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CHANGES TO SBA FINANCING PROGRAMS NEEDED FOR REVITALIZATION OF SMALL MANUFACTURERS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

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TO SBA FINANCING PROGRAMS NEEDED FORREVITALIZATION OF SMALL MANUFACTURERS

THURSDAY, MARCH 20, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
Washington, D.C.

The committee met, pursuant to call, at 9:38 a.m. in Room 2360, Rayburn House Office Building, Hon. Donald A. Manzullo, [chairman of the committee] presiding.

Present: Representatives Velazquez, Akin, Ballance, Napolitano, Bordallo, and Majette.

Chairman MANZULLO. Good afternoon. I would like to welcome everyone to the committee's first in a series of hearings on the most important legislative initiative the committee will consider this year—the reauthorization of the SBA programs. I look forward to working with the committee, the Administration, and the small business community to draft a reauthorization bill that addresses the concerns of small businesses and small manufacturers in particular.

Fifty years ago, America was engaged in the great ideological conflict with communism. President Eisenhower created the Small Business Administration to ensure that America's small business industrial base would be healthy enough to assist in that great ideological conflict. Fifty years ago, America's small manufacturers provided many of the high-paying jobs that thrust this country into an era of unprecedented economic growth and security.

Fifty years later America is again faced with a great struggle for a secure America for ourselves and our posterity. A key force of this batter will be America's small businesses. Unlike 50 years ago, America's small manufacturers are not in the same position to provide the high paying jobs to help this country secure its economic future.

While others believe this great struggle for economic security can be won in a post-manufacturing society, I respectfully disagree. Only through a healthy manufacturing sector and small manufacturing sector, in particular, will America be able to provide the high quality jobs that allow people to buy homes, cars, eat in restaurants, travel, and purchase consumer goods that create true economic growth and security.

During this reauthorization process, I will be examining each SBA program to determine whether it maximizes assistance to small manufacturers. This does not represent anything new; rath-

er, it returns the SBA to its original purpose—maintaining a sound small business industrial base. even though at least one survey of America's small industrial businesses showed that they were optimistic, the fundamental question remains are we in congress and the government doing enough to ensure this optimism comes to fruition.

At today's hearing, we will examine the various financing programs operated by the SBA—the 7(a), 504, microloans, SBICs, and New Market Venture Capital Companies. These programs have provided useful in providing financing to hundreds of thousands of small businesses. But are they designed to truly help America's small manufacturers? Do they provide the right type of financing and make sufficient funds available to meet the needs of America's small manufacturers? If not, what changes have to be made? Or are offshoots of these programs needed that are targeted to small manufacturers in the same way that SBA has targeted financial assistance for exporters?

Let me make it clear. This is only the first step in the long process. The committee remains open to any suggestions from anyone that will help focus the SBA programs on small manufacturers. What has been said here today may be forgotten, but the action this committee takes during the next six months may well be long-remembered by the owners of America's small manufacturers and their children and grandchildren.

Let me announce that on March 26, next week, we are going to be having a hearing on why the Department of Defense is allowing Pratt & Whitney to buy titanium from Russia to go on C–17s and on tankers that are being used by the United States Government.

We have formed a coalition. It started with a question, started by Tim Ryan who was then on our committee for a short period of time, and then went to Armed Services, as to why the titanium manufacturing industry is under seize, and why the United States Government is going to Russia, who is not even an ally in this conflict, to buy titanium. It is a continuation of a government scandal that we uncovered here a year and a half ago when we found out that the United States Government was buying black berets from Sri Lanka, Indian, Union of South Africa, China, and Canada.

There are 615,999 black berets made in China rotting in a warehouse in Mechanicsburg, Pennsylvania thanks to Mrs. Velazquez and me. We insisted that our fighting men and women should be using products made in America, and we are undergoing a very interesting and aggressive campaign to make sure the Berry Amendment is enforced to save the textile industry, to save the manufacturing industry in this country.

We are going to have amendments to the Berry Amendment to make sure it applies to the Government Printing Office. This was the organization that took up a subcontract from the Air Force that put out an RFP for 115,000 baseball caps. After six explanations as to what a simple baseball cap would look like, the Air Force canceled the contract, assigned it to the Government Printing Office, which is not governed by the Berry Amendment yet. It will be by the time Congress is done.

When Mrs. Velazquez and I found out who got the contract on those baseball caps, guess in which country GPO had contracted to

make those baseball caps? China. And we severed that contract because we were very upset over what is going on with our manufacturing base in America.

That is a continuation, that is an inkling of the nature of the hearings we are going to have on manufacturing. This is hardball. We have lost 10,000 manufacturing jobs in the congressional district that I represent in the last two years, and so has the Speaker of the House.

There is a hollowing out of manufacturing that is going on, and even when we see items that are supposedly made in America, hey, guys, check to see what the contents are. The hollowing out is we are becoming a nation of assemblers as opposed to a nation of manufacturers.

So we are on a roll, Mrs. Velazquez. We are going to get this job done. We are going to save a lot of jobs in America. I yield to you.

[Mr. Manzullo's statement may be found in the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

As the committee begins the process of reauthorizing the Small Business Administration today, we look at one of the most critical challenges facing small business—access to capital. When small businesses cannot find capital, they cannot survive.

With the current economic downturn, finding capital is becoming harder and harder for small firms. Many are forced to use credit cards or depend on family and friends to fill this financing vacuum.

Thankfully the SBA loan programs were created to fill this gap. Last year these programs provided $21 billion in capital, accounting for 40 percent of all long-term small business lending to this nation's entrepreneurs. These programs play a valuable role in helping our nation's small businesses.

And in today's hearing, we will look at how the SBA loan programs can be improved to meet the financing needs of small businesses.

This year has been a difficult one for the SBA loan programs. Higher fees, lack of funding, and problems with subsidy rates have plagued some of the SBA's most important lending programs like the 7(a), 504, and SBIC.

Given this, the reauthorization we are about to undertake will be all the more difficult. Because of the very complex issues surrounding the SBA loan programs, I believe we should only reauthorize the agency for one year at a time while the problems are sorted out. This will be in the best interests of the agency and the small business owners it serves.

Aside from this nuts and bolts problem, we also need to answer some more philosophical questions surrounding the mission of the loan programs. The agency has been so focused on other things, including making more small loans and offering short-term credit, that it seems to have lost sight of the reason the SBA loan programs were created in the first place—to provide long-term capital to this nation's small businesses. This was their original purpose.

In keeping with this spirit, we need to find new and creative ways to make the SBA programs into the premier lending tools of the 21st century that they could be and should be. By opening up avenues of capital, we open up opportunities for small businesses.

First and foremost we need to drastically reduce the paperwork burden of the lending programs. There is simply too much red tape. Right now lenders must assembly 120 documents that comprise 1,000 pages to make a loan. This discourages them from making loans, and small businesses from using the programs.

If we can streamline the programs and make them more user friendly, then more lenders and small businesses will tap into them. We want to avoid its lenders and small businesses sitting on top of a mount of paperwork when using the SBA's loan programs. This is not an incentive, but rather a disincentive. In offering more incentives to entice lenders and small business owners to use the programs we can get capital where it belongs—into the hands of small business owners.

Much like our nation, the SBA and its loan programs are at a crossroads. Right now the SBA loan programs make up almost half of all financing, both public and private. Imagine what they could do if they were adequately funded and operating under new and innovative policies. These programs could finance the next Microsoft or FedEx, which have revolutionized the way we do business.

Working together, I know that we can make the lending environment more conducive to small businesses. Given the current economic situation small businesses need our help now more than ever, and it is the SBA loan programs that can make a real difference.

Thank you, Mr. Chairman.

[Ms. Velazquez's statement may be found in the appendix.]

Chairman MANZULLO. Thank you.

Our first witness is Mr. Ronald Bew, Associate Administrator for Capital Access at the SBA.

