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Statement of

Elizabeth A. Duke

Member

Board of Governors of the Federal Reserve System

before the

Financial Services Committee

and the

Committee on Small Business

of the

United States House of Representatives

February 26, 2010

Chairman Frank, Chairwoman Velázquez, Ranking Member Bachus, Ranking Member Graves, committee members, thank you for the invitation to today's joint committee hearing to discuss the availability of credit to small businesses as well as the steps being taken to help ensure that the credit needs of creditworthy borrowers are met. As you are well aware, the Federal Reserve has taken significant steps to improve financial market conditions, and has worked with the Treasury and bank and thrift supervisors to strengthen U.S. banking organizations. We remain attentive to the need for banks to remain in sound financial condition and to continue to lend prudently to creditworthy borrowers. Loans to small businesses are especially vital to our economy, as they employ nearly 40 percent of the private sector workforce.

First, I will discuss the overall state of small business lending and address the causes of reduced lending to small businesses. I will then discuss the improving prospects for small business lending in 2010, key preconditions of which include a sustainable economic recovery, financial stability, and the overall safety and soundness of the banking system. Finally, I will discuss measures taken by the Federal Reserve, including recent guidance issued in cooperation with other bank regulators, to ensure that supervisory policies do not impede credit availability for creditworthy borrowers.

The State of Small Business Lending

While conditions in financial markets continue to improve, access to credit remains difficult for many small businesses that largely depend on banks for credit. Lending by commercial banks dropped precipitously in 2009. With the exception of consumer lending in the early part of the year, lending of all types declined. Between June 30, 2008, and June 30, 2009, outstanding small loans to businesses and farms declined by more than $14 billion, a reduction of

nearly 2 percent. Commercial and industrial (C&I) loans, including loans to small businesses, fell particularly rapidly, declining by double-digit percentages during 2009.[1] Commercial real estate (CRE) and credit card lending, categories that include loans to small businesses, also fell throughout the year.

Notably, the contraction in lending has been less severe at smaller banks, which tend to cater to small businesses. For example, banks with less than $10 billion in total assets reduced their business loans (including C&I and CRE loans) at about a 12.8 percent annual rate in the fourth quarter of 2009, while at larger banks business loans dropped at a pace of more than 20 percent. Although the pattern of reduced lending differed across banks, in aggregate, banks of all sizes have reduced their business loan portfolios. This development is especially problematic for small businesses, given that they typically lack access to public capital markets.

The terms of the small business loans that are being made also have tightened considerably since the beginning of the recession. Responses to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) indicate that banks, on net, have significantly tightened credit standards on C&I loans to small firms over the past few years. In addition, the pricing of C&I loans to small businesses became more stringent last year. Data from the Federal Reserve's Survey of Terms of Business Lending show that interest rate spreads on loans between $100,000 and $1,000,000 increased by about 100 basis points during 2009, reaching their highest levels in more than a decade. However, pricing for large loans has tightened as well, with spreads on loans from $10 million to $25 million also increasing about 100 basis points in 2009.

[1] The most recent data from the Federal Reserve's Flow of Funds report indicate that, for example, C&I lending by commercial banks declined by about 24 percent. Declines for other categories of lending in the same period were about 9 percent for commercial real estate and residential real estate, and 5 percent for consumer lending.

The Causes of Reduced Lending to Small Businesses

Numerous factors have contributed to the reduced lending to small businesses. For instance, for most commercial banks, the quality of existing loan portfolios continues to deteriorate even as levels of delinquent and nonperforming loans remain on the rise. Throughout 2009, loan quality deteriorated significantly for both large and small banks, and the latest data from the fourth quarter indicate continuing elevated loss rates across all loan categories. Anecdotal information suggests that, while consumer delinquencies may be close to peaking, other types of lending such as CRE and small business lending are likely to see delinquencies and charge-offs continue to rise for some time to come. In response to a special question in the January SLOOS, a large net fraction of banks reported that the credit quality of their existing C&I loans to small firms was worse than that for their loans to larger firms in the fourth quarter. In addition, respondents did not, on net, anticipate an improvement in the performance of their small loan portfolio over the next year. Accordingly, banks have reduced existing lines of credit sharply and tightened their standards and terms for new credit. While some businesses are being denied credit due to a recent history of payment problems, even businesses with excellent payment records may find credit restricted or unavailable due to weakened balance sheets, reduced revenues or falling real estate collateral values. Further, businesses that qualified for credit under more accommodative conditions may not meet new tighter standards. Credit conditions may be particularly tight for small businesses because their finances are, in many instances, very closely intertwined with the personal finances of their owners. Data from the Federal Reserve's 2007 Survey of Consumer Finances showed that approximately 11 percent of households own and actively manage a small business.[2] Of these households,

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[2] "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin,* February 2009, page A35.

about 18 percent used personal assets to guarantee or collateralize loans for their businesses and a similar fraction made at least one loan to the business. Thus, the condition of household net worth is often relevant to the ability of some small businesses to obtain credit. With declines in house prices since 2006 and consequent weakened household balance sheets, the ability of many small business owners to borrow has likely been impaired.

