very much for participating today. In listening to your testimony, I harken back to a story that I heard when I was in Charleston, South Carolina, a couple months ago, meeting with one of the small community banks there, and they were telling me about the last visit they had from their examiner. And the examiner at the end of the process asked them how they were dealing with Dodd-Frank. And the bank president said, well, it is absolutely killing us. The additional paperwork has required us to hire three new people to do nothing but fill out the new oversight paperwork. And the examiner's response was, well, then it is working, because you have created three jobs.

I think we could leave for another day the discussion as to whether or not that is really jobs created or jobs simply shifted

from one part of the economy to another. But it reminds me of something that Mr. Green spoke to, which is the impact of Dodd-Frank on capital available for lending. It strikes me if I have to hire three people to fill out paperwork, that takes money away from what I can lend out to my customers and so forth.

Mr. Green, walk me through just a couple examples you think of how Dodd-Frank is impacting the capital available for small business lending.

Mr. GREEN. Well, Congressman, first off, the example you gave is what we hear from all of our bankers throughout the State, and I would think many of our counterparts throughout the country. There is a shift of resources away from customer contact, bankers, those that might be out looking for loans and making loans, now to the compliance side.

The banking industry, bankers by definition are risk averse. They have to understand the risk, they have to put in policies and procedures to manage that risk. And with the mountain of regulations that have come and been thrown on the banking industry, and not only the volume but the velocity, the quickness in which it has come in, the proposed regulations that will soon follow, the banks have had to go out and hire lawyers, consultants, compliance folks, as you indicated. And those are resources that had heretofore been out meeting the needs of the borrowing constituents around in the community. That is one example.

The other example would be documentation, and that is a big one, because lending is both an art and a science. When I started in the banking business, we called it the C's of credit. The science part of the C's of credit are cash flow, capacity, collateral, things like that.

The primary part of the C's of credit were characters. In the larger loan opportunities the quality of the financial information is much stronger than it is in the smaller borrowing entities, the smaller companies. The quality of their financial information is not as robust. They don't have as much information. They can't predict the future maybe as well based on trends. So the tipping point between whether many loans are made in that smaller category falls to character. And that is knowing the customer, knowing the community, knowing the competitors, and the ability to maybe take that risk.

Now, under Dodd-Frank and under the regulations, you have to document every loan opportunity. The problem there is you can't document the intangibles, like I just described. As a result, we have had many bankers come to us and say, we would have made this loan many times in the past, in fact made many loans like this in the past, and they are good customers today, but we can't make that loan today because we can't document this intangible piece that is so important. So as a result, there are, we think, a lot of loans, primarily in that smaller category, that aren't being made as a result of the regulations.

Mr. MULVANEY. I also get the impression that the compliance requirements are driving some consolidation. There is a great deal of consolidation in the industry, but some of it is being driven by compliance requirements because the smaller institutions simply don't have the infrastructure necessary to meet the compliance require-

ments. And it strikes me that is also limiting availability of capital to small businesses. Would you agree with that?

Mr. GREEN. I agree, yes, sir. If you think of it this way, compliance cost is a fixed cost. The larger the institution, that cost is spread over a larger asset base and larger earnings base. The smaller the institution, that is a heavier burden.

Regulation applies to all banks, regardless of size. So the smaller the institution, has to dedicate more resources, more cost, and it has a smaller base to spread it over. So therefore, their earnings capacity is less. Earnings capacity is less, the future is maybe uncertain. Consolidation has occurred and will continue to occur. I have talked to a number of investment bankers who have told me that there is a tremendous amount of conversation going on now with smaller community banks, and a lot has to do with this increased cost structure as a result.

Mr. MULVANEY. And there was something that Mr. Laplanche said—I am not going to get a chance to ask questions, maybe we will get a second round later on—that said that because of the character, the intangible nature of small businesses, that it is higher cost to lend to small business, it is harder to do, and if we don't have these community-based institutions, the larger institutions simply aren't going to take on that lending possibility. But I will maybe get a chance to ask that question later on.

Thank you, Mr. Chairman.

Chairman RICE. Thank you, Mr. Mulvaney.

Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman, and to the ranking member.

Let's see. Mr. Laplanche, you in your written testimony are proclaiming to have solutions to bring underwriting costs down and create conditions to increase credit availability and affordability. Please share some of those ideas with the Committee.

Mr. LAPLANCHE. Yes. Thank you for giving me this opportunity. So, first, I want to start by saying that nothing will ever get better, no underwriting process would ever get better than the relationship between a community banker and a small business owner. That is always going to be the best way to—combined with financial information and credit data—the best way to assess a small business owner's ability to repay the loan and make the business successful.

I think the solutions we are working on are not designed to be a substitute. They are really designed to fill in a void. So in the absence of that relationship, or in circumstances where these relationships do not lead to a successful loan application, we believe we can offer tools that help make these loans possible and at a low underwriting cost.

And part of the answer here is technology. And we believe that technology can be applied in two different ways. One, to aggregate financial data and make the financial data more readily available to loan underwriters. And two, by looking into new, nontraditional underwriting data sources.

So in the first category we are working with a number of data providers to help pool data about the small businesses that apply for a loan with the expressed consent of the small business owner.

For example, we are working with Intuit Corporation, the maker of QuickBooks, to through an API code for a technology solution, essentially collect all the QuickBooks data, so the entire accounting of the small business, and extract that information, run analysis on that information, calculate ratios how that can be used as part of the underwriting and can be reviewed by the underwriter.

And that data extraction, the data analysis process can make the job of the underwriter easier and can also lower the burden for the business owner to collect the data and transfer the data to the underwriter. That is one category.

The other category is incorporating in the decision, in the pricing decision of the underwriting decision, data sources that are available online now through the Internet and can be used as a proxy of business reputation and future business performance. There are rating and customer satisfaction Web sites like Yelp or OpenTable or Angie's List that give the opportunity to customers to rank small businesses and give feedback on the experience they had with the business.

Our ability to collect that data, analyze that data, and use that data as an additional source for underwriting can be extremely useful, can be done in a way that is highly automated, low cost, and provide some insight as a complement to other more traditional sources, provide some insight into future business performance.

Mr. PAYNE. Okay. Thank you.

In the interests of time, I will yield back so we can possibly get to a second round. Thank you.

Chairman RICE. Mr. Schweikert?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

And forgive me if this one becomes a little ethereal, but on particularly small, truly small businesses, you know, the one with under 25 employees that comes into an institution, and I don't know if this might be from a regulator's standpoint, if it were a decade ago and I am coming in for working capital, do you feel, for those of you on the lending side, you had more flexibility? Okay, you have a couple trucks that you have equity in. All right, well, we know you own your home. And are the regulators not allowing you to look at their full asset bundle, and do you get punished if you have done that look at the asset bundle when you have your auditing mechanics?

Mr. Green.

Mr. GREEN. Congressman, let me start with that. I do think the flexibility has been significantly reduced. I mentioned the regulatory scrutiny and documentation. You know, a lot of times the primary asset of a small business owner is their home and equity in their home. To be able to take that equity now as collateral requires a whole lot more cost, a whole lot more scrutiny, a lot more documentation than it would have before. And the same goes for other type assets. So, yes, sir, it absolutely has changed.

Mr. SCHWEIKERT. On that same look on cosigners for debt, I don't know how many people in the room at sometime in their life have had a family member wanted to start a business, and we were all really, really stupid or very, very loving, whatever you want to consider it, in helping cosign, you know, them to get some of their debt

instruments to start their business. And my understanding is that also is one of the things we will see dramatically less of as being an acceptable collateral mechanic today. I mean, is what I am being told your experiences?

Mr. GREEN. Yes, sir. I will just add one more comment and let my other panelists talk about it.

That is important, because I mentioned earlier about character sometimes being the tipping point. A lot of those guarantors are family members. And having a family member on there, father, mother, that would guarantee it, a lot of times they were tougher on that borrower maybe than the lender would be because of that.

Mr. SCHWEIKERT. Well, it just makes Thanksgiving really uncomfortable when you have problems.

Mr. GREEN. Yes, sir.

Mr. SCHWEIKERT. And forgive me, is it Wyrich?

Ms. WIERSCH. Wiersch.

Mr. SCHWEIKERT. Wiersch. Now, you actually, with your position, you actually touch probably a lot of accumulated data. Are you seeing something in the data that is sort of outside the folklore we are having this discussion of? You know, is it those small businesses aren't walking into their credit unions or their community banks to even ask for a loan? I mean, what do you see really going on in the data?

Ms. WIERSCH. Really, I think it is the combination of factors. Demand is definitely part of the issue. And, you know, in terms of some of these, the impact of regulatory scrutiny, as we are talking about it, it is interesting. If you look at the data, you see that the— and this is information that we can get in terms of why banks are tightening their lending standards. Regulation is less of a concern, in terms of regulatory policy, regulatory scrutiny, that is the side that we are looking at it from, it is less of a factor now. The bigger factors in tightening lending standards would be, you know, issues like their perception of the economic environment, their risk appetite, you know, those types of issues. Loan performance. You know, their market strategy.

Mr. SCHWEIKERT. In that area, when I have some of my regulated entities, you know, my community banks come to me and say, our discussion about our buckets, I am holding too much real estate, I need to roll to this, roll to that. So there is entire silos of what you might have used in that cross-collateralization that, boom, are gone, that you can't use. Doesn't that ultimately, that mechanic have the cascade effect of, don't come talk to us, I have no capacity?

Ms. WIERSCH. You know, I would just reiterate that, you know, lending decisions and the decisions about portfolio composition are truly—these are bank decisions and bank management decisions. There is an influence from——

Mr. SCHWEIKERT. Are they truly a bank decision? I mean, I know that you are on the Fed side, not the FDIC side, but that is in many ways a regulator decision.

Ms. WIERSCH. There is some consideration of the information the regulators give. And I think maybe from the bankers' side they can provide a little more insight on that. From what we see in the data, it just shows that regulatory policy is less of a factor in deter-

mining, you know, the lending types of decisions. Now, in terms of this idea of——

Mr. SCHWEIKERT. And I don't mean to cut——

Ms. WIERSCH. No, no, that is okay.

Mr. SCHWEIKERT. We are over time. But this is actually a really interesting discussion. At some point I hope we can wrap to it. Because I am trying to mix what we get anecdotally with where we find actual data.

So thank you, Mr. Chairman. Sorry for going over time.

Chairman RICE. Thank you, Mr. Schweikert.

Ms. Chu.

Ms. CHU. Thank you, Mr. Chair.

Mr. Farmakides, credit unions have expressed to the Committee that the barriers to entry to participate in SBA lending are too great, and that is why very few credit unions opt to participate. Now, you have a most interesting history because you worked for the SBA and yet you also represent the credit unions. So you have seen things from both sides of the fence. Other than what you have mentioned in your testimony about permanently exempting SBA loans from counting against the MBL cap, what else can we do to encourage credit union participation in SBA lending programs?

Mr. FARMAKIDES. I think there has been bills presented before us today that basically are looking for ways to allow credit unions like ours to do more SBA lending. I think the key for that is changing the way SBA administers its program. The way that they have done it right now, the rules and the regulations to follow are very difficult and time-consuming, and quite honestly are just almost impossible to clearly manage the process without a full-time person in place. So the changing in the way that the program is administered.

The other areas that we most definitely could hopefully spur more credit unions to getting involved is taking that SBA loan, the entire loan, and changing the cap so that way it does not go against a credit union's lending cap. If you were to free that counting against the lending cap, more credit unions would be encouraged to invest the time, effort, and staff costs in order to get into that program. And it is, quite honestly, a time-intensive and expensive way of doing business, one that credit unions can serve in, but right now the way that the laws are currently written it is very preclusive.

Ms. CHU. And specifically in terms of reducing the level of expense to participate in the SBA program, like what specifically, what would be one suggestion that you would have?

Mr. FARMAKIDES. There is a number of suggestions. But the one that I think to reduce the expense that we would want to have is lowering the cap, just lifting the cap entirely, because then it frees us up to make those decisions across the board both in commercial real estate finance, SBA lending, then also working lines of credit that in essence will allow us to do a better job managing our expenses against those type of loans.

Ms. CHU. I see.

Ms. Wiersch, you stated in your testimony that one factor in reduced credit supply for small businesses is a decade-long shift in

the financial industry away from this type of lending. In your opinion, what could we do to reverse this trend?

Ms. WIERSCH. You know, the trend really, if you look at the data you can go back even to the 1980s, where we had 17,000 banks in our country, and we are down to about 7,000 now. And most of that consolidation has taken place in the smallest category, you know, the small community banks. And, you know, whether that trend can be reversed, you know, I am not sure I can say that I see any evidence that is, you know, likely or in any way possible. I am sure it is possible, but I mean there is just no signal that that is even something that could happen.

And as I am, you know, hearing the concerns about regulation and the pressure that puts on community banks, I would imagine that that is certainly a concern. We have not done any research to say that, you know, there are different factors forcing the regulation—or the consolidation. Regulation, I imagine, is just one of many factors in that. But I don't see any indications that the trend is changing.

Ms. CHU. And, well, in terms of reversing this trend, is there any kind of additional Federal program that could fill the gap?

Ms. WIERSCH. I have not looked at anything or seen anything in that regard.

Ms. CHU. Okay.

Mr. Stibel, small businesses and startups are responsible for nearly two-thirds of net job creation. You mentioned in your testimony that there is a large discrepancy in access to capital across business size, where small and microbusinesses face tougher lending standards. SBA has traditionally filled this void, but small dollar loans have steadily declined since 2007. What should be done to realign SBA's lending activity with its mission to provide access to capital to our Nation's smallest businesses?

Mr. STIBEL. I think that is a great question, and one that speaks to the problem that Ms. Wiersch was alluding to, which is, you know, we keep redefining the line and definition of what a small business actually is. And, you know, before we can even have a cogent argument and discussion about what can be done, we have got to figure out what the actual problem is.

And, you know, small businesses are the same size they were 100 years ago. They don't grow with inflation. Right? A start-up starts with zero revenues and zero employees always. The problem is we have redefined the boundaries what a small business is over and over again, on one hand. And on another, we have got different definitions. I mean, I am sure if we asked everyone here, each one of us would have a different definition for what a small business is. It would be a good, strong definition. But without a singular definition, I think it is very hard to start addressing the problem.