We have the lights at the five-minute. If you all could follow that as closely as possible, we would appreciate it.

I understand we may have a series of votes some time past ten o'clock, and we will adjourn accordingly and come on back.

Mr. Bew, we look forward to your testimony.

STATEMENT OF RONALD BEW, ASSOCIATE ADMINISTRATOR FOR CAPITAL ACCESS, SMALL BUSINESS ADMINISTRATION

Mr. BEW. Thank you, Mr. Chairman.

Chairman MANZULLO. If perhaps you need one or two more minutes because of your key position there representing the administration, we can accommodate you.

Mr. BEW. Thank you, sir.

Chairman MANZULLO. Thank you.

Mr. BEW. Good morning. Thank you, Mr. Chairman, Ranking Member, and Members of the Committee. I appreciate the opportunity to discuss SBA's financial assistance programs.

Before I begin, the thoughts and prayers of the SBA with our servicemen and women protecting our freedoms.

President Bush recognizes the vital role that small businesses play in creating opportunity for millions of Americans. One of the key items in the President's small business agenda is assisting entrepreneurs. SBA's role in achieving that goal is to increase opportunities to start and grow small businesses by expanding access to capital and providing technical assistance.

I am proud of the accomplishments Capital Access has achieved so far. We have dramatically increased small businesses' access to credit: one, through the improvements in the SBA Express; two, adding credit unions as eligible intermediaries; three, exploring wider coverage in our 504 program; four, looking to private sector solutions to help us in our oversight and portfolio management; and five, providing 65 percent by number of all venture capital investments through our SBICs.

When I came to the SBA, the administrator set clear goals for me: improve access to capital, expand economic opportunity, and help small businesses do what they do best, create jobs and stimulate our economy. Small businesses create two-thirds of all new jobs in this country. This chart illustrates our contribution.

This administration is committed to reaching more small businesses while using the same amount of taxpayer resources. By reducing the average loan size, we are assisting more small businesses and creating more jobs. In 2002, Capital Access created or retained 573,000 jobs.

Historically, we calculated job creation and retention by estimating one job created or retained for every $32,000 lent. Now SBA is using actual portfolio data to determine job creation. The data indicates that smaller loans create more jobs than larger loans.

In fact, loans under $50,000 have the greatest return on the number of jobs created, requiring only $14,717 to create one job whereas loans between $1 million and $2 million require over $140,000 to create one job.

Clearly, these numbers prove we get more impact on job creation from smaller loans. This is one more indication that our performance goals will continue to create greater employment opportunities to assist in the recovering economy.

Additionally, SBA found that the smaller loans are helping more emerging small businesses, including minorities and women. While the dollar amount lent to minorities has remained unchanged or increased slightly, the number of loans has increased dramatically over the past year. In the first five months of 2003, we are 43 percent ahead of last year's numbers for lending to minorities, 43 percent, and 35 percent ahead for women.

We believe that reducing the average loan size has provided increased economic opportunities to more emerging small businesses, thus improving the effect our programs have in helping the economy.

Now let me be clear, we are not ignoring small businesses that need larger loans. The goal of the administration is to maximize the economic impact of our loan program. That means job creation and retention, and marketing focus on small loans is meant to do precisely that.

As part of our goal to make smaller loans, SBA consulted with the industry to improve the SBA Express Program. In SBA Express, the guarantee is 50 percent in exchange for the lenders using their own processes and forms to make the credit decision. We are still evaluating aspects of the pilot.

The most important task is to find a right balance between simplification and maintaining adequate oversight. To date, SBA Ex-

press and smaller loans in general tend to have lower defaults than larger loans.

As for funding, the 7(a) funding request for 2004 is in line with historical levels. In 2002, the SBA had a lending level of $9.4 billion in 7(a) loans. Additionally, in 2002, the SBA guaranteed $1.8 billion under the STAR program.

STAR, which expired in January, was specifically designed to assist small businesses that had been negatively affected by the September 11th terrorist attacks. Some have suggested that SBA's baseline for 7(a) should include STAR amounts. However, because STAR was designated for 9/11 relief, we cannot assume that those borrowers would have sought out a 7(a) loan if there had not been a terrorist attack.

As you know, SBA is celebrating its fiftieth anniversary this year. We feel this is an excellent opportunity to take a look back and reflect on our successes and then move forward with renewed vision.

Administrator Barreto and I are very happy with SBA's results so far but we know that we can accomplish more. The administration is submitting legislative proposals for your consideration. The proposals are designed to improve existing SBA programs to better serve America's small businesses and stimulate our economy.

I would like to highlight four of them:

One, small business lending companies oversight improvement. SBA is the sole regulator of the SBLCs. Our proposal will allow SBA to regulate these SBLCs in a manner consistent with other federal regulators. This proposal is in response to recommendations from the inspector general, the GAO and congressional committees.

Two, improvements to the microloan program. We are proposing changing the eligibility requirement with participation in the microloan program to include employees' experience and allowing intermediaries more flexibility in determining how to best serve their customers with technical assistance.

Three, changes to the loan loss reserve applicable to the 504 premier certified lending program. SBA recognizes that the original statutory formula is unduly restrictive and burdensome. The proposal is a less restrictive, more flexible graduated system commensurate with risk. It is our hope that this will encourage our 504 partners of whom choose not to participate in the PCLB lending due to the high reserves current requirement.

And four, a statutory change to allow the SBIC program to remain at a zero subsidy.

Finally, Mr. Chairman, I will address the question you posed in your invitation letter. All of our programs are available to the small manufacturers. The 504 and SBIC programs may be better suited to manufacturing expansion than others. I can tell you that in 2002, SBA provided financing of over $2.7 billion to small businesses in the manufacturing sector as the chart reflects.

However, in the 504 program, loans to manufacturing businesses have dropped over the last four years. As you are aware, SBA just completed the comment period for potential improvements to the 504 program. We see great opportunities for this program to assist more small manufacturers.

We are looking forward to working with you to come up with creative solutions to assist small manufacturers and to discussing those needs with you and other witnesses here today.

Thank you for your time, and I am happy to answer questions you may have.

[Mr. Bew's statement may be found in the appendix.]

Chairman MANZULLO. I thank you for preparing your testimony to coincide with the theme of the hearing. It is extremely refreshing. Thank you so much.

Mr. BEW. All right.

Chairman MANZULLO. Our next witness is my constituent, John Phelps. John is the Executive Director of Rockford Local Development Corporation in Rockford, Illinois, a city which in 1981 led the nation in unemployment at 24.9 percent. We know something about unemployment and manufacturing, do we not, John.

Mr. PHELPS. Yes, we do, Chairman.

Chairman MANZULLO. Thank you. I look forward to your testimony.

STATEMENT OF JOHN PHELPS, EXECUTIVE DIRECTOR, ROCKFORD LOCAL DEVELOPMENT CORPORATION.

Mr. PHELPS. Thank you, Chairman.

Good morning, my name is John Phelps, and I am pleased to comment on the reauthorization of the 504 program and on our industry's proposals to help revitalize America's small manufacturing industries.

The NADCO CDC members and first mortgage partners provided $6 billion in long-term capital to job-creating small businesses last year. SBA has just released data stating that 504 created or retained more than 325,000 jobs in just the last three years. Using SBA's loan and job data, the 504 job creation costs for these three years is $20,268 per job.

Thank you also, Chairman, for starting the SBA reauthorization process early this year. To continue our service to small business, the 504 program must be reauthorized prior to October 1, 2003. If not signed into law by that date, our authority to provide 504 ceases.

Further, to ensure the program is delivered at no cost to the government, our user fees must also be reauthorized. We urge the committee to act quickly to authorize the program for another three years and to consider our program initiatives to expand the program.