Despite general improvements in financial market conditions and in bank stock prices and earnings during the second half of 2009, lending is likely inhibited by various problems afflicting many banks, both large and small. Banks with capital positions that have been eroded by losses or those with limited access to capital markets may be reducing risky assets to improve their capital positions, especially amid continued uncertainty about the economic outlook and possible future loan losses. Indeed, with the number of problem banks having risen to 702 institutions with $402.8 billion in assets, many firms are capital constrained and may be unable to increase lending. And, even though deposits are now plentiful, some banks have funding concerns. Bank funding markets were badly impaired for a time, and some banks have accordingly decided to hold larger buffers of liquid assets than before. A number of other factors are also likely in play. Higher deposit insurance assessments increase funding costs. Some securitization markets remain impaired, reducing an important source of funding for bank loans. Finally, changes to accounting rules, beginning in 2010, will require many banks to move a large volume of securitized assets back onto their balance sheets, perhaps putting further pressure on bank capital.

During the financial crisis, a number of lending relationships have been severed as individual banks sought to reduce loan portfolios, or concentrations within those portfolios, or as banks failed or merged. Established banking relationships are particularly important to small

businesses, who generally do not have access to the broader capital markets and for whom credit extension is often based on private information acquired through repeated interactions over time. When existing lending relationships are broken, time may be required for other banks to establish and build such relationships, allowing lending to resume.

Some banks may be overly conservative in their small business lending because of concerns that they will be subject to criticism from their examiners. While prudence is warranted in all bank lending, especially in an uncertain economic environment, some potentially profitable loans to creditworthy small businesses may have been lost because of these concerns, particularly on the part of small banks. Indeed, there may be instances in which individual examiners have criticized small business loans in an overly reflexive fashion. As I will discuss later in my testimony, the Federal Reserve has worked with other bank and thrift supervisors to ensure that supervisory policy does not unnecessarily constrain credit to creditworthy borrowers.

The reduction in the availability of credit, however, is not the whole story. There is also less demand for credit. The most severe economic downturn since the Depression, resulting in high levels of unemployment and following significant increases in personal debt levels during the past decade, has suppressed demand for goods and services produced by all businesses, including smaller firms. Many businesses are, in turn, reluctant to make new investments until they are confident that consumer demand will continue to strengthen. Business inventories, a key component of gross domestic product over the business cycle, unexpectedly declined 0.2 percent in December after rising by a revised 0.5 percent in November. It is notable that banks report utilization rates of existing lines of credit to be at historic lows, despite the fact that, in many cases, this credit is already approved and generally priced attractively.

According to recent surveys conducted by the National Federation of Independent Businesses (NFIB), financing conditions continued to be ranked as the top business concern by only a modest fraction (less than 5 percent) of small businesses; in contrast, about one-third of respondents cited poor sales as their most important problem. Commercial bank responses to the SLOOS continue to indicate reduced demand for loans from small businesses. Similarly, a poll conducted by the Independent Community Bankers of America on January 8 revealed that a lack of loan demand was the factor most frequently cited by member institutions as constraining small business lending.

Improving Prospects for Small Business Lending in 2010

Improvement in a number of the conditions that depressed lending in 2009, however, lead me to be somewhat optimistic that we may begin to see an increase in bank loans later this year. *First,* economic conditions, the most important determinant in the demand for, and availability of, small business lending, have improved considerably since the early and middle part of last year. In particular, spending by businesses and households appears to have gained some momentum. However, unemployment remains high, and concerns about the pace of job creation this year may restrain the consumer spending that is essential to overall business confidence. Encouragingly, financial market conditions have become more supportive of economic growth, with notable declines in many risk spreads, some resumption of securitization activity, and a rebound of equity prices since their market low in early 2009.

While financing conditions certainly remain tight for many small businesses, conditions would be considerably worse were it not for the action taken by the Federal Reserve and other government agencies in response to the financial crisis. Beginning in September 2007, the Federal Reserve sharply reduced its target for the federal funds rate, which influences interest

rates throughout the economy, and since December 2008, the target has been near zero. To improve mortgage market functioning and support housing markets and economic activity more broadly, the Federal Reserve has purchased large amounts of debt and mortgage-backed securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae in addition to purchasing long-term Treasury securities to help improve conditions in private credit markets.