With regards to the smallest of businesses, the ones that are starting and the entrepreneurs and the true Main Street businesses, the core problem here is because those definitions keep growing, the government and banks keep shifting towards the larger businesses, and they ignore the current and present problem, which is most of our employment comes from the starting of businesses and their growth.

And, you know, I think the first and foremost thing that the SBA can do is take a leadership position here. Define what it means to be a small business or a microbusiness or a startup, and then put a strong emphasis on lending to those companies, and encourage that lending first and foremost, and don't focus on loan size, don't focus on anything other than the size of a business, from start to whatever the current definition of small is.

Ms. CHU. Thank you for that.

Mr. Laplanche, I found your suggestions on how to reduce the underwriting costs to be very interesting. And you are the CEO of Lending Club. It is a credit platform that employs over 300 people in San Francisco. But could you describe how you implement your ideas in this credit platform, the Lending Club?

Mr. LAPLANCHE. I can. I shared some of these ideas earlier, but I can expand on it. Certainly looking at the, like $2 billion in loans that we have made this year, and these were mostly consumer loans, we have created what we call a credit review center that is essentially a technology tool that aggregates data from 25 different data sources. And what is interesting is now with the Internet there are many, many new data sources that are created on an ongoing basis, and many new things you can learn about individuals or small businesses.

In the case of individuals, there are privacy issues, there are FCRA issues. In the case of small businesses, with the authorization of the business, that helps us be more flexible and access more freely some of these data sources. So I mentioned Yelp ratings, Angie's List ratings. Many small businesses, Main Street businesses, whether it is a hair salon or restaurant, have a Facebook page. The number of likes on their Facebook page is an indicator of a trend in the business. The number of tweets and retweets, so the activity on Twitter is also an indicator of performance of the business.

There are data sources that are not readily available but can be accessed through partnerships. So, for example, the ability to connect to UPS or FedEx and get shipping data about a business, it is a third-party validation of that shipping data, and get that data collected and analyzed automatically is another sort of indication of performance and a forward indicator of business activity.

So there are all these data sources that are available either publicly or through partnerships with companies that service small businesses, that because we are operate online in a way that utilizes technology we can connect to and analyze quickly and incorporate in the decision. But then the very interesting things we do is the capital can come from many different data—very different sources. And we have partnerships with a number of banks. So now over seven community banks are investors on the Lending Club platform and can sort of buy loans from Lending Club this way.

Ms. CHU. Thank you for that.

And, Mr. Green, as you know, one of the provisions of the Dodd-Frank Act known as the Collins amendment increases the minimum capital requirements on large financial institutions, while exempting bank holding companies with assets of $500 million or less. This encompasses the overwhelming majority of all commu-

nity banks. Will this provision help to level the playing field and allow community banks to better compete with big banks?

Mr. GREEN. I think, Congresswoman, when you look at all the regulation combined, you know, what you mentioned on Dodd-Frank, and then you go back to Basel III, Basel III goes into the larger banks, but that will ultimately come down to the smaller banks, there might be a window where the smaller institutions, below $500 million, you know, might have a slight advantage over the large ones as it relates to capital. But the general thought is that that, like most other regulations, will continue to filter down and ultimately impact them, and that would change as well.

Ms. CHU. Okay. Thank you. I yield back.

Chairman RICE. Thank you, Ms. Chu.

Ms. Wiersch, you mentioned the decline in the number of small banks. In your data at the Federal Reserve, do you know what is the primary source of capital for small businesses?

Ms. WIERSCH. Well, in terms of where small businesses get funding, we have some information on this. We know from an NFIB comprehensive survey that 85 percent of small businesses identify a commercial bank as their primary financial institution. Some of the information outside of the commercial bank area we don't have a real good idea of who the borrower is. So we have limited information——

Chairman RICE. You mean the lender, right? You mean the lender, not the borrower.

Ms. WIERSCH. I am sorry. Well, no, who the borrower is. Like, if you are looking at aggregate numbers for finance companies and who their—we don't know often who they are lending to. We know total loan volume, for example.

Chairman RICE. But the NFIB says 85 percent of small businesses identify commercial banks as their primary source.

Ms. WIERSCH. That is correct.

Chairman RICE. And would you say those would be large commercial banks or small commercial banks, or do you have any data on that?

Ms. WIERSCH. There isn't any specific breakdown on that. Now, what I can tell you is that there has been a shift in the commercial bank area where small businesses are lending from. And that shift has taken it from a little over a decade ago small community banks had a 51 percent market share of the small loan market, and that has completely shifted. So now the large banks have the largest share of the small loan market and the community banks share has shrunk significantly.

Chairman RICE. Now, additional Federal regulation, whether it be Dodd-Frank or any other Federal regulation, increase compliance cost. Correct?

Ms. WIERSCH. Yes.

Chairman RICE. So that just makes it more difficult to do business. Correct?

Ms. WIERSCH. I would say so.

Chairman RICE. So if we are saying that, you know, small banks are declining, that historically they have had over half of the small business loans, wouldn't it be logical to assume that additional

Federal regulation is one of the reasons why they are disappearing and small businesses are now moving to larger banks?

Ms. WIERSCH. I don't have any research to definitively say that. But, you know, certainly those are all factors in the trends that we are seeing.

Chairman RICE. Thank you, ma'am.

Mr. Stibel, you said something that was really interesting to me. My primary focus is jobs and American competitiveness. And I truly believe that competitiveness is measured in small degrees. You know, we are competing around the world. It is not major things, it is small degrees, because everybody is trying to compete, and everybody tries to do the best they can. And one of our primary advantages historically in America has been access to capital.

You mentioned that small businesses don't have access to capital these days and that they have increased revenue, but they are not adding jobs because they don't have access to capital. Is that correct?

Mr. STIBEL. That is, yes.

Chairman RICE. So can we translate that an increased presence of the Federal Government in the banking system through Dodd-Frank has led to a reduction in jobs?

Mr. STIBEL. The cause and effect between I think is a bit hard to dissect and pinpoint on either a single piece of legislation or any type of regulation. You know, regulation can be good or bad. But I think it is causing pain points right now. And, you know, ultimately, without lending you are not going to have job growth. You know, as I said earlier and you saw in that written testimony, we have now got some clear evidence that shows that, you know, America's small businesses are getting back on their feet. But America's individuals, the employees, are not.

And, you know, we are seeing this in payroll numbers, we are seeing this in revenue growth personally. So in terms of people's income. And then we are seeing this in terms of a lack of an economic recovery on the job side, right, the jobless economy. And I think a lot of this does come down to the banking sector. And, you know, included in that is regulation.

And, you know, we can do a lot more from that standpoint to free up that access to capital to the best businesses right now in our economy. And, you know, the irony is that it's the smallest businesses. They are the hardest to determine. They are often the hardest to find when you see more and more banking consolidation. But they tend to be the best ones for sustained growth, for job growth. And ultimately, it is those small businesses that will become the next large businesses.

Chairman RICE. And so if Dodd-Frank makes it significantly more difficult to comply with regulatory burdens and small banks go out of business, then that is just that much less access to capital for small businesses. Correct?

Mr. STIBEL. If we see more and more small community banks and alternative sources of lending either disappearing, those banks going out of business, or becoming more restrictive in terms of how they lend to small businesses, then absolutely we will see less capital flowing into small businesses, and ultimately we will see less job growth.

Chairman RICE. Ms. Wiersch, Dodd-Frank was passed on the theory that we were trying to prevent what happened in the financial crisis from happening again and keeping financial institutions from becoming too big to fail. Correct?

Ms. WIERSCH. Yes.

Chairman RICE. All right. So, in your opinion, does the regulatory burden under Dodd-Frank fall disproportionately on bigger banks or smaller banks?

Ms. WIERSCH. I can't say. I mean, my research did not address that specifically.

Chairman RICE. Thank you, ma'am.

Mr. Green, under Dodd-Frank does the regulatory burden fall more disproportionately on larger banks or smaller banks?

Mr. GREEN. Mr. Chairman, it does fall more disproportionately on the smaller banks than the larger banks. The cost, as I mentioned, is a fixed cost spread over smaller assets. The restrictive nature of some of the documentation, underwriting standards, all of those type things limit also the ability to make certain type loans.

Chairman RICE. Thank you, sir.

Mr. Laplanche, you mentioned something that was very interesting to me. You said that no underwriting process will ever be better than the relationship between a borrower and a community banker. And why is that, sir?

Mr. LAPLANCHE. I think it comes back to the fourth C of credit, character. And I think especially for small businesses and for startups, there is just not a lot of data you can look at.

Chairman RICE. Okay. So it comes down to I call it community banking or relationship banking. Hard to quantify and put in a file. Correct?

Mr. LAPLANCHE. That is right.

Chairman RICE. And the effect of the regulations under Dodd-Frank are to try to make every loan fit in this box. Correct?

Mr. LAPLANCHE. That is my understanding. I am no expert in——

Chairman RICE. So you take that discretion out, you eliminate that discretion, and the effect of that, in my opinion, is less lending to small business. Would that be a logical conclusion?

Mr. LAPLANCHE. That seems to be a logical conclusion, yes.

Chairman RICE. Mr. Green, would you agree with that?

Mr. GREEN. Yes, sir, I would.

Chairman RICE. Let's talk for a minute about, so if we are taking the relationship banking off the table, who does that affect? Does that affect more large businesses that want to borrow with high income and plenty of assets, or does that affect more small businesses that want to borrow, start ups and so forth?

Mr. GREEN. It affects the smaller businesses. Again, the quality of the financial information for a smaller business is not as robust as a larger business. And as a result, you have to rely more on relationships, knowledge of that customer, their community, their competitors, things that are intangible for smaller businesses, smaller owners than you would larger businesses.

Chairman RICE. So we are penalizing small banks with this additional regulation under Dodd-Frank, we are penalizing small businesses with this additional regulation under Dodd-Frank.

Ms. Wiersch, where do most of the jobs come from, big businesses or large businesses?

Ms. WIERSCH. If you looking back to the 1970s, the highest net job creation rate is for among the smallest of businesses.

Chairman RICE. Thank you very much.

Mr. Farmakides, do you all do mortgage loans?

Mr. FARMAKIDES. We do, sir.

Chairman RICE. Are you familiar with these new qualified mortgage regulations?

Mr. FARMAKIDES. I am, sir.

Chairman RICE. How is that going to affect your mortgage lending?

Mr. FARMAKIDES. It is going to create some significant issues for us.

Chairman RICE. All right. Now, so if somebody comes in with high income and plenty of assets, is that going to affect the loan to them at all, these qualified mortgage rules?

Mr. FARMAKIDES. No, it is not.

Chairman RICE. But somebody who comes in with a relationship with you guys, that you may recognize that they might not have quite a 41 percent loan to whatever that number is, income to loan ratio, but you feel like they are good for the loan and you otherwise would have made that loan in the past, are you going to be able do that now under this Dodd-Frank?

Mr. FARMAKIDES. Under great difficulty.

Chairman RICE. It is going to be very difficult to do.

Mr. FARMAKIDES. Nonqualified mortgage.

Chairman RICE. So it is going to make it harder for you to loan to moderate income, middle class people, but it is not going to affect the higher income people. Is that correct?

Mr. FARMAKIDES. It is going to make it more difficult.

Chairman RICE. So we are penalizing small banks, we are penalizing small businesses, we are penalizing low and moderate income people, and we are preventing job creation. Other than that, this is a great law. Thank you.

I am going to defer.

Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman.

And this is, I guess, a question any panelist could answer. You know, it has been stated today that there is a weaker demand for credit as an issue in most of your testimonies. Should we expect this demand to return to prerecession levels or accept weak credit demand and credit alternatives as the new norm or the new trend?

Mr. GREEN. I will start out. The uncertainty in the economy limits the small business. They are more hesitant to invest in capital goods to expand because the future is less certain. As a result, that has created less demand. If there is more clarity about the future and elimination or reduction in uncertainty, I think you will see greater expansion in the economy, greater capital expansion, greater job creation, which will lead to more loan demand.

Mr. FARMAKIDES. I just am going to give a slightly different picture here from a credit union perspective. We are in the last year seeing greater demand for smaller lines of credit. We are talking lines of credit under $250,000, more opportunity. But we are still not able to serve that. So we are seeing greater opportunity in 2013. We have closed 13 loans, 10 of them to small businesses, 2 of which were startups, small working capital lines of credit that currently the market isn't providing that capital access. And because of the current caps that are in place, we are having a really hard time getting that money out there. So there is regulatory caps that we would hope could be modified in order to allow us to make those type of loans.

Mr. STIBEL. And I would just add to the distinction between those two last comments and say I actually believe that the demand is there. And we are seeing that with the surveys that we are doing to the small businesses out there. It is more the desire that is lacking right now.

Part of that is certainly uncertainty. A big part of that is frustration, whether it is regulatory, whether it is just the banks turning, you know, turning businesses down throughout the recession. But the demand is absolutely there. And once, you know, once businesses become more comfortable that the loans are available you will see lending improve.

Mr. PAYNE. Okay.

Yes, sir.

Mr. LAPLANCHE. If I might add, I think that is absolutely right. And the supply and demand are very tightly intertwined. A survey from the Federal Reserve Bank of New York shows that again, out of 70 small business owners who wanted capital, 29 did not even apply. So there is a self-selection out of the process for many small business owners. So when they feel supply of capital will be there, I think we will see demand come back.

Mr. PAYNE. Okay.

And, Ms. Wiersch, you know, in your testimony, you point out the fact that more lending is secured by collateral now than before the great recession. Do you think reversing this trend would be beneficial for small business? And what could we do in our capacity in Congress to help support that?

Ms. WIERSCH. You know, it is an interesting question. Looking at the shift in data, we do see that more banks are requiring collateral. I am not sure that there is a policy solution to alter, you know, the way that banks are making their lending decisions and setting the terms of their lending. But it is important to note that, you know, as property values rise that will help the collateral side of things so borrowers can meet bank lending standards.

Mr. PAYNE. Okay. Thank you.

I yield back, sir.

Chairman RICE. Mr. Mulvaney, you have anything?

Ms. Chu?

Okay. Well, I just have one more question, and that is what, if anything, just one thing, would you guys suggest that the Federal Government could do to improve the small business lending situation?

Ms. Wiersch, I want to start with you and we will go down the line.