The 504 fees are a product of the subsidy model forecast developed by SBA and OMB. We believe the current process continues previous flaws. The default forecasts need further work, the 17 percent recovery forecast seems disconnected with the highly publicized successes of both the asset sales and 504 liquidation pilot created by Congress. We ask you to seek further information on these figures so crucial to calculating our borrower fees.

I would like to address the needs to support America's small manufacturing firms. NADCO believes that a return to a growing economy must include a revitalization of our core manufacturing industries. Given the connectivity of international markets, our small manufacturers must achieve extraordinary new levels of pro-

ductivity to compete on both price and quality. Doing this requires additional capital expenditures for plant expansions and sophisticated new equipment.

The National Association of Manufacturers, one of America's most respected trade groups, completed a survey last year on credit rationing by lenders. They concluded: Even with record low interest rates, 43 percent of small manufacturers said their cost of borrowing had increased due to lender fees and interest charges. Restrictive lending has impacted capital spending and new hiring for 37 percent of firms.

With low interest rates and favorable loan terms from 504, we can provide substantial expansion capital to small manufacturers who are expanding their markets, products and most importantly, their employment levels.

Our request to the committee is to provide an extraordinary series of changes to immediately address the capital needs of small manufacturer. These include: an update of the rural definition to assist rural manufacturers that have no supportive banks; provide debt refinancing to enable them to immediately lower their borrowing costs; enable a combination with 7(a) to allow greater financing for great plant and inventory; provide special debenture up to $4 million to reach capital-starved manufacturers; provide a special job ration of one job per 100,000 for purchase of more machinery for manufactures.

I would like to share just one example of why our program changes are needed to jump start manufacturing in Rockford, Illinois.

Increasing the loan size eligibility amount is critical to keeping W.A. Whitney in Rockford, Illinois and locally owned. This manufacturer of stamping machines and other large metal cutting machines employs 125 skilled machinists. It has been put up for sale by its corporate parent, and a local buy-out group faces a $3 million funding gap to purchase the business. Unless Rockford can bridge this gap, Whitney will likely be sold to an out-of-state or offshore competitor, and our community will lose 125 skilled manufacturing jobs.

This need could be solved through use of a larger debenture as we propose in our legislative package.

To put Americans back to work and to get new capital to manufacturing, our country needs 504 more than ever. NADCO is providing today your committee with a comprehensive legislative package that will expand access to 504 by growing capital-starved borrowers.

Additionally, we recently gave SBA more than 100 pages of program regulatory recommendations to enhance and grow the program. I am convinced that Administrator Barreto also plans to expand our program to reach small business. Our industry is working overtime to grow this program and provide its advantages to more businesses.

We urge the committee and the administrator to support our proposals to expand economic stimulus. And I am pleased to answer any questions. Thank you.

[Mr. Phelps' statement may be found in the appendix.]

Chairman MANZULLO. W.A. Whitney makes a laser cutting machine that's the most powerful in the world. It will cut through one and a half inches of armor plate. There is not anything like that.

John, I want to work with you on keeping those jobs in Rockford. That is obviously cutting-edge technology we want to keep there.

Mr. PHELPS. Thank you, Mr. Chairman.

Chairman MANZULLO. Our next witness is David Bartram. David is Vice Chairman of the National Association of Government Guaranteed Lenders, and President of the SBA Division of the U.S. Bank. I look forward to your testimony.

STATEMENT OF DAVID H. BARTRAM, PRESIDENT U.S. BANKS/ SBA DIVISION, AND VICE PRESIDENT, THE NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS, INCORPORATED

Mr. BARTRAM. Thank you very much, Mr. Chairman, and I certainly appreciate the opportunity to be here to testify.

I am David H. Bartram, President of the SBA Division of U.S. Bank. I am here today in my capacity as Vice Chairman of the National Association of Government Guaranteed Lenders.

Let me begin my testimony by saying that we are deeply disappointed to learn that the SBA will not rescore STAR loans using the new econometric model made this fiscal year before the expiration of the program on January 10th. Clearly, STAR loans are 7(a) loans since the terms and fees are identical to 7(a) loans made during this fiscal year. And S. 141 provides for econometric model to be used retroactive to October 1 of 2002.

We believe these loans should be rescored, and we ask that this committee and Congress vigorously pursue this issue. Without rescoring of STAR loans made this fiscal year, there is a strong likelihood that the SBA will not have sufficient loan funds to meet demand for the balance of this fiscal year.

Additionally, the administration's requested Fiscal Year 2004 program level would be more than 25 percent below the projected level of demand of $12.5 billion. A $9.3 billion program would most likely result in SBA rationing of credit, something that the leadership of this committee has already objected to for the current fiscal year.

A Fiscal Year 2004 7(a) loan program of only $9.3 billion will likely lead to impose loans size caps again next year.

For whatever reason, the administration continues to say that the FY 04 requested 7(a) program level is in line with historical usage. We all know that the history changed on 9/11 of 2001. This SBA in a recent response to committee questions says 9/11 was a one-time event that funded through a supplemental appropriation.

Clearly, the impacts of 9/11 continue to have an impact on small businesses. Today, the economy continues to operate at levels far below economic levels prior to 9/11. Lenders have tightened their conventional credit standards. Small businesses that used to qualify for conventional credit now find they must turn to the SBA programs.

As a result, 7(a) loan volume has been increasing. During Fiscal Year 2002, $11.1 billion in 7(a) loans were made. For Fiscal Years 2003, 7(a) lending is slightly ahead of Fiscal Year 2002 pace event

though there was a $500,000 7(a) loan cap in place for the first five months of this fiscal year.

Without the loan cap, loan volume for this fiscal year would be farther ahead of last year's. The relevant history for borrowers who need access to long-term capital through the 7(a) program is post-9/11. Loan demand last fiscal year was $11.1 billion, and we anticipate as much as $11.8 billion this year, and $12.5 billion in 2004.

Mr. Chairman, as you know many small manufacturers turn to the SBA program for financial assistance. Through the 7(a) program, manufacturers can purchase capital assets like plant and equipment, or they can obtain much needed long-term working capitals. Companies have a cash flow benefit from the longer maturities offered by the SBA's 7(a) loan programs.

Manufacturers need sizable loans for plant and equipment as well as working capital. The National Association of Manufacturers is already indicating its members are being faced with credit crunch and more manufactures are turning to the 7(a) program. This would be the wrong time to limit SBA 7(a) financing.

Inadequate budget request could cut off the borrowing capabilities of businesses like manufacturers who need larger 7(a) loans. In order to preserve jobs and productions and to avoid loan caps next year, a $12.5 billion program level will be needed.

As part of the reauthorization bill, the National Association of Government Guaranteed Lenders has recommended some changes to the 7(a) program. I would like to have these put into the record. There are nine items that are attached to my testimony.

I would certainly be glad to answer any questions. And again, thank you very much for the time.

[Mr. Bartram's statement may be found in the appendix.]

Chairman MANZULLO. Your requested exhibits will be placed into the record without objection.

Our next witness is Raymond Moncrief; is that correct?

Mr. MONCRIEF. Yes, sir.

Chairman MANZULLO. Executive Vice President and Chief Operating Officer of Kentucky Highlands Investment Corporation, and we look forward to your testimony.

STATEMENT OF L. RAY MONCRIEF, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, KENTUCKY HIGHLANDS INVESTMENT CORPORATION

Mr. MONCRIEF. Thank you, sir.

Chairman Manzullo, Ranking Member Velazquez and members of the Small Business Committee, I thank you for the opportunity to testify before you today on behalf of a very important investment program, and that is the New Market Venture Capital program.

Again, my name is Ray Moncrief, and I am Chief Operating Officer of the Kentucky Highlands Investment Corporation. I am also Chairman of the General Partner of the Southern Appalachian Fund, one of seven conditionally approved new market venture capital companies.

I am also here today to urge the reauthorization of the New Markets Venture Capital Program.