In the context of the enormous stress in many markets that characterized the financial crisis, the Federal Reserve also established new lending facilities and expanded existing facilities to respond to the unusual absence of liquidity in important markets and thereby enhanced the flow of credit to businesses and households. In particular, the Federal Reserve has provided support to securitization markets, which had been an important source of funding for loans to households and businesses. Securitization markets (other than those for mortgages guaranteed by the government or government-sponsored enterprises) essentially shut down in mid-2008. In response, the Federal Reserve, with the support of the Treasury Department, developed the Term Asset-Backed Securities Loan Facility (TALF). The TALF promotes the issuance of securities backed by loans to households and small businesses, including auto loans, credit card loans, student loans, and loans guaranteed by the Small Business Administration (SBA). In 2009, the program was broadened to allow investors to use the TALF to finance both existing and newly issued commercial mortgage-backed securities (CMBS).

The TALF helped restart securitization markets and increase the availability of credit to small businesses and consumers. To date, the TALF program has helped finance 480,000 loans to small businesses, 2.6 million auto loans, 876,000 student loans, more than 100 million credit card accounts, and 100,000 loans to larger businesses. Included among those business loans are 4,900 loans to auto dealers to help finance their inventories. About half of the SBA securities

issued in recent months--corresponding to roughly $250 million in loans a month--were sold to investors that financed the acquisitions in part with TALF loans. In an encouraging sign, rate spreads for asset-backed securities (ABS) have declined significantly, and a substantial amount of ABS are now being brought to market and purchased by investors without TALF financing. Thus, the TALF and other Federal Reserve programs provided critical liquidity support to the economy until the financial system stabilized. With the extraordinary stress on liquidity in many markets having abated, many of these programs either have been or are scheduled to be wound down.

A *second* reason to expect some improvement in credit conditions for small businesses is that bank attitudes toward lending, including small business lending, may be shifting. The January SLOOS showed that bank tightening of credit standards for small business C&I lending appeared to be nearing an end with similar numbers of banks reporting tightening and easing of their lending standards.

There is also some tentative, anecdotal evidence that many bankers may be devoting considerably more energy toward extending new loans in 2010, as contrasted with their overwhelming preoccupation in 2009 with collecting on or writing down loans already on their books. With respect to small business lending in particular, some banks have instituted so-called “second look” programs that--as the name implies--involve a reconsideration of loan applications that would not be pursued based on a credit scoring model alone. Some banks are also increasing lending through the use of SBA guarantees. Finally, the more noticeable improvement that has already taken place in credit conditions for larger companies should, to some degree, pass through in the form of trade credit to the smaller suppliers or distributors for the larger firms.

Still, as with improvement in macroeconomic conditions, the impact of the turnaround in bank attitudes and strategies will likely be gradual. As noted earlier, the January SLOOS also revealed that the credit quality of loans to small firms in the fourth quarter of 2009 was worse than for loans to larger firms, so many banks may move cautiously in making new loans.

Additional Steps to Meet the Needs of Creditworthy Small Business Borrowers

Despite these prospects for improvement, credit conditions for many small businesses are likely to remain challenging this year. That is why the Federal Reserve has been placing particular emphasis on ensuring that its supervision and examination policies do not inadvertently impede sound small business lending. If financial institutions retreat from sound lending opportunities because of concerns about criticism from their examiners, their long-term interests and those of small businesses and the economy in general could be negatively affected, as businesses are unable to maintain or expand payrolls or to make otherwise profitable and productive investments.

On February 5, the banking agencies issued guidance to examiners that reinforced a simple message--institutions should strive to meet the credit needs of creditworthy small business borrowers, and the supervisory agencies will not hinder those efforts.[3] For the reasons noted earlier, we recognize that the ongoing financial and economic stress has resulted in a decrease in credit availability, including loans to small businesses, and has prompted institutions to review their lending practices. Although current loss rates would indicate that a measure of tightening was appropriate and necessary, some institutions may have become overly cautious in their lending practices. Thus, while prudence must remain the watchword for both banks and

[3] Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers (February 2010); http://www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm

their supervisors, we do not want our examiners to take an overly mechanistic approach to evaluating small business lending.

The Federal Reserve has directed examiners to be mindful of the effects of excessive credit tightening on the broader economy. As a general matter, we do not expect examiners to adversely classify loans based solely on a decline in collateral value where, for example, the borrower has stable revenue streams and thus the ability to repay the loan. We have implemented training for examiners and outreach to the banking industry to underscore this expectation. We are aware that bankers, as well as examiners, may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers.

The most recent guidance is the latest in a series of actions taken by the Federal Reserve and the other banking agencies to support sound bank lending and the credit intermediation process. In an effort to encourage prudent CRE loan workouts, the Federal Reserve led the development of interagency guidance issued in October 2009 regarding CRE loan restructurings and workouts.[4] That policy statement provides guidance for examiners and for financial institutions who are working with CRE borrowers experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties, particularly as the loans on those properties mature and need to be refinanced. The statement is especially relevant to small businesses because owner-occupied CRE often serves as collateral for small business loans.