Ms. WIERSCH. Of course our research did not attempt to make any policy recommendations. The one issue I would like to reiterate is that this is really a complex issue. There are a lot of factors at play. And any policy action should consider all of these factors. And addressing just one factor is unlikely to really move the needle on this problem as, you know, there are so many things happening here.

Chairman RICE. Mr. Stibel.

Mr. STIBEL. I think it is as simple as defining what a small business is. You know, if I had one thing that I would recommend doing, start there.

Chairman RICE. So this is for SBA lending, is what you are talking about?

Mr. STIBEL. I would love to see it across the board. I mean, there is a bill right now on the floor for small business access to capital where they are talking about certain businesses' funds being upwards of $150 million in size. Puts our business in the small business category. So I think it is critically important to do that broadly, and to make sure that that is disseminated not just through the SBA, but through to the IRS when they are looking at small business tax credits, through to banks, both community and large banks, and through alternative lending sources.

Chairman RICE. Thank you, sir.

Mr. STIBEL. You are welcome.

Chairman RICE. Mr. Laplanche.

Mr. LAPLANCHE. So I focus on the data accessibility part of the equation, because we use so much data as part of the underwriting. If the government could make more data more readily available to lenders, I think that would help the underwriting decision. So we have had discussions with the Treasury on better access to IRS data and the ability with the business owner to easily access tax filings so that we can incorporate this data into the lending decision. That is one area where the government can help.

Chairman RICE. Thank you, sir.

Mr. Green.

Mr. GREEN. Thank you. I think, Congressman, Mr. Chairman, the mountain of regulations that have been levied on the banking industry has had the unintended consequence of hurting most, if not all of the community banks. I would hope that Congress would maybe go back and look at some of those regulations to see if there is a disparity between what was originally intended and what has actually happened, maybe modify some of those, certainly going forward, those that are in the works to make sure that that does not continue.

I will add that, maybe in closing comments, that there is a tremendous amount of capacity within the banking industry to lend to small businesses. The capital levels are the highest they have ever been. Liquidity is there. Competition is strong. There are nonbank competitors, like the credit unions, farm credit, others.

I know the gentleman to my right has mentioned the cap. In our State, the credit union that—the percentage of business loans relative to assets at the highest level is below 5 percent. So they have

tremendous capacity as well. In fact, I think nationally less than 1 percent of the credit unions are at or near that peak. So there is tremendous capacity in the banks, farm credit system, significant capacity with the credit unions, and alternative lenders. So if we could find a way, again, to eliminate or reduce those unfavorable negative consequences, that would be very helpful.

Chairman RICE. Thank you, sir.

Mr. Farmakides.

Mr. FARMAKIDES. The one thing for us would be to remove the member business lending cap and reintroduce the Credit Union Small Business Lending Act from the 112th Congress, which directs the SBA Administrator to establish programs for credit unions. I think that would be very beneficial for us.

Chairman RICE. Thank you.

Ms. Chu.

Ms. CHU. If I could ask a follow-up question.

Mr. Stibel, why is the SBA definition of small business not adequate?

Mr. STIBEL. For a couple of reasons. Number one, there is no single definition. So the definitions right now are by category. And number two, and this is probably the most important thing, no one else is using it. And that is the real reason. What you need is you need a centralized definition that Bank of America is using, that Wells Fargo is using, that Lending Club is using, that we are using so that we can actually have a proper dialogue about what a small business is. So it is less about what the definition is. It is more about making sure that everyone follows that definition.

Ms. CHU. Okay.

Chairman RICE. I just want to thank all you witnesses for being here today. Your testimony has been very enlightening. Thank you very much for putting up with me. And this hearing is adjourned.

[Whereupon, at 11:26 a.m., the subcommittee was adjourned.]

A P P E N D I X

Statement by

Ann Marie Wiersch

Policy Analyst

Federal Reserve Bank of Cleveland

before the

Subcommittee on Economic Growth, Tax, and Capital Access

Committee on Small Business

U.S. House of Representatives

December 5, 2013

Chairman Rice, Ranking Member Chu, and distinguished members of the subcommittee, it is an honor to testify before you today on the state of small business lending. My testimony will focus on the decline in lending to small businesses and the factors that are driving that decline.[1] My remarks represent my own views and are not official views of the Federal Reserve Bank of Cleveland or any other element of the Federal Reserve System.

Background

Recent industry and media reports provide a mix of perspectives on the sate of small business lending. Contradictory messages abound, and often result from inconsistent definitions of what constitutes a small business and from the absence of comprehensive and reliable data on small business lending. Banks and government agencies use a wide range of parameters to classify firms as small businesses. One frequently cited definition of what constitutes a small business is so expansive that it includes more than 99 percent of the businesses in the U.S. It should not come as a surprise that we hear so many differing reports about small business conditions when firms of so many different sizes and industries are compared with one another by analysts relying on different definitions of a small business. In addition, the considerable lack of data on small business lending and the variance in the size of firms or loans included in the lending data leads to inconsistency in reporting among the data that are available.

Small business lending has dropped substantially since the Great Recession. While some measures of small business lending are now above their lowest levels since the economic downturn began, they remain far below their levels before it. For example, in the fourth quarter of 2012, the value of commercial and industrial loans of less than $1 million—a common proxy for small business loans—was 78.4 percent of its second-quarter 2007 level, when measured in inflation-adjusted terms.[2]

Some policymakers are concerned that the decline in small business lending may be hampering the economic recovery. Small businesses employ roughly half of the private sector labor force and provide more than 40 percent of the private sector's contribution to gross domestic product. If small businesses have been unable to access the credit they require, they may be underperforming, slowing economic growth and employment.

Industry participants, including small business owners, bankers, and regulators have offered differing reasons for the decline in lending. However, recent analysis by the Federal Reserve Bank of

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[1] The analysis presented in this Statement draws extensively from the Federal Reserve Bank of Cleveland publication, "Why Small Business Lending Isn't What It Used To Be," Ann Marie Wiersch and Scott Shane, 2013. (http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm).

[2] As reported by the Federal Deposit Insurance Corporation (http://www2.fdic.gov/qbp/). This report focuses on traditional commercial bank lending, as it is the most frequently utilized source of small business credit. According to a 2011 survey by the National Federation of Independent Businesses (http://www.nfib.com/research-foundation/surveys/credit-study-2012), 85 percent of businesses reported that a commercial bank was their primary financial institution, while only 5 percent has such a relationship with a nondepository financial institution (such as private finance companies).

Cleveland shows that there is no single explanation, but rather a number of factors driving this trend. Fewer small businesses are interested in borrowing than in years past, and at the same time, small business financials have remained weak, depressing small business loan approval rates. In addition, collateral values have stayed low, as real estate prices have declined, limiting the amount that small business owners can borrow.

Furthermore, increased regulatory scrutiny has caused banks to boost their lending standards, resulting in a smaller fraction of creditworthy borrowers. Finally, shifts in the banking industry have had an impact. Bank consolidation has reduced the number of banks focused on the small business sector, and small business lending has become relatively less profitable than other types of lending, reducing some bankers' interest in the small business credit market.

Because none of these factors is the sole cause of the decline in small business credit, any proposed intervention should account for the multiple factors affecting small business credit.

Weaker Demand for Credit

Small businesses were hit hard by the economic downturn. Analysis of data from the Federal Reserve Survey of Consumer Finances reveals that the income of the typical household headed by a self-employed person declined 19 percent in real terms between 2007 and 2010. Similarly, Census Bureau figures indicate that the typical self-employed household saw a 17 percent drop in real earnings over a comparable period.[3]

Weak earnings and sales mean that fewer small businesses are seeking to expand. Data from the Wells Fargo/Gallup Small Business Index—a measure drawn from a quarterly survey of a representative sample of 600 small business owners whose businesses have up to $20 million a year in sales—show that the net percentage of small business owners intending to increase capital investment over the next 12 months fell between 2007 and 2013. In the second quarter of 2007, it was 16 (the fraction intending to increase capital investment was 16 percentage points higher than the fraction intending to decrease capital investment), while in the second quarter of 2013, it was negative 6 (the fraction intending to decrease capital investment was 6 percentage points higher than the fraction intending to increase it). Similarly, the net percentage of small business owners planning to hire additional workers over the next 12 months was 24 in the second quarter of 2007, but only 6 in the second quarter of 2013.[4]

Reduced small business growth translates into subdued loan demand. Thus, it is not surprising that the percentage of small business members of the National Federation of Independent Busi-

[3] Federal Reserve Survey of Consumer Finances (http://www.federalreserve.gov/econresdata/scf/scf_2010.htm): Census Bureau: Income, Poverty, and Health Insurance Coverage in the United States: 2010 (http://www.census.gov/prod/2011pubs/p60-239.pdf).

[4] Wells Fargo Gallup Small Business Index (https://wellsfargobusinessinsights.com/research/small-business-index).

nesses (NFIB) who said they borrowed once every three months fell from 35 percent to 29 percent between June 2007 and June 2013.

Some of the subdued demand for loans may stem from business owners' perceptions that credit is not readily available. According to the Wells Fargo/Gallup Small Business Index survey, in the second quarter of 2007, 13 percent of small business owners reported that they expected that credit would be difficult to get in the next 12 months. By the second quarter of 2013 that figure had increased to 36 percent. By contrast, 58 percent of small business owners said credit would be easy to get during the next 12 months when asked in 2007, compared to 24 percent six years later.

Reduced Credit Supply

Lenders are approving fewer small business loan applications, since many firms lack the cash flow, credit scores, and collateral that banks require. According to the latest Wells Fargo/Gallup Small Business Index, 65 percent of small business owners said their cash flow was "good" in the second quarter of 2007, compared to only 48 percent in the second quarter of 2013.

Small business credit scores are lower now than before the Great Recession. The Federal Reserve's 2003 Survey of Small Business Finances indicated that the average PAYDEX score of those surveyed was 53.4.[5] By contrast, the 2011 NFIB Annual Small Business Finance Survey indicated that the average small company surveyed had a PAYDEX score of 44.7. In addition, payment delinquency trends point to a decline in business credit scores. Dun and Bradstreet's Economic Outlook Reports chart the sharp rise in the percent of delinquent dollars (those 91 or more days past due) from a level of just over 2 percent in mid-2007 to a peak above 6 percent in late-2008. While delinquencies have subsided somewhat since then, the level as of late 2012 remained at nearly 5 percent, notably higher than the pre-recession period.

More lending is secured by collateral now than before the Great Recession. The Federal Reserve Survey of Terms of Business Lending shows that in 2007, 84 percent of the value of loans under $100,000 was secured by collateral. That figure increased to 90 percent in 2013. Similarly, 76 percent of the value of loans between $100,000 and $1 million was secured by collateral in 2007, versus 80 percent in 2013.[6]

The decline in value of both commercial and residential properties since the end of the housing boom has made it difficult for businesses to meet bank collateral requirements. A significant portion of small business collateral consists of real estate assets. For example, the Federal Reserve's 2003 Survey of Small Business Finances showed that 45 percent of small business loans were collateralized by real estate.

On the residential side, Barlow Research, a survey and analysis firm focused on the banking industry, reports that approximately

[5] 2003 Survey of Small Business Finances (http://www.federalreserve.gov/pubs/oss/oss3/ssbf03/ssbf03home.html).

[6] Survey of Terms of Business Lending (http://www.federalreserve.gov/releases/e2/default.htm).

one-quarter of small company owners tapped their home equity to obtain capital for their companies, both at the height of the housing boom and in 2012. The value of home equity has dropped substantially since 2006. According to the Case-Shiller Home Price Index, the seasonally adjusted composite 20-market home price index for April 2013 was only 73.8 percent of its July 2006 peak.

On the commercial side, the Moody's/Real commercial property price index (CPPI) shows that between December 2007 and January 2010, commercial real estate prices dropped 40 percent. While prices have recovered somewhat since then, the index (as of May 2013) is still 24 percent lower than in 2007.

Tighter Lending Standards

At the same time that fewer small businesses are able to meet lenders' standards for cash flow, credit scores, and collateral, bankers have increased their credit standards, making even fewer small businesses appropriate candidates for bank loans than before the economic downturn. According to the Office of the Comptroller of the Currency's Survey of Credit Underwriting Practices, banks tightened small business lending standards in 2008, 2009, 2010, and 2011.

Loan standards are now stricter than before the Great Recession. In June 2012, the Federal Reserve Board of Governors asked loan officers to describe their current loan standards "using the range between the tightest and easiest that lending standards at your bank have been between 2005 and the present." For nonsyndicated loans to small firms (annual sales of less than $50 million), 39.3 percent said that standards are currently "tighter than the midpoint of the range," while only 23 percent said they are "easier than the midpoint of the range."

Moreover, while banks have loosened lending standards for big businesses during the recent economic recovery, they have maintained tight standards for small companies. The Office of the Comptroller of the Currency's Survey of Credit Underwriting Practices tracks the changes in lending standards for small and large customers between 2003 and 2012. The net tightening of lending standards (the percentage of banks tightening lending standards minus the percentage loosening them) was slightly greater for small businesses than large businesses in 2009 and 2010. However, in 2011 and 2012, there was a net tightening of lending standards for small businesses, despite a net loosening for big businesses.[7]

While banks adjust lending standards for a number of reasons, there is some evidence that heightened scrutiny by regulators had an impact during and after the Great Recession. Recent research quantifies the impact of tighter supervisory standards on total bank lending. A study by Bassett, Lee, and Spiller finds an elevated level of supervisory stringency during the most recent reces-

[7] The Office of the Comptroller of the Currency Survey of Credit Underwriting Practices (http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/index-survey-credit-underwriting-practices-report.html).

sion, based on an analysis of bank supervisory ratings.[8] This research concludes that an increase in the level of stringency can have a statistically significant impact on total loans and loan capacity for several years—approximately 20 quarters—after the onset of the tighter supervisory standards.

Longer-Term Trends

Declines in small business lending also reflect longer-term trends in financial markets. Banks have been exiting the small business loan market for over a decade. This realignment has led to a decline in the share of small business loans in banks' portfolios. The FDIC reports that the fraction of nonfarm, nonresidential loans of less than $1 million has declined steadily since 1998, dropping from 51 percent to 29 percent.

The decades-long consolidation of the banking industry has reduced the number of small banks, which are more likely to lend to small businesses. Moreover, increased competition in the banking sector has led bankers to move toward bigger, more profitable, loans. That has meant a decline in small business loans, which are less profitable because they are banker-time intensive, are more difficult to automate, have higher costs to underwrite and service, and are more difficult to securitize.