First, let me begin by expressing deep appreciation on behalf of myself, the Community Development Venture Capital Alliance, and

the six other conditionally approved new markets venture capital companies to Chairman Manzullo and Ranking Member Velazquez for your steadfast commitment to ensuring the successful implementation of the New Markets Venture Capital Program.

Your support for technical legislative adjustments and your insistence that the conditionally approved New Markets Venture Capital Companies be given adequate time to raise the private regulatory capital required under the statute has been absolutely essential to the success of this program. I deeply appreciate your leadership and your staff's hard work on your behalf.

Congress enacted the New Markets Venture Capital Program for three reasons:

One, many low-wealth towns and cities across the country missed out on the infusion of equity capital and business wealth generated during the nineties economic boom;

Two, 98 percent of traditional venture capital is invested in metropolitan areas, the majority of which are along either of the two coasts;

And three, SBA does not operate a similar program targeted to equity investment in low-income communities; the majority of investments made by SBICs are made in middle to upper-income communities.

My company has a great deal of experience in helping small businesses, primarily manufacturing business, succeed in low-income area. We are based in London, Kentucky. Kentucky Highlands works in some of the poorest counties in the country where the unemployment rate stays consistently above the national average.

Since 1968, Kentucky Highlands has invested more than $100 million in over 200 business ventures, and helped create or maintain 8,000 jobs in our service area. We have accessed over $30 million of business investment capital at any time, of which $11 million is for equity investment.

We have invested successfully in many manufacturing enterprises, including a houseboat manufacturer, a military tent manufacturer, and an electronics fabricator.

The New Markets Venture Capital Program occupies a unique niche in promoting investments in small businesses in poor communities. The New Markets Venture Capital Program provides guaranteed financing to help capitalize venture capital funds and grant financing to provide operational assistance to portfolio companies.

There are two key elements to the New Markets Venture Capital Program that distinguish it from conventional-like refunds and from other SBA programs.

First, it is the only federal program targeted specifically towards leveraging equity capital for small business investments in low-income areas; and secondly, the program builds into it grants for operational assistance that fund managers can work with portfolio companies on a daily basis to help ensure their success.

I am here to declare that the program thus far is a success, and it is meeting the expectations that Congress established for it under the statute. Two new markets venture capital companies have already begun investing, and there are five companies that

expect to complete final approval and begin investing in the coming weeks.

Of the five remaining, there are two that will close eminently, and there are three that really is on the marginal bubble by March 31st of closing. They have all raised their regulatory capital and operational assistance dollars, but they are on the bubble of being able to being able to get through the paperwork of getting that done.

Despite not having two years to raise the regulatory capital allowed under the program, the conditionally approved companies succeeded in raising the required capital within 17 months of designation. Collectively, the seven conditionally approved companies raised a total of $70 million of private investment capital in less than 18 months despite the poor economy.

We did this in one of the most difficulty fund raising environments the venture capital industry has ever faced. In the year 2000, before the stock market crashed, the venture capital industry raised $106 billion in new capital. In 2001, it raised $26 billion. And the economic environment in which we were operating our ability to raise our full requirement for regulatory capital for venture funds targeted to some of the most economically distressed parts of our nation was truly extraordinary.

Due to the New Markets Venture Capital Program approximately 175 million of venture capital will be available for small business development in targeted low-income communities in 16 states.

Chairman MANZULLO. How are you doing on time? I would like to try to get as many statements in before the bell goes off because we are having a security briefing, and I have got to do some juggling here.

So we thank you for your testimony.

Mr. MONCRIEF. Thank you, sir.

[Mr. Moncrief's statement may be found in the appendix.]

Chairman MANZULLO. You end right in the middle of it, sorry about that.

Our next guest, Zach Gast is a substitute guest here because the person originally designated to come here got caught in snowstorms in Colorado.

Mr. GAST. That is right. She has reported she cannot even get out of the house.

Chairman MANZULLO. So if you can identify the group which you are representing today and a little bit about your personal background, go right ahead.

STATEMENT OF ZACH GAST, POLICY AND RESEARCH MANAGER, ASSOCIATION FOR ENTERPRISE OPPORTUNITY

Mr. GAST. Sure. Thank you, Mr. Chairman, Ranking Member Velazquez, and members of the committee for the opportunity to testify before you today.

My name is Zach Gast, and I serve as policy and research manager for the Association for Enterprise Opportunity. We represent more than 450 microenterprise programs across the country, and

we are testifying for the MicroLoan Program today, which is the capital access program we work on.

Unfortunately, Ceyl Prinster, who was scheduled to testify before you today, has been snowed in due to the blizzard in Colorado. I would like to submit her written testimony for the record, and then make a brief statement in support of those.

[Ms. Prinster's statement may be found in the appendix.]

Chairman MANZULLO. All those statements will be submitted to the record without objection. Thank you.

Mr. GAST. Okay. The SBA MicroLoan Program which was created as a demonstration project during the first Bush Administration is unique because it was created with the needs of specific target market in mind: entrepreneurs that need both access to capital and intensive management assistance. These are typically entrepreneurs that are just starting out. They have been in business for awhile, but they are looking to expand and need assistance to do so.

The SBA MicroLoan Program provides two types of funding to nonprofit intermediaries around the country:

Loan capital, repayable over 10 years to the SBA on slightly concessionary terms. This capital is then loaned out by the nonprofit intermediary to microenterprises in loans of $35,000 or less. To receive any loan capital, an intermediary must provide an up front cash match that the SBA holds a collateral along with an assignment of all the loans made with the funds.

Second, operational grants to provide intensive marketing management and technical assistance to assist microloan borrowers. This assistance is the key to successful outcomes for the businesses that access the MicroLoan Program.

While some have suggested that the MicroLoan Program be replaced with guaranteed bank loans, I would reiterate micro lending does not serve bankable clients, but works to build businesses, creating revenue, income and jobs with those individuals to which the banks cannot provide loans successfully. In a few cases the loan sizes may be the same but across the board the target market is very different. Most borrowers from the MicroLoan Program would fall under the bank's criteria even with a guarantee.

With this program we are enable entrepreneurs to increase revenue, general personal income and create jobs. Recent estimates put the return on investment in microenterprise development at $2.06 to $2.72 per dollar invested. Is the federal government willing to invest $1 to receive more than $2 in return?

I would like to offer some additional statistics to detail the work of the program. In the last fiscal years, the SBA MicroLoan Program closed 2,580 loans with an average loan size of $14,238, which is remarkably similar to the a statistic we have seen earlier.

Forty-four percent of these businesses were start-ups with less than six months of operation. More than half were minority-owned and more than half were women-owned.

You heard at your budget hearing in February that this recent research has demonstrated that microloans are our most effective tool in creating jobs. In addition, I would emphasize to members that the microloan industry is more effective now than ever. Last year's loans account for nearly one-sixth of the program's historical

loans, and that's a 12-year history, so we are making progress and getting better, and it's an indication of the demand for these products across the country.

I would now like to address our suggested changes to the authorizing legislation. We continue to think about ways to improve the program but would offer the following thoughts today.

As the microenterprise industry has become more advanced, many intermediaries have begun to see the need to develop more sophisticated loan instruments to match the need of our clients. Intermediaries are developing lines of credit and other loan terms that more closely match the cash flow and capital needs of micro entrepreneurs across the country. I would particular point to manufacturing businesses.

Right now we are restricted to providing short-term loans, which means that investments in capital equipment are particularly difficult for these small enterprises that don't have the liquidity to support repayment in those first couple of years of the loan.

Likewise, a similar evolution has occurred in the provision of technical assistance. Intermediaries and national technical assistant partners are increasingly being asked to provide more specialized assistance for entrepreneurs, moving beyond generalized technical assistance to sector-specific and technical issues for these businesses.