Prudent loan workouts are in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions. Accordingly, the CRE policy statement details

[4] Interagency Policy Statement on CRE Loan Restructurings and Workouts (November 2009); http://www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm

risk-management practices for loan workouts that support prudent and pragmatic credit and business decision making within the framework of financial accuracy, transparency, and timely loss recognition. We hope that the detailed examples in that guidance will be of particular use to examiners, who themselves face the difficult task of assessing bank credit practices in this uncertain environment.

Immediately after the release of the CRE guidance, the Federal Reserve conducted a Systemwide teleconference with examiners to underscore the importance of this new guidance and promote its consistent application in all regions. In conjunction with the other federal and state banking agencies, Federal Reserve staff has participated in a number of teleconferences with various industry groups to discuss the guidance, which have reached several thousand bankers to date. Examiner training and industry outreach will continue, and specific activities related to the guidance issued in early February targeting small businesses will augment existing examiner training.

In January, the Federal Reserve launched a comprehensive Systemwide training initiative to further underscore our expectations regarding CRE. These initiatives themselves build off of guidance that the Federal Reserve and other federal banking agencies issued in November 2008 to encourage banks to meet the needs of creditworthy borrowers--in a manner consistent with safety and soundness--and to take a balanced approach in assessing borrowers' abilities to repay and to make realistic assessments of collateral valuations.[5] Achieving this balance will not always be easy. We certainly do not want to lay the seeds for future bank problems by encouraging or permitting imprudent lending today. That is why we have emphasized to both

[5] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

bankers and our examiners the importance of careful analysis of the circumstances of individual borrowers.

While aggregate figures are useful to policymakers in assessing overall trends in the financial system, they do not tell the whole story. Determining whether supervisory policies and practices are appropriately balanced also requires a close examination of specific circumstances--for example, through evaluating particular loans that banks were discouraged from making. Ongoing outreach will thus be essential as the regulatory agencies and the industry continue to work through the many difficult issues brought about by the financial crisis. Members of the Board and senior supervisory staff have met with bankers, including community bankers, to elicit examples of supervisory policies or actions that bankers believe may have inhibited prudent lending and to discuss in detail some examples of the supervisory agencies' responses to specific lending situations. It is important that we identify cases in which examiners may be too cautious and to further clarify our general guidance. It is equally important that we reinforce those cautious instincts where the circumstances of an application for credit indicate excessive risk.

In addition to our outreach to banks and bank examiners, the Federal Reserve has conducted several forums in recent months to better understand the difficulties faced by small businesses. In mid-November, the Board and the Federal Reserve Bank of San Francisco, in conjunction with the SBA, held small business forums in San Francisco and Los Angeles. We are now conducting a series of meetings on small business access to credit hosted by the Reserve Banks. The meetings will be followed by a capstone event at the Board of Governors. These forums examine the evolving difficulties faced by small businesses and will inform additional efforts to help this important sector. Meetings this week focused on minority entrepreneurship

and SBA lending. Some of these meetings will focus on a specific aspect of small business lending such as credit gaps with respect to small business credit products, types of financial institutions, or demographic groups (including minority borrowers). Others will employ a standard agenda in different parts of the country to ascertain regional differences in small business access to credit and support services.

Finally, in your invitation letter you asked that we discuss actions taken by the Administration to assist small business owners. As you know, the Administration has undertaken a number of actions aimed at improving small businesses' access to credit. Since the signing of the American Reinvestment and Recovery Act in February 2009, SBA 7(a) and 504 loan volumes have increased quite substantially relative to the period immediately preceding the bill's passage. Most recently, the Administration announced a small business lending initiative to provide low-cost capital to community banks that submit a plan to increase their small business lending and to Community Development Financial Institutions that serve the hardest-hit communities. A number of these small business lending initiatives are new, and their effects on small business lending cannot yet be measured. Nonetheless, a number of programs have been established to assist small businesses and the regulatory agencies recently issued guidance that strongly encourages banks to meet the needs of creditworthy borrowers. We will closely monitor credit conditions to consider whether additional measures may be needed to ensure that the funding needs of qualified small businesses are met in the coming months.

Conclusion

While financial market conditions have improved in the United States, the overall lending environment remains strained, and significant concerns have been raised about the availability of credit to small businesses. The Federal Reserve, in collaboration with the other banking agencies, has worked to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We also have aggressively pursued monetary policy actions and have provided liquidity to help restore stability to the financial system and support the flow of credit to households and businesses.

It will take time for the banking industry to fully recover and to serve as a source of strength for the real economy. The Federal Reserve is committed to working with the other banking agencies and the Congress to promote the concurrent goals of fostering credit availability for creditworthy borrowers and ensuring a safe and sound banking system.

Thank you again for your invitation to discuss these important issues at today's hearing. I would be happy to answer any questions that you may have.