Conclusion

The decline in the amount of small business credit since the financial crisis and Great Recession is unmistakable. The most recently available data put the inflation-adjusted value of small commercial and industrial loans at less than 80 percent of their 2007 levels. While different industry participants offer different reasons for the drop in small business credit, a careful analysis of the data suggests that a multitude of factors explain the decline.

The forces unleashed by the financial crisis and Great Recession added to a longer-term trend. Some banks have been shifting activity away from the small business credit market since the late 1990s, as they have consolidated and sought out more profitable sectors of the credit market. Small business demand for lending has decreased, as fewer small businesses have sought to expand. Credit has also become harder for small businesses to obtain. A combination of reduced creditworthiness, the declining value of homes (a major source of small business loan collateral), and tightened lending standards has reduced the number of small companies able to tap credit markets.

This confluence of events makes it unlikely that small business credit will spontaneously increase anytime in the near future. Given the contribution that small businesses make to employment and economic activity, policymakers may be inclined to intervene to promote greater access to credit for small business owners. When considering means of intervention, however, it is important

[8] "Estimating Changes in Supervisory Standards and Their Economic Effects," William F. Bassett, Seung Jung Lee, and Thomas W. Spiller. Federal Reserve Board, Divisions of Research and Statistics and Monetary Affairs, Finance and Economics Discussion Series, no. 2012–55. (http://www.federalreserve.gov/pubs/feds/2012/201255/201255pap.pdf).

to be cognizant that multiple factors are affecting small business credit demand and supply. Any proposed solutions should consider the combined effect of all of the factors involved.

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

HEARING: “EXAMINING THE POST-RECESSION SMALL BUSINESS LENDING ENVIRONMENT”

TESTIMONY OF JEFF STIBEL, CHAIRMAN AND CEO OF DUN & BRADSTREET CREDIBILITY CORP.

DECEMBER 5, 2012

Thank you Chairman Rice, Ranking Member Chu and the Committee for inviting me to testify on this important topic. By way of background, I am currently Chairman and CEO of Dun & Bradstreet Credibility Corp. Dun & Bradstreet Credibility Corp. is the leading provider of credit building and credibility solutions for businesses. Dun & Bradstreet Credibility Corp. provides the only real business credit monitoring solution available to companies looking to monitor and impact their own business credit profile. Our leading credit monitoring products are used by hundreds of thousands of companies interested in helping protect their business reputation. Dun & Bradstreet Credibility Corp. additionally resells D&B solutions that help businesses gauge their potential risk by tracking the credit and creditworthiness of the companies with which they do business.

Dun & Bradstreet Credibility Corp. is headquartered in Los Angeles, CA with offices throughout North America.

Current State of the Economy

Across the United States, businesses are recovering from the recession. The US GDP is expanding and the stock market is performing well. Our proprietary data shows similar progress. In order to effectively analyze the marketplace, we divide businesses into four categories by size: micro (less than $500,000 in annual revenue), small (less than $5 million in annual revenue), medium ($5 million to $100 million in annual revenue) and large (over $100 million in annual revenue). Across each of these categories, businesses are doing well and we are seeing strong growth in annual revenues.

But when you look at the specific categories, an interesting trend emerges. It turns out that the smaller the business, paradoxically the better the performance. This is in contrast to what most people believe is happening. Yet, the numbers bear out the fact that the growth of sales are increasing the fastest in the smallest of businesses. The micro segment is performing best, followed by small, medium, and large. Small business growth is accelerating at a much faster pace than that of its larger counterparts. In 2013 alone, micro business revenue on average grew by 2.14% while small business revenue grew by 1.18%. Yet medium business revenue stayed relatively flat, losing 0.2% overall. The large businesses on average in our data decreased revenue by 1.56%.[1]

Current State of Job Growth

Despite the economic progress driven by business performance since the recession, the country has not recovered jobs at the same pace. Job growth, while improving, is slow by post-recession standards: The *New York Times* reported last year that percentage change in payroll, from business cycle trough to business cycle

[1] Proprietary data is composed of D&B Credibility Corp. data, and various other sources compiled by D&B Credibility Corp. for the year 2013.

peak, averaged from all previous recessions, is 15%.[2] For the current recovery it is 2%. By contrast, in an average recovery, corporate profits rise 38 percent from trough to peak. In this recovery, they have risen 45 percent. We have better than average profitability and much, much lower than average job growth.

Our proprietary data supports the conclusion that on average, job growth has been slow relative to other recessions. As with revenue growth, the lack of job growth is largely a tale of two economies. However, for job growth, it is the smallest businesses that are suffering, not thriving. Our data show that the rate of job growth is the lowest in the smallest business categories. In 2013, large businesses increased employment by 5.53%, medium-sized businesses increased employment by 0.93%, small businesses by 0.57%, and micro by only 0.44%.[3] It is a great paradox, an alarming problem, that even though small businesses are growing revenues at a faster pace, they are adding the fewest jobs.

Jobless Recovery is Due to Weak Hiring at the Small Business Level

Given that in past economic cycles, small businesses were the primary driver of employment growth, we can infer from our results that the disconnect between business success and job growth is one of the reasons for the "jobless recovery." When you dissect the data further and analyze revenues per employee, a proxy for productivity, the results bear out this conclusion. Employee productivity is rising at the fastest rate for the smallest businesses, as measured by sales growth per employee. From January to November 2013, micro businesses experienced 1.86% growth per employee, small businesses 0.75%, medium businesses -1.14%, and large businesses -6.72%.[4] (See attached figure.) The smaller the business, the greater the productivity gain on average per employee. Yet despite this gain in productivity, small businesses are not adding to their employment rosters at the same pace. Strong sales and greater productivity, without employment growth, yields a jobless recovery.

Small businesses not only employ almost half of the private sector, but they are also responsible for the lion's share of *new* jobs created. In the past 20 years, about two-thirds of all net new jobs were created by small businesses.[5] SBA data show that small businesses (those with 500 or less employees) amount to 99.7% of all businesses and employ 49.1% of private sector employment.[6] This means that small business job growth is critical after a recession.

Of those small businesses, microbusinesses are particularly important to job growth. According to the Association for Enterprise Opportunity (AEO), 92% of all U.S. businesses are microbusinesses.

[2] Catherine Rampell, "Is This Really the Worst Economic Recovery Since the Depression?, *New York Times*, August 10, 2012.
[3] Proprietary data is composed of D&B Credibility Corp. data, and various other sources compiled by D&B Credibility Corp. for the year 2013.
[4] Proprietary data is composed of D&B Credibility Corp. data, and various other sources compiled by D&B Credibility Corp. for the year 2013.
[5] SBA Office of Advocacy Frequently Asked Questions, Published September 2012.
[6] SBA Small Business Profile, Published February 2013.

Despite their size, the direct, indirect, and induced effects of these microbusinesses on employment amounted to 41.3 million jobs, or 31% of all private sector employment. "If one in three Main Street microbusinesses hired a single employee, the United States would be at full employment," the AEO reported in 2011 and reiterated in a new report last month.[7]

The Root Problem Is Access to Capital

We tend to equate job growth with business success but the reality is far more nuanced than that. Adding jobs is a capital investment, not a cash flow issue. Additional employees are hired for future growth, similarly to how business owners purchase computers, software, and other capital goods. Businesses may need to add jobs when revenues and profits rise but they cannot do so without a capital outlay.

For large businesses, the cost of employment is relatively low, so this point becomes largely academic. As revenues and profits rise, the largest businesses simply dip into their capital reserves to hire more people and grow their businesses. But small businesses do not have reserves significant enough to support new employment growth. It is a far bigger investment for a small business to hire an additional employee than for a larger business to do so. For microbusinesses, the situation is even more acute: adding a single employee to a microbusiness—where the average number of employees is 2.34 [8]—would require increasing payroll by nearly 50%. For a small business to increase hiring, they need access to capital.

Today, access to capital for small businesses is a significant problem. The data we've collected with our partners at Pepperdine University show a large discrepancy in access to capital across business size.[9] (See attached figure). The largest businesses are able to secure financing with relative ease and on strong terms, including historically low interest rates—the United States Federal Funds Rate is currently 0.25% and the WSJ Prime Rate is 3.25%.[10]

As business size gets smaller, access to capital shrinks dramatically. 66% of small business owners indicate that the current business-financing environment is restricting growth opportunities for their businesses, while only 44% of medium sized businesses feel this way. 74.2% of small business owners feel it is difficult to raise new external debt financing, while only 45.3% of medium size business owners feel this way.[11]

Our data show that 28% of micro, small, and medium sized businesses sought external financing in the past three months.[12] Of

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[7] "Bigger than You Think: The Economic Impact of Microbusiness in the United States," reported by Association for Enterprise Opportunity (AEO), 2013.

[8] Glenn Muske, Michael Woods, Jane Swinney and Chia-Ling Khoo, "Small Businesses and the Community: Their Role and Importance Within a State's Economy," *Journal of Extension,* Vol 45 (1): February 2007.

[9] Joint survey with the Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013

[10] Interest rate obtained from http://www.bankrate.com/rates/interest-rates/prime-rate.aspx.

[11] Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013

[12] Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013, p20

those, most (57.1%) sought a business bank loan.[13] The approval rates vary widely but the trend is consistent with our other data: 75% of medium-sized businesses who sought a bank loan were successful, as compared to 34% of small businesses and only 19% of microbusinesses.[14] Even alternative sources of capital that were once thought of as easy to acquire are becoming difficult for the smallest businesses in this environment. Of those business owners who attempted to acquire a business credit card, for example, in the past three months, only 51% of microbusinesses were successful, as compared to 62% of small businesses and 75% of medium-size businesses.[15] It is alarming that almost half of all microbusinesses in our data were unable to secure a business credit card, traditionally one of the easiest sources of capital.

Instead, micro and small businesses are turning to their personal assets to grow: our survey showed that 46% of micro business owners transferred personal assets to the business over the past three months, compared to 40% of small business owners and only 19.3% of medium business owners.[16] During the recession, these assets were largely frozen, but with the housing market recovering and personal debt expanding, this is a singular bright spot to the small business capital dilemma.

Ultimately, however, small businesses require business loans to succeed. Access to capital worsened significantly during the recession, but only for small businesses. Banks actually *increased* large business loans (defined by the FDIC as loans over $1 million) by 23% from 2007 (pre-recession) to 2012 (post-recession). During the same time period, they decreased small business loans (defined by the FDIC as loans $1 million and under) by 14%.[17]

External data show that banks and other traditional sources are trying to increase their small business lending, but even here, this lending is geared mostly to the larger "small" businesses. Many big banks now consider a small business as having up to $20 million in revenues, and evidence suggests that they are lending to those businesses with revenues closer to $20 million than $1 million or less. The average SBA backed 7(a) loan in 2012 was $337,730. This is much more than the average microbusiness would require and likely greater than the needs of many smaller businesses. In fact, *Forbes* reported this year that one firm who surveyed their small businesses seeking loans found that 59% of them were looking for a loan amount of $50,000 or less.[18]

Even definitions of small business have changed. The problem of defining a small business is not a new one: the War Mobilization and Reconversion Act of 1944 defined a small business as either "employing 250 wage earners or less" or having "sales volumes,

[13] Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013, p24
[14] Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013, p23 plus Special PCA Index Survey Responses for Businesses with Annual Revenues Under $500K, p16.
[15] Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013, p23 plus Special PCA Index Survey Responses for Business with Annual Revenues Under $500K, p16.
[16] Pepperdine Capital Access Index Survey Responses, Fourth Quarter 2013, p27 plus Special PCA Index Survey Responses for Businesses with Annual Revenues Under $500K, p20.
[17] Federal Deposit Insurance Corporation, Statistics on Depository Institutions, June 2007 through June 2012.
[18] Ty Kiisel, "65 Percent Isn't Enough and Job Creation is Suffocating," *Forbes,* August 13, 2013.

quantities of materials consumed, capital investments, or any other criteria which are reasonably attributable to small plants rather than medium- or large-sized plants."[19] The SBA's size standards were changed as recently as July 2013, when it increased the average annual revenue size standard from $7 million to $35.5 million for 25 industries.[20] This encourages banks and other lenders to lend to larger firms, despite the need from the smallest segment of our business economy.

Without capital, small business will not be in a position to increase employment. This explains why our data show that even though small businesses have increasing revenues and remain optimistic, they are still not adding jobs. Jobs require capital but it is the largest businesses that are having the easiest time financing growth, while the smallest businesses have much less access. As a result, we are investing in the least productive sector of our economy, which is yielding weak job growth. Improving small business access to capital would make the most positive economic impact.

Solving the Problem: Reduce Lending Risks to and for SMBs

The good news is that the problem is relatively clear: small business need access to capital in order to increase job growth. The solution, of course, is somewhat illusory. Previous attempts have focused on lowering interest rates but that is not the solution. Banks do not focus primarily on interest rate reductions in making lending decisions; they pass these costs on to businesses. Businesses in turn are not as focused as we might think on rates. We do not hear businesses complaining about high interest rates. In fact, many smaller businesses end up turning to alternative lending sources with very high rates and very high satisfaction. The solution, instead, lies with reducing risk, from both the lending side and the borrowing side.

1. On the lending side, we've observed that banks are risk adverse. In general, the larger the business, the less likelihood of a complete loan default. Hence, banks tend to focus on lending to larger businesses. The government has tried to stem this trend with positive results by providing backstops through the Small Business Administration. The SBA currently guarantees 85% of the value of loans up to $150,000 and 75% of the value of loans of more than $150,000. While this has had a positive effect on small business lending, small business lending may benefit from having that distinction be focused, not on loan size, but on business size. For example, the SBA could guarantee 85% of the loan value for microbusinesses, 75% for small businesses, 50% for medium-sized businesses, and zero for larger companies. This would effectively tier the risk for banks and incentivize them to lend to the smallest and most productive businesses.

2. On the borrowing side, many small business owners are hesitant to take out loans with personal guarantees. The SBA, tradi-

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[19] Robert Jay Dilger, "Small Business Size Standards: A Historical Analysis of Contemporary Issues," Congressional Research Service, June 20, 2013.