We are meeting this challenge by remaining flexible. We are finding individuals in the community who have those abilities and matching them up with businesses. Two changes to the program would facilitate this process.

First, the cap on pre-loan technical assistance should be lifted. It's currently at 25 percent. Second, the limit on outsourced technical assistance that uses these assets in the community should be increased from 25 to 35 percent.

Like many SBA loan programs, the MicroLoan Program subsidy rate has received increase in tension over the past two years.

Chairman MANZULLO. Mr. Gast, could I cut you off a second? We are expecting a series of three votes that are going to come up.

I would like to go to Mr. Finkel. I want your testimony before the bells go off and chaos starts around here. We will get back to you, Mr. Gast. Thank you.

STATEMENT OF ROBERT FINKEL, PRESIDENT, PRISM OPPORTUNITY FUND

Mr. FINKEL. Certainly.

Chairman Manzullo, Ranking Member Velazquez, and members of the committee.

First of all, it is my honor to testify on SBIC program issues that the committee will work on this year.

My name is Robert Finkel, founder and managing partner of Prism Opportunity Fund. We were licensed as a participating securities SBIC in 1999. We received a go-forward on a second SBIC license to focus in on manufacturing companies in the midwest.

With that introduction, I am going to turn to issues related to the SBIC program. I will summarize my testimony but ask that the full version be included in the record.

Consistent with what has been done in the past, we suggest a three-year reauthorization period. That is short enough to give Congress appropriate control over the program, yet sends the right signal to the marketplace that the program has strong congressional support. I would suggest the reauthorization levels are in my testimony.

We support the very minor increase in prioritized payment rate for the participating security SBIC. That is required to keep the subsidy rate at zero.

And turn to suggestions, to increase SBIC investments in manufacturing, SBIC provides significant support to U.S. manufacturer. To note, SBIC has invested $737 million in 434 manufacturing companies in 41 states. That was 28 percent of the SBIC dollars invested supporting 68,000 jobs. However, we believe we can do more.

To encourage and make more money available to invest in manufacturing companies, we suggest that SBICs investing in manufacturing companies be allowed to exceed the current maximum leverage cap; not to exceed the three-to-one leverage ratio set by the SBIA Act. However, investing in manufacturing is very capital-intensive, and by definition requires substantial capital resources.

As it stands, the out limits, the amount, the maximum amount of leverage available to any one SBIC or a group of SBICs no matter how much private capital it has attracted from the outside. The cap is constraining. The SBICs would be able to invest more in manufacturing companies but for that limit.

This exception to the limit would increase manufacturing investments by SBICs and lead to the formation of new SBICs with a manufacturing focus.

Another area of improvement would be the elimination of the mandatory requirement for SBICs, for the very largest SBICs to invest a portion of those dollars in smaller enterprises. These smaller enterprises for these bigger SBICs may not fit their investment focus or expertise, and therefore potentially a force fit.

What that leads us to is increased risk for the SBIC, and potentially SBA. It also provides less time for the SBIC to spend with the portfolio company. I am talking about SBICs that are large, $15 billion in private capital assets or more, and that represents four percent of the SBICs that are out there. We will all still be subject to investing in the small business concern, obviously.

Another suggestion is to clarify the congressional intent with regard to capital impairment. While capital impairment may not be a permissible reason for rejecting a leverage request, we believe it was not the congressional intent to unilaterally shut down or liquidate in advance the due date or force draw down of funds to pay down leverage versus investing in private companies.

If SBA becomes a judge to make a unilateral decision when to shut down a fund in advance of the due date of these outstanding securities, private investor support for the program will falter. If SBA is able to shutdown an SBIC in midstream simply because of the capital impairment ratios, SBA will not be viewed as a credible partner to sophisticated private investors.

Thank you for consideration of our proposal. We believe these changes that we have changes that we have suggested will make

the program stronger and will benefit U.S. small businesses, in particular, U.S. small manufacturers.

I would be pleased to answer any questions you have about the program or proposals.

[Mr. Finkel's statement may be found in the appendix.]

Chairman MANZULLO. Thank you.

We have three votes. It is going to be about 40 minutes. When we come back, Mr. Gast, we will let you start off to give us your recommendations for change. Okay?

We stand adjourned for about 40 minutes.

[Recess.]

Chairman MANZULLO. The committee is called back to order.

Mr. Gast, we cut you off at that point where you were in the process of making your recommendations; is that correct?

Mr. GAST. I was actually just wrapping up, but I would be glad to——.

Chairman MANZULLO. Well, why do you not go ahead because you—go ahead, take the time to wrap up.

Mr. GAST. Sure.

Chairman MANZULLO. Then we will get into the questions. Thank you.

Mr. GAST. The only thing I would like to add is that both the House and Senate Small Business Committee reviewed most of the changes I am recommending, and passed all of those out of committee last year, so we hope that this process can go forward smoothly in the coming year.

Chairman MANZULLO. Thank you.

I have a question of Mr. Bew. In fact, I handed him a copy of the question before so he had some opportunity to do some research on it.

Mr. BEW. Thank you.

Chairman MANZULLO. And so I will read the script on it.

Mr. BEW. Do you want me to read the question?

Chairman MANZULLO. Go ahead and read the question.

Mr. BEW. Okay. This in regards to the STAR program. Will you count the defaults under the STAR program in calculating the subsidy rate for the disaster loan program rather than the 7(a) loan program?

The experts tell me no, that this is a separate program and re-estimates will be done separately from 7(a), so it will have no impact on 7(a) or the disaster program.

Ms. VELAZQUEZ. Mr. Chairman.

Chairman MANZULLO. Why do you not go ahead?

Ms. VELAZQUEZ. No. I just—it was not that I was not paying attention, but can you please answer the question again?

Chairman MANZULLO. Let me conclude my questions. I will have some a little bit later on. Then why you not go ahead, Mrs. Velazquez.

Mr. BEW. Do you want me to repeat it?

Ms. VELAZQUEZ. What was your answer to the question?

Mr. BEW. I think the question was will the defaults be counted for the STAR program. And we feel that this is a separate program. Re-estimates will have no impact on the 7(a) or the disaster program.

Ms. VELAZQUEZ. Okay, thank you.

Mr. Bew, I am going to ask you the same question of you that I asked the Administrator during last month's budget hearing. In the omnibus appropriation bill, the appropriators admonish you to stop using risky schemes to fund the 7(a) program. Given those statements, how can the agency come before the committee and state that your $9.4 billion is sufficient when everything I am seeing is that your budget is $3 billion short?

Mr. BEW. We went back and looked at the historic usages and has averaged 9.3–9.4 for the last three years, and the assumption is that the STAR was a one-time situation; that it was a historic event, and we pray that it will not happen again.

And as far as the numbers themselves, we looked at last year, when we looked at the 2002 numbers, we looked at—12.2 was the gross. I think people referred to 12.2 a lot, even myself.

Ms. VELAZQUEZ. So you are saying——.

Mr. BEW. But the 11—excuse me. The 11, if you take the net loans, it is about 11.2, and subtract the 1.8 from the STAR, you get it down to about the 9.3 level.

Ms. VELAZQUEZ. So let me ask you. The Administrator was sitting right there in the center of that table. He told me when I asked him about the $12 billion that I was wrong, that he did not know where those figures were coming at, and he said that it was 9.4.

So what is it, 9.4 or 12 billion dollars?

Mr. BEW. If you follow the math, it's 12.2.

Ms. VELAZQUEZ. Can you give me a simple answer?

Mr. BEW. Gross——.

Ms. VELAZQUEZ. Is it 9.4 or just 12 billion dollars?

Mr. BEW. It is 9.4.

Ms. VELAZQUEZ. Okay. So I want to direct you, sir, to a recent ad that SBA took out in the New York Times that says, "Last year the agency did in excess of $12 billion in 7(a) lending."