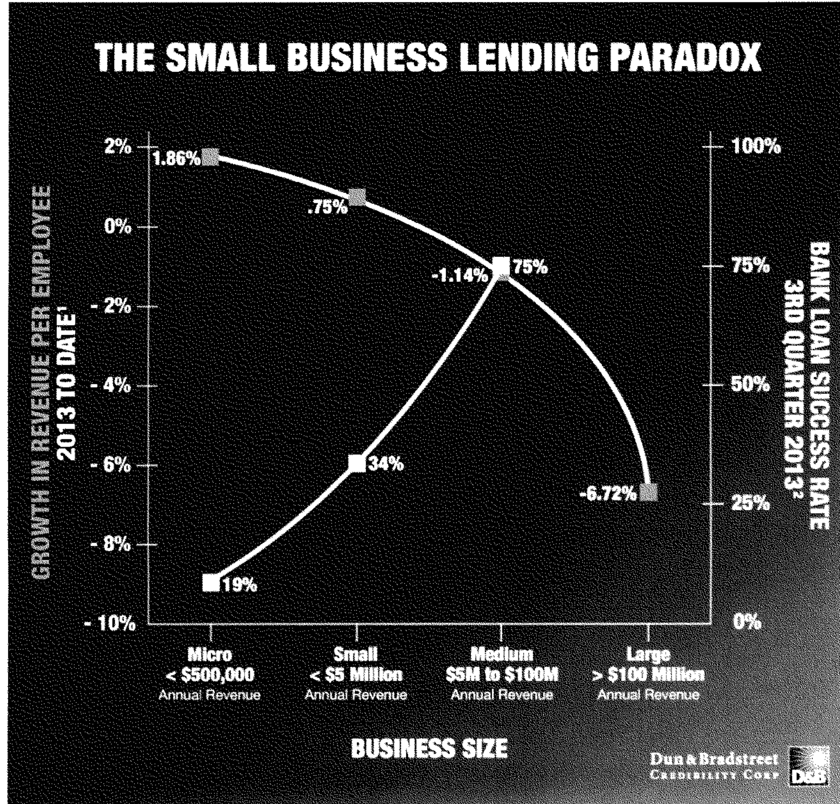
[20] Jack Fitzpatrick, "SBA Revises Small Business Size Standards," *USA Today,* June 21, 2013.

tional banks, and even many alternative lenders require personal guarantees. For example, the SBA requires all owners of 20 percent or more of the equity in a business to offer a personal guarantee, and may even require liens on personal assets.[21] When banks require personal guarantees for a business loan, that loan is essentially the same as a personal loan. In effect, our economy has no concept of business loans for small businesses: we only offer personal loans. The most savvy of business owners know this and it is why our data shows that many owners avoid business loans in favor of easier and cheaper personal loans that carry the same risk. This policy is costing the economy growth and our nation jobs.

We believe strongly that helping small businesses access capital is vital to our nation's recovery, and we have made this one of our missions at Dun & Bradstreet Credibility Corp. We launched our Access to Capital initiative in an effort to foster business lending and educate small business owners on the many types of financing that may be available to them. We have held four successful events in the past year, and have helped thousands of small business owners sit down for one-on-one meetings with traditional and alternative lenders, resulting in tens of millions in loan originations. We are also a partner in the Clinton Global Initiative, where we have provided over $2.5 million in free products and services to small businesses across the country who are in need of our credit building solutions but cannot afford them.

The best solutions occur when government and the private sector work together. The government has already done a great deal for its part. For small businesses, the government can even further and profoundly influence the growth of revenues and jobs by reducing risk on both sides of the equation.

[21] 7(a) loan repayment terms from Sba.gov.



[1] Source: D&B Credibility Corp. proprietary data for the year 2013.
[2] Source: Joint survey by D&B Credibility Corp. and Pepperdine University, Capital Access Index Survey, Fourth Quarter 2013.

Testimony of

Renaud Laplanche

Founder & CEO

Lending Club

before the

Subcommittee on Economic Growth, Tax and Capital Access

of the

Committee on Small Business

United States House of Representatives

5th December, 2013

My name is Renaud Laplanche and I am the founder and CEO of Lending Club, a credit platform that employs over 300 people in San Francisco. My father was a small business owner; he owned a grocery store in a small town in France and I spent every day of my teenage years from 5 am until 8 am before class helping him in the store. After having started two companies in New York and San Francisco, residing in the US for the past 14 years and starting a family here, I recently passed my citizenship test and will soon be a US citizen. Testifying before this Committee on the state of small business lending in America is a special moment for me.

Small Businesses are not only a driving force in the US economy; they are an essential part of the American Dream. I believe it is our shared responsibility to ensure that these businesses and their owners have sufficient access to capital on fair terms.

I have two points I hope to convey to you today. First, small businesses have insufficient access to credit, and that situation is worsening. Second, their credit performance as a group suggests that they should be getting more credit.

1. Small businesses have insufficient access to capital and that situation is getting worse.

A survey released by the Federal Reserve Bank of New York in August of this year was the latest to paint a grim picture of availability of credit to small businesses. Access to capital was reported as by far the biggest barrier to growth. Out of every 100 small businesses, 70 wanted financing. Of those 70, 29 were too discouraged to apply. Of the 41 that applied for credit, only 5 received the amount they wanted. Substantially all of these businesses (93%) were looking for $1M or less in capital. [NY Fed]

This situation has not gotten better: while the overall volume of loans of more than $1M has risen slightly since 2008, loans of less than $1M have fallen by 19%. The number of small businesses with a business loan fell by 33% from 2008 to 2011. [NFIB]

The problem is worse for the smallest businesses. While businesses with 20+ employees reported an increase in bank loans from 2009–2011, the majority of small businesses, which have fewer than 20 employees, reported a decline with the smallest businesses suffering the steepest decline. Businesses with 2–4 employees reported a 46% reduction in bank loans over the same period. [NFIB]

While traditional sources of capital have pulled back, alternatives are on the rise. Alternative lenders such as online lenders and merchant cash advance providers are the fastest-growing segment of the SMB loan market—recording a 64% growth in originations in the last 4 years. [Paynet] Many of these alternative lenders, however, charge fees and rates that result in annual percentage rates generally in excess of 40% and, without full transparency, business owners don't always understand the true cost of the loan. This lack of understanding can be very harmful to a small business, which could find itself in a spiral of inescapable debt service.

2. Small Business Loan Performance is Doing Just Fine.

Charge-off rates on small business loans have been below 1% since March 2012, down from a peak of nearly 3% in 2009. [SBFE] In contrast, charge off rates on consumer credit cards peaked above 10% during the financial crisis.

These figures show that absolute loan performance is not the main issue of declining SMB loan issuances; we believe a larger part of the issue lies in high underwriting costs. SMBs are a heterogeneous group and therefore the underwriting and processing of these loans is not as cost-efficient as underwriting consumers, a more homogenous population. Business loan underwriting requires an understanding of the business plan and financials and interviews with management that result in higher underwriting costs, which make smaller loans (under $1M and especially under $250k) less attractive to lenders. By contrast, larger loans—going mostly to larger businesses—are more attractive, as they allow underwriting costs to be amortized over a larger amount and longer loan term.

We believe we have solutions to bring underwriting costs down and create the conditions for credit to become more available and more affordable to small businesses in America, and would be honored to answer the Subcommittee questions in that regard.

Testimony of

Fred Green

before the

Subcommittee on Economic Growth, Tax and Capital Access

of the

Committee on Small Business

United States House of Representatives

Testimony of

Fred Green

before the

Subcommittee on Economic Growth, Tax and Capital Access

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Committee on Small Business

United States of Representatives

Dcember 5, 2013

Chairman Rice, Ranking Member Chu, and members of the Committee, my name is Fred Green. I am President and Chief Executive Officer of the South Carolina Bankers Association. We are the professional trade association that has represented South Carolina's banks for over 110 years. Our members are both large and small and collectively have over 99% of the deposit market share in our state.

I am pleased to share the banking industry's perspective on the state of the small business lending environment.

It is well-documented how crucial small businesses are to the national economy. Studies produced by the Small Business Administration demonstrate that small businesses account for over half of all jobs in the U.S. and this share of total employment has been fairly stable over the past few decades. More importantly, small businesses account for as much as 65 percent of net new jobs created over the past 15 years and most new job growth during economic recoveries occurs at new and small firms. Small firms and start-ups promote innovation because they are more flexible and often more daring than larger businesses.

Banks are the primary lender to small businesses and their presence in local communities throughout our nation is critical to meeting the unique needs of new and developing companies. There is a symbiotic relationship between the health of a community and the health of the banks located there. It is why small business lending is an important part of every bank's strategy and why banks today provide more than 20 million small business loans.

Loan demand has improved since the recession, however remains at relatively weak levels, held back by tremendous uncertainty about the future. Concerns over changes to taxes, employment costs and regulation make small business owners less interested in expanding and incurring new debt. Businesses simply are not willing to take on additional debt with so much uncertainty about the economic future they face.

Despite the low loan demand, banks continue to meet the needs of their customers. In every community, banks are actively lending and continually looking for lending opportunities. After declines in loan portfolios since the pre-recession peak, recent FDIC call report data shows that outstanding loans have been growing over the last 12 months. The presence of banks in communities throughout our nation is critical to meeting the unique needs of small businesses.

Historically, small business loans have been more risky than other loan types. Small business loan portfolios' credit metrics are improving but are still below pre-recession levels. Underwriting standards have forced banks to secure more of these loans with collateral. The smaller loans, generally $250,000 and less, are underwritten primarily on the owner's financial strength and personal assets. Since real estate is the primary personal asset for many small business owners, and real estate has decreased in value, this presents another challenge for banks.

Banks also face another challenge in providing loans to meet their customer's needs with the most recent wave of regulations. The cumulative impact of hundreds of new or revised regulations may be a weight too great for many small banks to bear. Congress must be vigilant in its oversight of the efforts to implement the Dodd-Frank Act to ensure that rules are adopted only if they result in a benefit that clearly outweighs the burden. Some rules under Dodd-Frank, if done improperly, will literally drive banks out of lines of business.

This last point is very important. It is not that these regulations will just increase compliance costs for banks, but banks are now, in their strategic planning, being forced to consider the elimination of certain products to which customers have grown accustomed. In South Carolina we recognized this growing concern and held a special conference for top bank executives recently to address significantly stricter mortgage regulations and capital standards banks will find themselves facing beginning next year. Some community banks have already told us they will most likely have to stop offering residential mortgage products because of these new lending regulations. And as we all know, fewer participants in the market means fewer options for consumers. For many, these community banks are the only option. In fact, community banks are the only physical banking presence in one fifth of the counties in the U.S. The calculus is fairly simple: More regulation means more resources devoted to regulatory compliance, and the more resources devoted to regulatory compliance, the fewer resources are dedicated to doing what banks do best—meeting the credit needs of local communities. Every dollar spent on regulatory compliance means as many as ten fewer dollars available for creditworthy borrowers. Less credit in turn means businesses can't grow and create new jobs. As a result, local economies suffer and the national economy suffers along with them.

In my testimony today, I'd like to make three key points:

- **Demand for Business Loans Remains Weak Due to Uncertainty.**
- **Banks are Making New Loans, Meeting Demand.**

- **New Regulations Threaten Banks' Ability to Meet Customer Demand.**

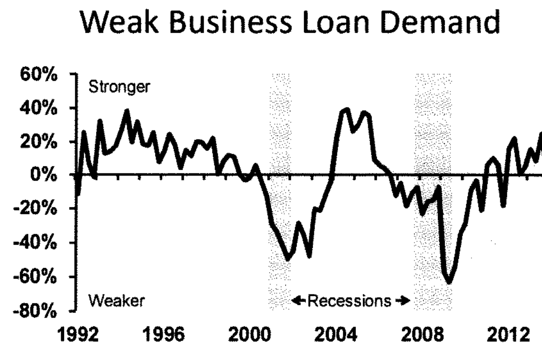
I will discuss each of these in detail in the remainder of my testimony.

Demand for Business Loans Remains Weak Due to Uncertainty

Loan demand has steadily improved since the recession, however remains at relatively weak levels. Although the economy continues its slow recovery, there remains tremendous uncertainty about the future. This uncertainty, particularly relating to potential changes to taxes and regulation makes borrowers less interested in adding new debt.

Small business sentiment has yet to recover from the recession. The National Federation of Independent Business's (NFIB) Small Business Optimism Index remains at depressed levels, and has yet to surpass pre-recessionary lows going as far back as 1980. Moreover, optimism has not seen any significant improvement in the past two years.

As a result, businesses are not looking to expand. In the NFIB's October survey, just 6 percent of small businesses see now as a good time to expand. In fact, 59 percent of the respondents cited the economic conditions and political climate alone as the reason not to expand. If businesses are not expanding, they are not taking out loans to fund expansion.



In South Carolina, our banks are reporting the same—that there is some demand, but economic uncertainty and the political climate are holding businesses back from making capital investments to grow their businesses.

Most bankers state that demand is low particularly from companies with stronger credit profiles. Financially strong companies are holding back because of the uncertainty generated by the debate on the budget and the debt ceiling; and over healthcare cost concerns.

Higher employment costs such as healthcare, taxation and labor are bigger issues than most realize, especially for the small-business owner. Our bankers repeatedly report speaking to companies that are cutting employees to get below the 50-worker threshold. For these businesses, that means no expansion and therefore a limited need for bank funding for expansion. One banker reported a common example. This banker had banked the local owners of seven fast-food restaurants. The owners recently refinanced all term debt and extended amortization to provide better debt coverage in preparation for the impact of increased healthcare costs. They currently have approximately 150 full time employees and 50 part time employees. They plan to cut full time employment by at least 50 percent and offset that by increasing their part time staff. In addition, they have put all expansion plans on hold. Another business owner is outsourcing instead of expanding and hiring new employees. He cites concerns over the rising cost of healthcare as one thing that keeps him from growing his employment base.

Due to this uncertainty and apprehension about the future, small business owners' loan levels have decreased. This leaves bankers to aggressively seek what little business is available, often taking business from one another; rather than seeing an expansion of the business market to pre-recession levels due to increased borrowing. Even though the resulting pricing and terms from this competition are very favorable to borrowers, lending levels remain low due to the lack of confidence on the part of small business owners, not banks' unwillingness to lend.

Business thrives when there is a level of stability in the economy. The unknowns associated with providing health care to employees is just one of many concerns in what business owners see as a confusing and convoluted environment.

Businesses simply are not willing to take on additional debt with so much uncertainty about the economic future they face. In fact, utilization of existing line commitments remains low at around 50 percent. Said differently, business owners are using only 50 percent of the dollar loan commitments already in place.

Banks are Making New Loans, Meeting Demand.

In every community, banks are actively lending and continually looking for lending opportunities. In spite of the slowly recovering pace of the economy, recent FDIC call report data shows that outstanding loans have been growing over the last 12 months and that after several years of contraction, the overall portfolio of small business loans has stabilized. The presence of banks in communities throughout our nation is critical to meeting the unique needs of small businesses.

Financing Least Cited Concern For Small Businesses

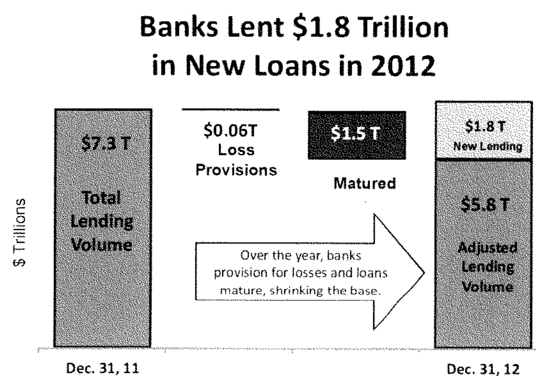
Single Most Important Problem	Share of Respondents
Government Requirements & Red Tape	21
Taxes	20
Poor Sales	17
Cost/Avail. Of Insurance	8
Quality of Labor	8
Competition From Large Business	8
Other	8
Cost of Labor	5
Inflation	3
Financing & Interest Rates	2

Source: National Federations of Independent Business, as of October 2013

In fact, banks are meeting the majority of loan demand of small businesses. In the NFIB's October 2013 Small Business Optimism Index, financing and interest rates were the least cited concern facing small businesses. In fact, just two percent of respondents identified this as their chief concern, a survey low. On the other hand a combined 41 percent of respondents cited government requirements or taxes as their greatest concern.

Banks still continue to make loans to creditworthy borrowers, constantly assessing whether some businesses can reasonably take

on more debt in this economy. In 2012 alone, banks made $1.8 trillion in new loans and business loan volumes have grown by 10 percent in the past year alone.



The pace of business lending is affected by many things, most importantly being the demand from borrowers. The state of the local economy—including business confidence, business failures, and unemployment—and regulatory pressures to be conservative plays important roles too. The rise in new credit means that businesses are borrowing more from banks and using that money to grow and improve the economy.

New Regulations Threaten Banks' Ability to Meet Customer Demand.

Banks are currently contending with a wave of new regulations. During the last decade, the regulatory burden for community banks has multiplied tenfold, with more than 50 new rules in the two years before Dodd-Frank. And with Dodd-Frank alone, there are more than 5,500 pages of proposed regulations and 6,700 pages of

final regulations (as of November 19, 2013). What is frightening to consider is that we are not even half way through Dodd-Frank's 398 rules that must be promulgated under the new law.

In many cases, the cumulative impact of the last few years of new regulation threatens to undermine the community bank model. Banks certainly appreciate the importance of regulations that are designed to protect the safety and soundness of our institutions and the interests of our customers. We recognize that there will always be regulations that control our business. But the reaction to the financial crisis has layered regulation upon regulation, doing little to improve safety and soundness and, instead, increasing our operating costs and handicapping our ability to serve our communities.

Community banks pride themselves on being agile and quick to adapt to changing environments. During the recession, banks tightened lending standards. Even though underwriting has loosened some, it is still tighter than before. Yet what will discourage loosening underwriting standards even further are the regulatory pressures on small community banks, the banks that make the majority of the small business loans. New laws or regulations might be manageable in isolation, but wave after wave, one on top of another, will undoubtedly overwhelm many community banks. Given that the cost of compliance has a disproportionate impact on small banks as opposed to large banks, it is reasonable to expect this gap to widen even more as Dodd-Frank is fully implemented.

The cumulative impact of hundreds of new or revised regulations may be a weight too great for many small banks to bear. Congress must be vigilant in its oversight of the efforts to implement the Dodd-Frank Act to ensure that rules are adopted only if they result in a benefit that clearly outweighs the burden. As mentioned earlier, some rules under Dodd-Frank, if done improperly, will cause many banks to eliminate or drastically limit products and services many businesses have used for years. New rules on mortgage lending, for example, are particularly problematic.

In dramatic illustration of this point, a 2011 ABA survey of bank compliance officers found that compliance burdens have caused almost 45 percent of the banks to stop offering some loan or deposit products. In addition, almost 43 percent of the banks decided to not launch a new product, delivery channel or enter a geographic market because of the expected compliance cost or risk.

The bottom line is this—additional regulations mean more resources devoted to compliance, and dollars directed toward compliance are dollars that can't be directed toward meeting the credit needs of local communities. Banks understand regulation is necessary, but they also understand that burdensome regulation ultimately means they have fewer dollars to lend, which means less opportunity for businesses to grow and create new jobs. As a result local economies suffer and the national economy suffers along with them.

Conclusion

Banks in South Carolina and across the nation are eager to serve the financing needs of small businesses. They understand they play a critical role in their local economies and no bank has or wants to stop pursuing small-business lending. Yet, small businesses remain very hesitant on the whole to embrace expansion due to economic uncertainty, concerns over healthcare and the political climate. Businesses that are ready to expand, hire and invest find themselves increasingly apprehensive as a result of the external turmoil and, as a result, have held off significantly from enacting growth plans.

This does not mean that banks are not making loans. Our economy is growing and banks are addressing financing needs. But these loans are being made to creditworthy borrowers with vanilla financials; businesses with financials that vary from norm, sometimes even in small measures, often finding themselves unable to secure financing.

Finally, regulatory pressures on banks have slowed banks' ability to provide their communities the economic financing they need. Regulations restrict what loans can be made and the amount of regulations greatly increase compliance costs, thus reducing the ability to lend. The bottom line is that while banks may be eager to lend, and business may be eager to grow, the environment that exists at present is hindering efforts by both to make transactions a reality. As such, it's not only banks and small businesses that are hurt, but communities as a whole.

Healthy, properly financed small businesses are absolutely critical to our communities' economies. Banks understand their role in this and continue to make every good loan they can, despite an increasingly difficult lending environment.

Thank you once again for the opportunity to testify.

Testimony of

John Farmakides

President/CEO of Lafayette Federal Credit Union

On behalf of

The National Association of Federal Credit Unions

"Where Are We Now? Examining the Post-Recession Small Business Lending Environment"

Before the

House Small Business Committee Subcommittee on

Economic Growth, Tax, and Capital Access

December 5, 2013

Introduction

Good morning, Chairman Rice, Ranking Member Chu and Members of the Subcommittee. My name is John Farmakides, and I am testifying on behalf of the National Association of Federal Credit Unions (NAFCU). Thank you for holding this important hearing today. I appreciate the opportunity to share our views on small business lending from a lender's perspective.

Currently, I serve as the President and CEO of Lafayette Federal Credit Union headquartered in Kensington, Maryland, a position I have held since 2007. Lafayette has a rich history of serving the greater Washington, D.C. area and was established in 1935 offering small personal loans to members. Today Lafayette has approximately 14,000 members, over 65 employees and more than $366 million in assets. We provide a full range of financial services including member business loans through several branches in Maryland, Virginia, and the District of Columbia. I have been an active member of the Lafayette community for over 20 years, serving on the supervisory committee as chairman and as treasurer of the board before being named President and CEO in 2007. I also have experience in investment banking and commercial real estate.

In addition to my responsibilities at Lafayette, I also currently sit on the Regulatory Committee at the National Association of Federal Credit Unions (NAFCU). As you may know, NAFCU is the only national organization that exclusively represents the interests of the nation's federally chartered credit unions. NAFCU member credit unions collectively account for approximately 68 percent of the assets of federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this important and timely discussion.

Background on Credit Unions

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche credit unions fill today for nearly 97 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 § USC 1752(1)). While over 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,

- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

The nation's approximately 7,000 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit unions have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided, but also—more importantly—to quality and cost of those services. Credit unions are second-to-none in providing their members with quality personal financial services at the lowest possible cost.

Impediments to Credit Union Business Lending

When Congress passed the *Credit Union Membership Access Act* (CUMAA) (P.L. 105–219) in 1998, it put in place restrictions on the ability of credit unions to offer member business loans (MBL). Credit unions had existed for nearly 90 years without these restrictions. Congress codified the definition of an MBL and limited a credit union's member business lending to the lesser of either 1.75 times the net worth of a well-capitalized credit union or 12.25 percent of total assets.

CUMAA also established, by definition, that business loans above $50,000 count toward the cap. This number was not indexed and has not been adjusted for inflation in the 15 years since enactment, eroding the *de minimis* level. Where many vehicle loans or small lines of credit may have been initially exempt from the cap in 1998, many of these types of loans that meet the needs of small business today are now impacted by the cap due to this erosion. To put this in perspective relative to inflation, what cost $50,000 in 1998 costs $71,639 today, using consumer price index data. That is a change that is completely ignored by current law and greatly hamstrings a credit union's ability to meet its members' needs.

The mere existence of an member business lending cap acts as a deterrent for credit unions to start an MBL portfolio knowing that as their program thrives they will face this arbitrary threshold and may have to turn members away. Furthermore, it should be

noted that those credit unions that do have an MBL program are disincentivized from offering working capital lines of credit given that, regardless of whether or not the line of credit is actually drawn, it still counts against the cap. As members of the subcommittee are aware, working capital lines of credit are critical to small companies as a way to meet day-to-day cash shortfalls and manage the needs of a growing business.

It should be noted that the government guaranteed portions of Small Business Administration (SBA) loans do not count toward the member business lending cap, but the non-guaranteed portions do. This could ultimately lead to a situation where a credit union may be an excellent, or even preferred, SBA lender and ultimately have to scale back participation in SBA programs as they approach the arbitrary cap. This would likely hit SBA Express or Patriot Express loans first, as those have lower guarantees and thus may have a bigger impact on money available below the cap. As you know, Patriot Express loans help give our nation's veterans more opportunities after they return from serving our country. The member business lending cap can deter the availability of those opportunities.

Also, pursuant to section 203 of CUMAA, Congress mandated that the Treasury Department study the issue of credit unions and member business lending. In January 2001, the Treasury Department released the study, "Credit Union Member Business Lending" and found the following: "...credit union's business lending currently has no effect on the viability and profitability of other insured depository institutions." (p. 41). Additionally, when examining the issue of whether modifying the arbitrary cap would help increase loans to businesses, the study found that "...relaxation of membership restrictions in the Act should serve to further increase member business lending..." (p. 41).

The 2001 Treasury study found that credit unions do not pose a threat to the viability and profitability of banks, but that in certain cases, they could be an important source of competition for banks. It is important to note that credit unions have a nominal market share of the total commercial lending universe (approximately 6% of all small business loans from insured depository institutions), and are not a threat to other lenders (who control nearly 94% of all small business loans from insured depository institutions) in this environment.

A 2011 study commissioned by the SBA's Office of Advocacy affirms these findings. (James A. Wilcox, *The Increasing Importance of Credit Unions in Small Business Lending,* Small Business Research Summary, SBA Office of Advocacy, No. 387 (Sept. 2011)). The SBA study also indicates, importantly, that credit union business lending has increased in terms of the percentage of their assets both before and during the 2007–2010 financial crisis while banks' has decreased. This demonstrates not only the need for lifting the cap in order to meet credit union members' demand, but also that credit unions continue to meet the capital needs of their business members even during the most difficult of times. One of the findings of the study was that bank business lending was large-

ly unaffected by changes in credit unions' business lending. Additional analysis is the study also found that credit unions' business lending can actually help offset declines in bank business lending during a recession.

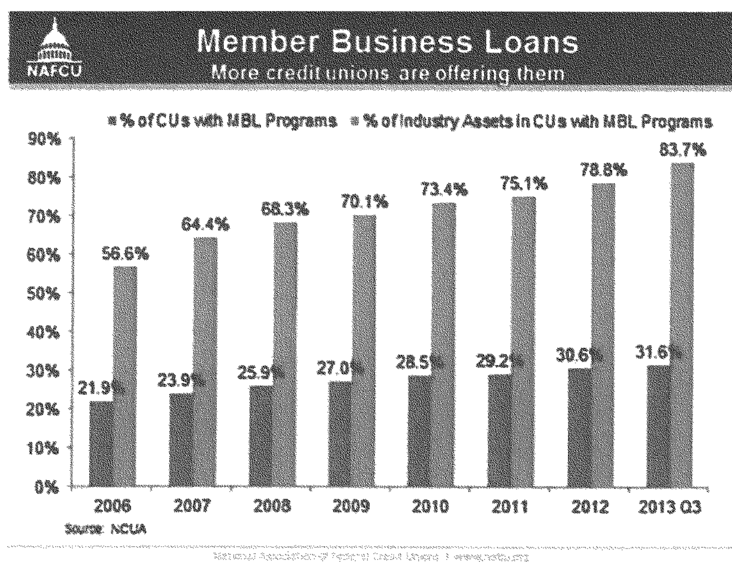
Bipartisan legislation to address this issue, in the form of H.R. 688, the *Credit Union Small Business Jobs Creation Act,* is pending before the Financial Services Committee. Introduced by Reps. Ed Royce (R-CA) and Carolyn McCarthy (D-NY) this legislation would raise the current 12.25% limit to 27.5% for credit unions that meet certain criteria. One alternative to the approach in H.R. 688 would be to raise the outdated "definition" of an MBL from last century's $50,000 to a new 21st century standard of $250,000, with an indexing of inflation to prevent future erosion. Furthermore, MBLs made to non-profit religious organizations, made for certain residential mortgages (such as non-owner occupied 1–4 family residential mortgages), made to business in "underserved areas" or made to small businesses with fewer than 20 employees should be given special exemptions from the cap.