So what is it? The Administrator come before this committee, and when asked to justify the inadequate funding, he starts that $12 billion is wrong. You say that it is not $12 billion, but in the ad, when you want to brag about everything that the Bush Administration is doing for small businesses, you talk about $12 billion.

Mr. BEW. Well, I think about everyone is happy to use the larger number probably to emphasize the——.

Ms. VELAZQUEZ. So you come here and you mislead this committee because in fact it is 9.4, or is it 12 billion?

Mr. BEW. 9.4 net.

Ms. VELAZQUEZ. And then you take an ad. So were you including the STAR program in that $12 billion?

Mr. BEW. It all hinges—I think the whole argument on was STAR a one-time event or not.

Ms. VELAZQUEZ. Okay. If we were to agree to your supposed program level of $9.4 billion, can I get a commitment from you that if it comes up short, that you will not impose a cap or any other limitation from loans, and that you will seek a supplement appropriation so that we can meet the Chairman's goal of helping manufacturers?

Mr. BEW. We anticipate that 9.3 will be sufficient in 2004, and definitely in 2003. We certainly look at any proposal. We entertain anybody's proposal and solicit ideas of what we can do to serve small business.

Ms. VELAZQUEZ. But how could you achieve the goal of the Chairman of lending more loans to manufacturers with 9.4 is adequate?

So I am willing to make a commitment, why cannot you not put your money where your mouth is?

Mr. BEW. I think manufacturing can be also served not just by looking at the 7(a) program, but it also can encompass the 504 program.

Ms. VELAZQUEZ. Okay, let us move to the next question.

Mr. BEW. Well, as the chart shows——.

Chairman MANZULLO. If you could let the witness finish his answer.

Mr. BEW. As the chart showed, there has been a decrease in 504 lending in manufacturing when both the SBIC and the 7(a) numbers have gone up over the five years, and I think there is great opportunity there for manufacturing to be served by the 504 program.

Ms. VELAZQUEZ. Okay.

Mr. BEW. Of course, there is a lot of authority there also that is not used.

Ms. VELAZQUEZ. Mr. Bew, why did you not mention in your ad in the New York Times when you were bragging about the $12 billion, why did you not mention the 504 program in the ad?

I know the administration has said that the 504 program is ineffective, but why ignore it? What kind of message do you think that that sends to the 504 lenders in New York like Empire Development that, by the way, was one of the largest 504, about how the agency regards the work that you will not even take a great opportunity to market the 504 program in the ad that you paid for in the New York Times?

Mr. BEW. Yes. Yes. That is a good question. Someone else asked me that, and that is one of four, four ads.

Actually, I thought I did mention the 504. I was talking to my senior advisor who was in the interview. He said you did mention the 504, and apparently the reporter did not mention it.

But in some of the speeches I have made this year, we called this the year of the 504, and we really look—we just finished an ANPR process to solicit comments. We see great potential to change and expand the reach of the 504 program. So even though it was not mentioned in that particular ad, it is definitely a focus and a high priority of us——

Ms. VELAZQUEZ. I can see that.

Mr. BEW [continuing]. For us to streamline that.

Ms. VELAZQUEZ. Mr. Bew, in answering the budget question, SBA stated that they were not going to apply the new model to STAR funds because the legislation was signed after the STAR program had expired.

Is that a correct characterization of the agency's position?

Mr. BEW. I am not sure. Please repeat that question?

Ms. VELAZQUEZ. When the administration, SBA stated that they were not going to apply the new model to STAR funds because the legislation was signed after the STAR program had expired.

Mr. BEW. I do not believe we have the authority at the SBA to rescore that program since the program was ended on January 10, but I will be happy to look into that.

Ms. VELAZQUEZ. Why do you think you do not have the authority?

Mr. BEW. Because the program legally ended January 10.

Ms. VELAZQUEZ. I have got to tell you that the day the bill was signed it does not matter, it is irrelevant. So the law says that STAR loans made after October 1, 2002, are to have the econometric model apply to them. And the day when S. 141 became law is immaterial.

Mr. BEW. I will be happy to look into that.

Ms. VELAZQUEZ. Okay. I want to direct you back to the New York Times ad. Clearly, to get the $12 billion number for the 7(a) touted here, SBA included STAR, and you just said that, right?

Mr. BEW. Yes.

Ms. VELAZQUEZ. So once again, when the administration wants to brag about the great work it is doing you use one set of numbers. But when it comes to doing the right thing by small business you do another.

Explain for the committee why for the purpose of this ad STAR loans are a part of 7(a), but when it comes to applying the new model that will provide more capital for small business the agency refuses to do so.

Mr. BEW. I look at that as STAR as a historic event one time. It was a supplemental program authorized by Congress, and as I said earlier, I pray to God we never have to go that route.

Ms. VELAZQUEZ. I would invite you to go back and read the law because that is not what the law says.

By refusing to apply the econometric model to the 7(a) STAR program loans originated after October 1, the administration is trying to precipitate another shortfall in the 7(a) loan availability and trying to impose another loan cap, is it not?

Mr. BEW. I am not sure I understand where you are going with the question.

Ms. VELAZQUEZ. If you do not apply the econometric model, you are going to be short in terms of money, and what you are going to do is you are going to impose a cap.

Mr. BEW. Okay, I see.

Our projections for this year are—we were running behind with the amount of money we have on a daily basis. We track the loan volumes we are making on the 7(a) program daily, and we have adequate money to meet the needs of small business this year.

Ms. VELAZQUEZ. Mr. Bartram, would you comment about the fact that they are not applying the econometric model to the 7(a) STAR program? And do you see, as I see it, that if they are going to run short of money, then they will impose a cap?

Mr. BARTRAM. Well, the figures that we have seen is that we are running ahead of last year's pace, not behind.

Secondly, lenders were encouraged last year to use the STAR program. In fact, representatives from central office told us if we

cannot figure out a way to make a loan into STAR, call us and we will help you. So the rules were extremely loose and we were encouraged to use STAR program to save funding.

So I am not sure that we believe that these loans are something that will not happen again in the future. And if we do not apply the new econometric model, we lose about 1.1 billion in possible funds that could be used this fiscal year, which we are estimating around $11.8 billion, not the 9.4.

Ms. VELAZQUEZ. Thank you, Mr. Bartram.

Mr. Bew, is it the committee's understanding that SBA is considering a credit card program? Can you please describe how do you envision that program?

Mr. BEW. We do not per se have a credit card program. As you are aware, the 7(a) programs traditionally had revolving lines of credit where companies can go up and down and borrow, and normally it is an unsecured working capital line of credit. Many of the banks—I do not know the exact number—have used a credit card as a medium to administer that working capital line of credit. So per se, we do not have one.

Ms. VELAZQUEZ. Are you thinking of creating one?

Mr. BEW. I would look at any avenue that we can get out and touch more small businesses.

Ms. VELAZQUEZ. So is that a yes?

Mr. BEW. We would look at that, yes.

Ms. VELAZQUEZ. I have one more question, Mr. Chairman, and that will be it.

Chairman MANZULLO. Okay.

Ms. VELAZQUEZ. So you are thinking about it, and will you—you are going to look at how that credit program will affect the 7(a) subsidy rate?

Mr. BEW. We are looking at—we would look at credit cards. The banks have asked us to do that. There are a whole lot of platform problems in delivering that product.

But let me make one point clear. The revolving lines of credit can be administered in many ways. If a small business wants $5,000 on its, for example, $50,000 line of credit, they might call in, and say, okay, put $5,000 into my checking account. Some banks will just give that person a credit card, and that will be the way they can go purchase an item. It is just a more efficient way of administering the revolving line of credit.

Ms. VELAZQUEZ. Well, all I can tell you is that from where I sit the agency has not authority to create such a program, and my guess is that you will have to seek legislation to do so.

Chairman MANZULLO. Mr. Ballance.