The ever-growing regulatory burden being placed on credit unions also serves to hamper the ability of credit unions to make business loans, as capital is diverted from lending to compliance costs. In early February of this year, NAFCU was the first credit union trade association to formally call on the new Congress to adopt a comprehensive set of ideas generated by credit unions that would lead to meaningful and lasting regulatory relief for our industry (A copy of the letter is attached to my testimony). Based on feedback from our membership and the strong expectation for future growth, regulatory relief on the member business lending front is a key component of NAFCU's five-point plan. Another important aspect of this proposal is capital reforms for credit unions, such as establishing a risk-based capital system and allowing credit unions to seek access to supplemental capital. Providing regulatory relief on these fronts will help make sure credit unions continue to have the capital available to lend our nation's small businesses.

The Member Business Lending Environment Post Financial Crisis

A November 2013, survey of NAFCU members found that member business lending is expected to grow over the next twelve months. On a scale that goes from -100 to +100 (where zero indicates flat growth), the August-October median growth expectation for credit unions regardless of geographic location was 35.6. Furthermore, asset quality continues to improve for member business loans at credit unions, with charge-offs down to only 0.38%.

As illustrated in the graph below, the percentage of credit unions with member business lending programs has been rising steadily since the financial crisis.



While other lenders pulled back on business lending during the economic downturn, credit unions continued to lend to their small business members. Furthermore, as those small business members lost lines of credit from other lenders, they turned to credit unions to help meet their needs, leading to an increased demand for credit union business loans.

Member Business Lending at Lafayette Federal Credit Union

Lafayette has seen a need arise from our small business members to get lines of credit that they have lost from other lenders. As a result, we have expanded our focus into this area in 2013. For example, we gave a $125,000 line of credit to a local bike rental and touring company to help with their cash flow due to the cyclical nature of their business. This loan helps them maintain their 8–10 full-time employees in the off-season (which then grows to 50–60 in season).

While our credit union proudly meets our local communities' lending needs, the arbitrary member business lending cap is now having a direct negative impact on how well we can serve our members. Many small businesses come to us looking for large lines of credit to help them meet cyclical challenges. However, any line of credit above $50,000 counts toward our member business lending cap, even if the funds are not extended. This fact hampers our ability to meet the needs of many of our small business members.

So far in 2013, we have done ten commercial and industrial member business loans averaging out at about $61,000 each, evidence that most are considered small but are still "large" enough to count against the arbitrary cap. Many of our loans in this area tend to be lines of credit advances aimed at financing for cash flow purposes or startup costs. We have also been able to assist very small traditional companies like a specialty bakery with a single employee-owner and a trucking delivery service. At the same time, we have made loans to several consulting firms related to government contracting as well as an innovative solar energy appliance company.

It is worth noting that Lafayette takes our MBL program very seriously and we have recruited the appropriate personnel with the appropriate experience to ensure it is sound and successful. While others in the financial services industry may claim credit unions aren't sophisticated enough or able to attract the correct personnel to make member business loans, this is simply a misnomer.

SBA Lending at Lafayette Federal Credit Union

Small businesses are the backbone of our economy and an important source of jobs for Americans. The Small Business Administration's loan programs serve as an important resource that helps credit unions provide small businesses with the vital capital necessary for growth and job creation. However, utilizing any SBA loan guaranty program requires meeting stringent government regulations. While we are an approved SBA 7(a) lender, we currently have just one SBA 504 loan outstanding, and one USDA Business & Industry loan outstanding.

Determining overall applicant eligibility to participate in an SBA program is nearly as important as determining the applicant's creditworthiness. Failing to meet certain eligibility criteria may preclude the applicant from participating in an SBA guaranteed loan program. Eligibility criteria includes among other things: size

restrictions, type of business, use of proceeds, credit standards, and meeting a 'credit-elsewhere' test.

If Congress and the SBA were to make it easier for credit unions to participate in these programs, small businesses throughout the nation will have greater access to capital at a time when it is needed most. NAFCU would support SBA loans being permanently exempted from counting against a credit union's MBL cap in full. These suggested changes, which allow credit unions to do more to help our nation's small businesses, are an important step to help our nation recover from the current economic downturn.

Conclusion

Small businesses are the driving force of our economy and they key to its success. The ability for them to borrow and have improved access to capital is vital for job creation. Credit unions play an important role in helping our nation's small businesses get the access to funds that they need. We want to do more, however, we are hamstrung by an outdated artificial member business lending cap that ultimately hurts small businesses. We urge the subcommittee to support legislation to make it easier for credit unions to meet the business lending needs of their members and to expand participation in SBA programs.

We thank you for your time and the opportunity to testify before you here today on this important issue to credit unions and our nation's economy. I would welcome any questions that you may have.

Attachment: NAFCU letter to Chairman Johnson, Chairman Hensarling, Ranking Member Crapo and Ranking Member Waters calling on Congress to provide credit union regulatory relief; February 12, 2013.

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Fred R. Becker, Jr.
President/CEO

February 12, 2013

The Honorable Tim Johnson
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Michael Crapo
Ranking Member
Senate Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

Re: NAFCU Calls on Congress to Provide Regulatory Relief for Credit Unions

Dear Chairman Johnson, Chairman Hensarling, Ranking Member Crapo and Ranking Member Waters:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, I write today to call for Congressional action during this session of the 113th Congress to enact broad-based regulatory relief that is essential to the credit union industry's ability to serve its 95 million members.

Our nation's credit unions are struggling under an ever-increasing regulatory burden that must be immediately addressed. A survey of NAFCU members late last year found that 94% have seen their regulatory burden increase since the passage of the *Dodd-Frank Act* in July 2010. The regulatory onslaught continues to compound as credit unions now have over 5,000 pages of rules from the Consumer Financial Protection Bureau (CFPB) that they must understand, interpret, and ultimately comply with – despite the fact that Congress has widely acknowledged that credit unions were not the cause of the financial crisis. Credit unions, many of which have very small compliance departments, and in some cases only one compliance officer, must comply with the same rules and regulations as our nation's largest financial institutions that employ armies of lawyers. The impact of the ever-increasing regulatory burden is even more sobering, as the number of credit unions continues to decline. There are nearly 700 fewer credit unions today than there were before the passage of the *Dodd-Frank Act.*

It is with this regulatory onslaught in mind that we call on Congress to enact meaningful regulatory reforms and provide much needed assistance to our nation's credit unions. Over the past year, we have been actively conversing with our member credit unions to identify those areas where regulatory relief is requisite.

Our ongoing discussions with our members have led us to draft a five point plan for credit union regulatory relief:

I. Administrative Improvements for the Powers of the NCUA

We believe there are changes that must be made to strengthen and enhance the National Credit Union Administration (NCUA).

First, the NCUA should have authority to grant parity to a federal credit union on a broader state rule, if such a shift would allow them to better serve their members and continue to protect the National Credit Union Share Insurance Fund.

Second, the NCUA should have the authority to delay the implementation of a CFPB rule that applies to credit unions, if complying with the proposed timeline would create an undue hardship. Furthermore, given the unique nature of credit unions, the NCUA should have authority to modify a CFPB rule for credit unions, provided that the objectives of the CFPB rule continue to be met.

Third, the NCUA and the CFPB should be required to conduct a look-back cost-benefit analysis on all new rules after three years. The regulators should be required to revisit and modify any rules for which the cost of complying was underestimated by 20% or more from the original estimate at the time of issuance.

Fourth, new examination fairness provisions should be enacted to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation.

Finally, the Central Liquidity Facility (CLF) should be modernized with changes such as: (1) removing the subscription requirement for membership, and (2) permanently removing the CLF borrowing cap so that it may meet the current needs of the industry.

II. Capital Reforms for Credit Unions

NAFCU believes that capital standards for credit unions should be modernized to reflect the realities of the 21st century financial marketplace.

First, the NCUA should, with input from the industry, study and report to Congress on the problems with the current prompt corrective action (PCA) system and recommended changes.

Second, a risk-based capital system for credit unions that more accurately reflects a credit union's risk profile should be authorized by Congress.

Third, the NCUA should be given the authority to allow supplemental capital accounts for credit unions that meet certain standards.

Finally, given that very few new credit unions have been chartered over the past decade, and in order to encourage the chartering of new credit unions, the NCUA should be authorized to further establish special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

III. Structural Improvements for Credit Unions

NAFCU believes there should be improvements to the *Federal Credit Union Act* to help enhance the federal credit union charter.

First, Congress should direct the NCUA, with input from the industry, to study and report back to Congress suggested changes to outdated corporate governance provisions in the *Federal Credit Union Act*. Congress should then act upon those recommendations.

Second, a series of improvements should be made to the field of membership (FOM) restrictions that credit unions face expanding the criteria for defining "urban" and "rural"; and allowing voluntary mergers involving multiple common bond credit unions and allowing credit unions that convert to community charters to retain their current select employee groups (SEGs).

Finally, all credit unions, regardless of charter type, should be allowed to add underserved areas to their field of membership.

IV. Operational Improvements for Credit Unions

Credit unions stand willing and ready to assist in our nation's economic recovery. Our industry's ability to do so, however, is severely inhibited by antiquated legislative restrictions.

First, Congress should show America that they are serious about creating jobs by modifying the arbitrary and outdated credit union member business lending (MBL) cap. This can be done by raising the current 12.25% limit to 27.5% for credit unions that meet certain criteria or by raising the outdated "definition" of a MBL from last century's $50,000 to a new 21st century standard of $250,000, with indexing for inflation to prevent future erosion. Furthermore, MBLs made to non-profit religious organizations, businesses in "underserved areas", or small businesses with fewer than 20 employees should be given special exemptions for the arbitrary cap.

Second, requirements to mail redundant and unnecessary privacy notices on an annual basis should be removed, provided that the credit union's policy has not changed and additional sharing of information with outside entities has not been undertaken since the distribution of the previous notice.

Third, credit unions should be given greater authority and flexibility in choosing their investments.

Fourth, the NCUA should be given greater flexibility in how it handles credit union lending, such as the ability to establish longer maturities for certain loans.

Finally, Congress should clarify that Interest on Lawyers Trust Accounts (IOLTAs) at credit unions are fully insured and also that the NCUA should have practical requirements on how credit unions provide notice of their federally-insured status in any advertising.

V. 21st Century Data Security Standards

Credit unions are being adversely impacted by ongoing cyber-attacks against the United States and continued data breaches at numerous merchants. The cost of dealing with these issues hinders the ability of credit unions to serve their members. Congress needs to enact new 21st century data security standards that include: the payment of costs associated with a data breach by those entities that were breached; establishing national standards for the safekeeping of all financial information; require merchants to disclose their data security policies to their customers; requiring the timely disclosure of entities that have suffered a data breach; establishing enforcement standards for provisions prohibiting merchants from retaining financial data; requiring the timely notification of the account servicer if an account has been compromised by a data breach; and, requiring breached entities to prove a "lack-of-fault" if they have suffered from a data breach.

We have outlined a number of proposals that are necessary to providing the regulatory relief and assistance that credit unions urgently require. The number of credit unions continues to decline on a monthly basis and the ever-increasing regulatory burden the industry is facing is accelerating that decline as compliance costs become even more onerous. It is with that in mind that we call on Congress to act on any and all of these proposals, whether as a comprehensive package, or individually. Our nation's credit unions and their 95 million members desperately need this relief and we call on Congress to enact it.

Thank you for your attention to this important matter.

If you have any questions or would like further information about any of these issues, please do not hesitate to contact me or NAFCU's Executive Vice President of Government Affairs Dan Berger by telephone at (703) 842-2203 or by e-mail at dberger@nafcu.org.

Sincerely,

Fred R. Becker, Jr.
President and CEO

cc: Members of the Senate Banking Committee
Members of the House Financial Services Committee

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December 5, 2013

The Honorable Tom Rice
Chairman
Subcommittee on Economic Growth, Tax and Capital Access
United States House of Representatives
Washington, DC 20515

The Honorable Judy Chu
Ranking Member
Subcommittee on Economic Growth, Tax and Capital Access
United States House of Representatives
Washington, DC 20515

Dear Chairman Rice and Ranking Member Chu:

On behalf of the Credit Union National Association (CUNA), I commend you for holding a hearing on examining the post-recession small business lending environment. Credit unions share the Small Business Committee's goal of increasing small business access to capital through the reduction of statutory and regulatory impediments. CUNA is the largest credit union advocacy organization in the United States, representing America's state and federally chartered credit unions and their 98 million members.

As you may know, since their inception in the United States more than 100 years ago, credit unions have been offering business loans to their members. Since 1998, credit unions have operated under a statutory cap on business lending, which limits business lending at most credit unions to 12.25% of assets. Despite this cap, at the end of 2012, credit unions had $43.2 billion in business loans outstanding. While it is not the primary book of business for most credit unions, it has been the fastest growing type of credit union lending over the last several years.

In fact, bank commercial lending to small businesses (defined as loans less than $1 million dollars) has fallen from $756 billion in June of 2007 to only $653 billion today, a 13.6% decline. Bank loans of this type declined each year for the following five years, according to FDIC data. Meanwhile, credit union lending for member business loans (MBLs) rose from $26 billion in June of 2007 to $45 billion today, a 73% increase. As credit unions stepped up and filled the lending void created by banks pulling back in the small business loan arena, credit union market share rose from 3.3% in 2007 to 6.5% today, according to NCUA data.

There is no doubt that there has been a reduction in the demand for business credit as a result of the recession and the slow economic recovery. According to a recent Pepperdine Private Capital Access Index study,[1] 60% of small businesses say the current business financing environment is restricting growth opportunities and 48% of small businesses say the current business financing environment is restricting their ability to hire new employees. However, there is also evidence that a significant contraction in the supply of business credit has contributed to the reduction in credit outstanding.

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[1]Pepperdine Private Capital Access Index. "PCA Index Survey Responses, Third Quarter 2013". The Graziadio School of Business and Management, Pepperdine University. Presented by: Craig Everett, Ph.D., MBA, Assistant Professor of Finance and Associate Director of the Pepperdine Private Capital Markets Project. Available on the Internet at: http%3A%2F%2Fbschool.pepperdine.edu%2Fappliedresearch%2Fresearch%2Fpcmsurvey%2Fcontent%2Fq3_2013_pca_index.pdf&ei=CJGgUorcK8ivsATTpIGADA&usg=AFQjCNFFAD8AbhV-jasdiRcebNQgcsQyQg&sig2=dUwscf4NeMNQSA9L6boGXQ&bvm=bv.57155469,d.cWc&cad=rja

December 5, 2013
Page Two

For example, according to the Pepperdine survey of U.S. small businesses in the third quarter of 2013, over 59% of small businesses sought a bank loan in the preceding 3 month period, among those fully 56% indicated that they were not successful in obtaining financing. This is a clear indication that a substantial number of small businesses need increased access to capital.