Mr. BALLANCE. Thank you, Mr. Chairman. I do have a couple of question, I guess, Mr. Bew.

What extra steps do you take to make loans to minority applicants, if any?

Mr. BEW. We have outreach programs. It is definitely a high priority for us. We design the programs and seen a correlation between the smaller loan and minorities, African Americans, Hispanics, Asians, in their need because many of the minorities are starting businesses from scratch, and they need the smaller loan, which is one of the most difficult to get.

So we redesigned that SBA Express to emphasize the smaller loan, and you can see by the original—the chart there. Those changes took effect this year. In the first five months of this year we were up 42 percent overall, 42–43 percent overall in minority lending just through that SBA Express item. But in African Americans, I think it is 69 percent, and that is an actual five months comparison of last year versus this year.

We have also in addition we have some banks who are lending in that market.

Mr. BALLANCE. Just a couple of follow ups. There are a lot of people—I am from a rural area in North Carolina, eastern North Carolina.

Mr. BEW. Know it well. You can tell by my accent I am not far away.

Mr. BALLANCE. And there are a lot of people who need to have their credit adjusted. Do you get involved in, your agency, any of that?

Mr. BEW. On the——.

Mr. BALLANCE. I mean to look at their record, they could not go to a bank and get a loan, but they are solid business people.

Mr. BEW. Right.

Mr. BALLANCE. They just had a hard time. And I am wondering if the SBA makes any additional steps toward people in those categories.

Mr. BEW. Well, I think on the other side of the house, on the capital access side, we have the SBDCs, the SCORE, 12,000 SCORE counselors, some BICs that they can go and get advice on how to deal with a bank or a lender, or really how to adjust that credit report.

Mr. BALLANCE. And a bank is going to turn them out right quick.

One other question I have, Mr. Chairman, I saw your figures on Chart No. 2 that you just referred to, a 69 percent, and 1254 loans.

Do you have the number of applicants that it took to get those 1254 loans?

Mr. BEW. I do not, and I will be happy to try to go back and get that for you.

Mr. BALLANCE. All right.

Mr. BEW. Just one additional, it is a high priority of the Administrator to reach out to minorities, low to moderate income, and we are calling it emerging markets now, and we are doing what we can to design the programs to do that, and we are still not satisfied. We are very pleased with that percentage growth, but not the overall numbers, and we will do what it takes to get them up.

Mr. BALLANCE. Thank you, Mr. Chairman.

Chairman MANZULLO. Congresswoman Napolitano.

Ms. NAPOLITANO. Thank you, Mr. Chair.

Mr. Bew, there is a couple of questions that, and you and I have talked about certain issues dealing with credit units. That is another subject. But I was looking at your chart with the minority loan programs, that you were 42 percent ahead——.

Chairman MANZULLO. If you could suspend for a second. Could you put the chart back up again?

Ms. NAPOLITANO. Yes, that would help.

Chairman MANZULLO. Go ahead.

Ms. NAPOLITANO. Yes, the increase of 2002 and all the minorities, you have a total increase of 43 percent, and then you break it down by ethnicity, including veterans and women.

Could you tell me what your goal is, sir, for this year, for the Hispanics specifically, the national goal?

Mr. BEW. For Hispanics, the national goal is—if my memory serves me correctly—7,500.

Ms. NAPOLITANO. And that percentage is what?

Mr. BEW. I do not know what the exact percentage is.

Ms. NAPOLITANO. And what about African Americans?

Mr. BEW. It was—it was substantial. But these are, of course, not goals; these are just actual numbers.

Ms. NAPOLITANO. That's what I am banking it on is you had an increase. What are you—what is going to be the goal that the SBA is going to have to reach out and help those special interests, the minority interests?

Mr. BEW. Yes, I will be happy to give you the goals that have been set for the districts. I do not have them here with me. I happened to have remembered that particular one.

Ms. NAPOLITANO. Okay, could you do that for us? You know, I would like to see that, because some of the businesses that I deal with, they are all kinds of minorities, and also do the same for the African American businesses, and the women-owned business.

Mr. BEW. Okay.

Ms. NAPOLITANO. Because those are the figures in my area that are growing, and if we cannot help them, if we do not know what your goal is, we cannot be able to project to them what kind of help they may be able to get from SBA.

Mr. BEW. Okay.

Ms. NAPOLITANO. Now, the other question would be——.

Ms. VELAZQUEZ. Would the gentlewoman yield?

Ms. NAPOLITANO. I would be delighted.

Ms. VELAZQUEZ. Are you going to tell us what the national goal of your agency is going to be in each of those categories in writing, national goal?

1Mr. BEW. We have set some internal goals. We have an overall emerging markets goal just to encourage the district directors to market and do outreach programs.

Ms. VELAZQUEZ. So you do not have a national goal right now for Hispanics, minorities, blacks and women?

Mr. BEW. We have emerging markets goal, yes.

Ms. VELAZQUEZ. Is that the same?

Mr. BEW. Yes. I mean, we have it broken down, yes.

Ms. VELAZQUEZ. You have it broken down.

Mr. BEW. Yes.

Ms. VELAZQUEZ. But in answering to Ms. Napolitano, will you be able to have time to break to down?

Mr. BEW. Yes.

Ms. VELAZQUEZ. And establish a national goal?

Mr. BEW. We can look at that, yes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Ms. NAPOLITANO. Thank you.

And I guess maybe along the same line, Mr. Bew, and I am not trying to be hard, I want to be sure that I understand. Will the

agency be able to commit to setting a goal then? Can we count on that for minority business, for Hispanics, for women owned, or the other one would be African Americans, because those are the categories you have, Native American, veterans, woman owned and minorities?

Mr. BEW. From the internal goals, yes, we can set it.

Ms. NAPOLITANO. Would you be committing to setting a goal of 20 percent to all the categories?

Mr. BEW. I do not recall what the internal goals were.

Ms. NAPOLITANO. No, but I am asking you. Would you be willing to commit to trying to achieve a goal of 20 percent for those categories?

Mr. BEW. Twenty percent growth?

Ms. NAPOLITANO. Increase, yes.

Mr. BEW. I would like to look at the figures again to see what we have. I cannot recall offhand.

Ms. NAPOLITANO. Okay. But you will look at them?

Mr. BEW. Certainly.

Ms. NAPOLITANO. Thank you.

Chairman MANZULLO. Congresswoman Majette.

Ms. MAJETTE. Thank you, Mr. Chairman. Good morning, gentlemen.

I share the concern of the gentlewoman from New York regarding the 7(a) loan program, and it is one that is critical to the small businesses, I believe, throughout this country, but certainly in my district because these are small businesses, these small businesses are able to secure loans for a wide variety of purposes for which the regular lenders would not provide loans, and that obviously includes working capital, acquisition of furniture, machinery, equipment and inventory.

In fact, this year alone small businesses in my district have secured over 60 loans under the 7(a) program. That is a total of about $15 million so far. And from my point view this is critical to turning the economy around, being able to help to create these small businesses.

But I am concerned, as my colleague is, that the proposed 2004 budget underfunds this program, and it leaves very important—this very important program billions of dollars short.

Now, with respect to the issue, I guess more specifically of using credit cards as a way of funding these loans or making the funds available, I guess you would agree with me that often credit cards are a high cost funding alternative, and I am interested in hearing your view, Mr.—how is it pronounced?

Mr. BEW. Bew.

Ms. MAJETTE. Bew, yes. I'm interested in hearing your view about how a credit card program would really provide small business with an affordable source of capital. Can you go into more detail about that, please?

Mr. BEW. I would be happy to. The statistics, if I recall, is that 40 percent of start-ups use credit cards anyway to start their businesses, and they put maybe three or four personal credit cards together, paying up to 18 percent interest to start a business.

We could have a program with—of course, we would have caps on that, on our interest rates and they are nowhere near there, if

we could develop anything like that. But it definitely used by business. I think I read where 80 percent of small businesses use a credit card anyway.