Availability of small business credit is a problem, according to 66% of the businesses surveyed, it is difficult to raise external debt financing. In addition, according to a recent poll commissioned by the American Sustainable Business Council, the Main Street Alliance and the Small Business Majority,[2] 90% of small business owners believe that the availability of small business loans is a problem, and 60% have faced difficulty trying to obtain loans that would grow their small business. Further, the survey found that 90% of small business owners support making it easier for community banks and credit unions to make loans to small businesses.

The data points referenced above undoubtedly show that businesses want and need access to capital, but are experiencing difficulty and frustration when they approach their financial institution and discover that capital is not easily accessible, even if the business is successful. Credit unions are well capitalized and exist to serve the financial needs of their members. Allowing the free market to function by removing the restrictions on the business lending portfolios of credit unions, will inject more capital in the market place and encourage growth in businesses and the communities in which they operate.

The Credit Union Small Business Job Creation Act

Representatives Ed Royce (R-CA) and Carolyn McCarthy (D-NY) have introduced the Credit Union Small Business Jobs Creation Act (H.R. 688), which would permit well-capitalized, business lending credit unions that have been operating near the current member business lending cap to apply to the National Credit Union Administration for the ability to lend up to 27.5% of their assets to small businesses. We estimate that this bill would allow credit unions to lend an additional $13 billion to small businesses in the first year, helping them to create 140,000 new jobs at no cost to taxpayers.

The Credit Union Small Business Jobs Creation Act is fully consistent with both the history and mission of credit unions. Credit unions exist to promote thrift and provide access to credit for their members. Since their founding in the United States more than 100 years ago, credit unions have been serving the credit needs of their small business-owning members.

Unfortunately, since 1998, credit unions have been subject to an arbitrary statutory cap on business lending of 12.25% of a credit union's total assets; as a result, today, many credit unions are rapidly approaching the cap while others choose not to engage in business lending because of the cap.

The bank lobby opposes this bill because they oppose credit unions; their arguments are without merit. The bill will not endanger the small banks in your community; the bill will not alter the nature or focus of credit unions; the bill is not inconsistent with the credit union mission or the purpose of their tax status. This legislation recognizes that credit unions are working in their communities to help small businesses and it is important to enact despite opposition by bank lobbyists.

Credit unions understand that in order for the economy to fully recover, small businesses need access to credit, which will help their businesses grow. Credit unions have capital to lend, a history of prudent

[2] http://www.smallbusinessmajority.org/small-business-research/downloads/012612_Access_to_Credit_Poll_Report.pdf

and safe small business lending and a mission to help provide access to credit to their members – including their small business-owning members.

We also suggest the consideration of several smaller-impact proposals that would facilitate credit union services to their small business-owning members. Some of these proposals have previously passed the House of Representatives.

Treat Non-Owner Occupied One to Four Family Dwelling Loans as Real Estate Loans

As part of the Credit Union Membership Access Act (CUMAA), which imposed the cap on credit union member business lending, Congress included a provision designating loans made by credit unions for non-owner occupied one-to-four family dwellings as business loans, making these loans subject to the member business lending cap. However, if this type of loan is made by a bank, it is treated as a residential loan. We encourage Congress to enact legislation that treats these types of loans when made by credit unions as residential – not business – loans. While it would not have nearly the impact of increasing the credit union member business loan cap, it would give credit unions that are actively managing the cap additional capacity to serve their members with modest rental real estate holdings, and it would bring regulatory parity to the treatment on these loans.

Increase the De Minimus Business Loan Amount

The Federal Credit Union Act exempts business loans equal to or below $50,000 from the member business lending cap. The de minimus amount has not been adjusted, nor indexed for inflation since 1998.

We encourage Congress to significantly increase the de minimus amount of a credit union business loan and permit the NCUA to adjust this amount no more than once per year to adjust for the effects of inflation. As with the proposal related to one-to-four non-owner occupied dwellings, increasing the de minimus amount would provide credit unions that today are actively managing the credit union member business lending cap the ability to continue to serve their members. Increasing the de minimus to $500,000 and indexing that amount to take into consideration the effects of inflation would ensure that the loans exempted from the cap are truly small business loans and that the de mimus level, which has not been adjusted in 15 years, adjusts to economic conditions. Even though these loans would not count against the member business lending cap, we would not object to the NCUA having the authority to regulate them for safety and soundness considerations as if they were business loans.

Encourage Small Business Development in Underserved, Urban and Rural Communities

In 2008, the House of Representatives passed legislation, H.R. 6312, the Credit Union, Bank and Thrift Regulatory Relief Act, which included a provision that would have exempted from the credit union member business loan cap a loan made to a business operating in an underserved area. The language envisioned underserved areas as including New Market Tax Credit low-income community areas and Community Development Financial Institution investment areas.

Exclude Member Business Loans Made to Non-Profit Religious Organizations from the Member Business Lending Cap

A handful of very experienced credit unions specialize in making loans to non-profit religious organizations; and these loans are some of the safest loans written today. However, the member business lending cap constrains these credit unions' ability to serve this market, notwithstanding that

the credit unions that originate this lending as generally exempt from the member business lending cap under the grandfather provision enacted in 1998. The reason the cap affects these credit unions is that it is the normal course of business to sell participations of these loans to other credit unions that would be subject to the member business lending cap. Exempting these loans from the cap would permit other credit unions to purchase participations in these relatively safe loans without their parts of the loan counting against the cap. The only change in the treatment of these loans we are proposing affects the treatment under the cap. The participating credit union would still do the necessary underwriting for their portion of the loan; and the loan would continue to be regulated as a business loan, but would exempt it from the risk associated with these loans. We encourage Congress to enact legislation to exempt member business loans made to non-profit religious organizations from the member business lending cap.

Fully Exempt Government Guaranteed Business Loans from the Member Business Lending Cap

Under current law, the guaranteed portion of a business loan made through a government-guaranteed loan program is exempt from the credit union member business lending cap. Many credit unions participate in Small Business Administration (SBA) programs, including the 7(a) loan program. At the end of 2012, there were 347 credit union SBA lenders – collectively they reported $921 million in SBA loans outstanding in 8,142 individual loans (the average credit union SBA loan size is thus roughly $100,000). In dollar terms, SBA loans are equal to about 2.1% of total MBLs at credit unions. Since December 2008, the number of SBA loans outstanding has grown 89% at credit unions throughout the nation.

To encourage greater credit union participation in the 7(a) program and to help SBA-lending credit unions have additional capacity to manage the credit union member business lending cap, we encourage Congress to enact legislation that fully exempts loans made though the 7(a) program from the business lending cap. We appreciate that Representative Nydia Velazquez (D-NY) has in the past introduced legislation to this end, and we hope we can work with her and others on this issue.

Enable Full Credit Union Participation in the Section 504 Program

To facilitate credit union participation in the SBA's 504 loan program, we encourage Congress to enact a technical change that would permit credit unions to participate in the government guarantee loan programs on the terms set out in the regulations governing those programs. The regulations governing the 504 loan program permit lenders to take certain action that would otherwise be prohibited for federal credit unions under the Federal Credit Union Act. For example, the Federal Credit Union Act prohibits federal credit unions from imposing prepayment penalties; however, prepayment penalties are permitted by the regulations governing the 504 loan programs. We believe that federal credit unions participating in the 504 loan program should be able to exercise the same powers as other lenders participating in the program, consistent with current regulations. We encourage Congress to enact a technical amendment in this regard, noting that the House of Representatives passed such an amendment as part of the Credit Union, Bank and Thrift Regulatory Relief Act of 2008.

America's credit unions and their 98 million members stand ready to remain part of the solution to the economic problems our nation faces. To that end, we are encouraged by and appreciate your support for increasing the ability for credit unions to better serve their small business-owning members.

Reduce the Loan Loss Reserve Requirement of SBA's Microloan Program

The SBA's Microloan Program is designed to provide small businesses with short-term loans for working capital or to purchase inventory or supplies. Under this program, the SBA makes special funds available to nonprofit organizations with experience in lending and technical assistance called intermediaries. These intermediaries then make loans to eligible borrowers in amounts up to a maximum of $50,000.

In order to be an intermediary, the financial institution is required to have a loan loss reserve fund that is 15 percent of the outstanding balance of the notes receivable owed to the intermediary. While there are circumstances where the Administrator may reduce the annual loan loss reserve requirement, in no case will it be allowed to drop below 10 percent of the outstanding balance of the notes receivable owed. In the situations where the Administrator may reduce the loan loss reserve for an intermediary, the average loss rate for the intermediary must be less than 15 percent during the 5 years preceding said period.

We encourage Congress to enact legislation that reduces the loan loss reserve requirement for SBA microloans to no more than 5 percent of the outstanding balance of the notes receivable owed to the intermediary, and authorize the Administrator to reduce the annual loan loss reserve requirement to no less than 1 percent if the average annual loss rate for the intermediary is less than 5 percent.

On behalf of America's 7,000 credit unions and their 98 million members, thank you for your consideration.

Best regards,

Bill Cheney
President & CEO

Background Information on P2P & Online Small Business Lending

Prepared for Subcommittee on Economic Growth, Tax and Capital Access Hearing

Peer-to-Peer (P2P) Lending

In the United States, p2p lending began in 2006 with the launch of Prosper. The following year Lending Club launched and these two companies have come to dominate the industry.

Today, Lending Club is the clear market leader, having issued $3 billion in loans since inception. Their growth rate is around 200% a year annually and this year they will originate more than $2 billion in consumer loans. Prosper is the #2 player having loaned almost $750 million since inception and their 2013 loan total will be around $350 million.

Both Lending Club and Prosper issue personal loans in three or five year terms to prime or near prime borrowers. The most popular use of these funds is for debt consolidation where consumers obtain loans from the p2p platforms to pay off high interest credit cards. Some loans are used for small business purposes but both Lending Club and Prosper treat these loans as personal loans and use only a borrower's personal credit data to underwrite these loans.

Initially, investors on these platforms were individuals so it was a true peer-to-peer marketplace. In recent years, as the platforms have established a proven investor track record, institutional investors have joined individuals in loaning money to consumers.

Online Small Business Lending

Even as the Internet was dramatically impacting other industries during the 2000's small business lending remained largely unaffected. Then the financial crisis hit and banks become far tighter with their lending. Small businesses were forced to look for other options.

During this time entrepreneurs saw an opportunity to meet the demand from small businesses for loans. The obvious place for a small business owner to go after being denied a loan by a bank is to the Internet. Since 2008 dozens of companies have been launched looking to take advantage of this void left by the banks.

The table below shows data from the SBA Office of Advocacy study titled *Small Business Lending in the United States 2012*, released in July 2013. This shows the dramatic reduction in small business lending by FDIC member banks between 2008 and 2012 for loans of $250,000 or less.

FDIC Bank Lending - Billions of Dollars

	2008	2012	Change	%
Commercial Real Estate				
$100,000 or less	28.4	18	-10.4	-36.6%
$100,000 to $250,000	68.6	53.1	-15.5	-22.6%
Total	**97**	**71.1**	**-25.9**	**-26.7%**
Commercial and Industrial				
$100,000 or less	141.7	120.2	-21.5	-15.2%
$100,000 to $250,000	57.3	46.3	-11	-19.2%
Total	**199**	**166.5**	**-32.5**	**-16.3%**

Source: SBA Office of Advocacy

The sweet spot for online small business lending is for small loans, typically this $250,000 amount or less. As we can see from the table above the tightening of lending standards has had a major impact on the amount of money loaned to small businesses by banks. Online lending has begun to fill part of the void by providing loans to small businesses in an efficient and cost effective manner.

There are several different kinds of small business lenders that have emerged each filling a unique segment of the market.

Long Term Loans (2-5 year)

In the online lending space any loan of two years or more is considered a long term loans. There are two types of long term loans provided by funders:

1. Term loans – where the loans are fully amortized and owners pay principal and interest payments. These payments can be made, daily, weekly or monthly.
2. Revenue based financing – loans are offered in exchange for a percentage of future revenue.

The underwriting process on these loans is quite rigorous with extensive documentation required and online lenders typically require personal guarantees from at least one of the business owners. Liens are often placed on the assets of the business.

Short Term Loans (less than 2 years)

There are two kinds of short-term loans provided by online lenders:

1. Term loans – where the loans are fully amortized and owners pay principal and interest payment. These payments can be made, daily, weekly or monthly.
2. Merchant cash advance – Small businesses take an advance against future credit card earnings. Payments are typically sent directly from the credit card processor to the lender on a daily basis.

Supplier Marketplaces

There are two kinds of online supplier marketplaces:

1. Dynamic discounting marketplaces – These online marketplaces recognized that many large Fortune 500 buyers have healthy cash balances while many smaller suppliers are cash strapped. In exchange for faster payment on supplies purchased, the suppliers offer a discounts on pricing. The marketplaces dynamically match the supplier discount based on the speed of repayment.
2. Accounts receivable marketplaces – these marketplaces sell accounts receivables to qualified buyers at competitive prices in order to deliver cash to suppliers.

Industry Vertical Financing

These financing providers specialize in specific industries by extend revolving credit lines to buyers to be used with only pre-defined suppliers.

Small Business Loan Brokers

These businesses aggregate small business borrowers online and make their loans available to a selection of lenders, which typically includes banks, credit unions, and online small business lending platforms.

An Innovative Approach to Underwriting

One of the major differences between online lenders and traditional bank lenders is their approach to underwriting. While traditional sources such as financial statements, tax returns, bank statements, etc. are used; new sources of data are also used to assess creditworthiness.

They are often looking to get real time access to business data through online ecommerce marketplaces like eBay, Amazon, Yahoo!, and Etsy; ecommerce platforms like Shopify, Demandware, and Magento; payment platforms like PayPal, Stripe, Authorize.net, Square, and Braintree; credit card transactional data from Yodlee; panel based data from ComScore, Quantcast, and Compete; analytics data from Google Analytics and Adobe Site Catalyst (Omniture), accounting data from Intuit Quickbooks and Xero, and shipping data from UPS or Fedex.

In addition, some of these online lenders will incorporate social media and user ratings from sites like LinkedIn, Facebook, Twitter, Yelp, Four Square, and Trip Advisor.