Ms. MAJETTE. But what is the anticipated total return to the credit card company as you would envision it being part of the 7(a) program?

Mr. BEW. Again, there are caps on it, so it is traditionally not—if we had one, if they are using it, they are adhering to the 7(a) caps.

Ms. MAJETTE. So you are saying you would see this as being a substantial benefit rather than providing the loans in a more conventional way?

Mr. BEW. I would say traditionally if a company were to use a credit card, a personal type credit card, the rates would be substantially higher.

Ms. MAJETTE. Well, but I guess my—and I am have been a small business owner, and I know lots of small business owners, and usually what happens is that they we will use a credit card because they are not able to secure a loan through some other traditional means. It is not—it may be a matter of convenience. It is a matter of that financial access to the finances. I mean, the preference would be to get a loan at a lower interest rate going through the traditional route rather than using their own personal funds or accessing their own personal lines of credit at a higher interest rate.

So that really does not alleviate my concern of what you are saying, well, they would use a credit card anyway.

Mr. BEW. Yes.

Ms. MAJETTE. Is not the purpose of the loan and the program to provide funding at a lower rate than typically an individual would go out and have access to?

Mr. BEW. Yes, it is a mainstay of the 7(a) program. In 2002, I think the working capital lines, regardless of how the bank would deliver the program, whether it is a plastic card or just call in and get a draw on a working capital line of credit, it is—you know, that is what the 7(a) program is about. It is being done.

Ms. MAJETTE. So you are saying there is no difference in the interest rate whether you use a credit card or the traditional means. Is that what you are saying?

Mr. BEW. I am saying the 7(a) caps are generally prime plus 2, 2¼, 2¾ on working capital lines.

Ms. MAJETTE. Well, I understand that you are saying that that is what the cap is.

Mr. BEW. Yes.

Ms. MAJETTE. But my question is, is there a difference between the actual rate of using a credit card versus the traditional loan regardless of what the cap is?

I mean, the cap may—let me try and make it a little more clearer what my concern is. The total cap may be—let us just say for purposes of this discussion the cap is 10 percent.

My question is, is the interest rate on the credit card nine percent and the interest rate on the traditional loan five percent? Is there a difference between using one vehicle or the other even though both may be below the cap? Or are you saying that using

the credit card would give you the same interest rate, the same interest rate would apply as if you had a traditional loan?

Mr. BEW. If you had a 7(a) loan with a revolving line of credit, there is a cap that the SBA sets that is traditionally lower than out in the private markets for a credit card.

Does that answer your question?

Ms. MAJETTE. No, it does not.

Mr. BEW. Okay.

Ms. MAJETTE. My question is——

Mr. BEW. Let me give you an example then.

Ms. MAJETTE [coninuing]. If the vehicle—if you are using a credit card, and it is under the 7(a) program, is the interest rate going to be the same as if you get a traditional loan, non-credit card loan under the 7(a) program? Is it the same interest rate, and so it is just a matter of convenience that they use plastic versus paper, or is there a difference—is there an additional difference in cost between using paper versus plastic, as they say in the grocery store?

Mr. BEW. The traditional 7(a) rate on a revolving line of credit would be, I think, max, we cap it at prime plus two and three-quarters. If prime is four and a quarter, so whatever tune—my brain is failing me, but it is seven percent. If they happen to use SBA Express, and put a working capital line of credit through the SBA Express, it would be prime plus six and a half. So that would be what, six and a half plus four and a quarter. What is that? Ten and three-quarters.

Ms. MAJETTE. So there is a——.

Mr. BEW. If they went out on the regular market and you know what you would pay on a personal credit card, it could be prime plus 10 or more; maybe 18 percent. So that kind of gives you the relative difference of them.

Ms. MAJETTE. So the answer to the question is paper versus plastic under 7(a), there is a cost difference between paper versus plastic under 7(a)?

Mr. BEW. Well, the plastic—I think people are getting hung up on the plastic. The plastic is just a medium to deliver, to deliver a 7(a) product.

Ms. MAJETTE. I understand, I understand that. I am trying to get—I am sorry. I am trying to find out whether the difference in the medium used creates an additional expense to the small business owner even though both medium are covered under or within the 7(a) guidelines.

Mr. BEW. That is a difference——.

Ms. MAJETTE. Well, I want to hear you tell me that that is what is the difference. It is four percent? Is that what you are saying?

Mr. BEW. Whatever the numbers were, yes.

Ms. MAJETTE. Okay. So it does cost four percent more if you use one versus the other?

Mr. BEW. If you go under the SBA Express versus the regular 7(a).

Ms. MAJETTE. So it is four percent more under SBA Express versus 7(a)?

Mr. BEW. If that is what the difference is, yes.

Ms. MAJETTE. And that is the difference in the use of the two mediums, is that——.

Mr. BEW. Yes, if the bank under an SBA Express would choose to use a credit card, a piece of plastic, or they may just have a regular working capital line of credit, and the bank would call in, the customer would call in and ask for a draw, and they would put it in their checking account.

Ms. MAJETTE. Well, that is why I am concerned about the uses of the option because it seems to me that that would reduce the access to those loans.

Am I misunderstanding something?

Mr. BEW. No, I am not following.

Chairman MANZULLO. If I could ask?

Ms. MAJETTE. Yes. Yes.

Chairman MANZULLO. Let me make this very simple for the SBA. We are writing into the reauthorization language a complete prohibition on the use of credit cards for any programs at the SBA. And I would like for you to instruct the people working there now to go down different avenues as soon as you get back.

Under no circumstances whatsoever. I as Chairman of the Small Business Committee, and see the disgrace that has taken place at the Department of Energy where people are taking credit cards and buying jewelry, using it for gambling debts, for any type of thing like that.

I mean, I just—maybe I am reading it wrong, but credit cards is how people get in trouble. These two members are small town lawyers, and I know exactly the background in which they are involved, and I come from the same background too.

But I am just telling you right now.

Ms. VELAZQUEZ. Mr. Chairman.

Chairman MANZULLO. Yes, go ahead.

Ms. VELAZQUEZ. But in answering my question Mr. Bew said they were not working on a credit card.

Chairman MANZULLO. Well, they were thinking about it.

Mr. BEW. We do not have a specific credit program. I think many banks, and I would have to research the numbers, actually use the piece of plastic to administer the 7(a) working capital line of credit. But I would be happy to research it and get back with you.

Chairman MANZULLO. Does anybody here know about any plastic being used by any programs?

Mr. BARTRAM. Well, if I could, Mr. Chairman, go ahead and——.

Chairman MANZULLO. Sure.

Mr. BARTRAM. The SBA Express program allows you to disperse a loan through the use of a credit card, but it is nothing more than a debit card at that point.

Chairman MANZULLO. It is a debit card.

Mr. BARTRAM. So it is not a credit card per se.

Chairman MANZULLO. Then how does the bank determine that the money is being spent for the expressed purpose? Is there an internal audit that goes on with the bank?

Mr. BARTRAM. This is just for ease to disperse. It would be akin to giving somebody a check or putting funds in their account. It makes it easier on the clientele to have access to those funds. The

client has to basically attest that those funds are being used for business purposes.

Chairman MANZULLO. Attest.

Mr. BARTRAM. Which is typical with a conventional loan as well.

Chairman MANZULLO. What is the accounting procedure that goes on in the banks or the different development corporation to make sure that money is spent for the intended purpose?

Mr. BARTRAM. Is that a question?

Chairman MANZULLO. Anybody. John, did you want to take a stab at that.

Mr. PHELPS. It is a little bit easier for development companies because we are take-out permanent financing, and so the bank will make certifications that the construction loan was advanced according to the authorization. We come in and then we take out the bank. We refinance that interim loan on a permanent basis. So it is very easy to monitor.

Chairman MANZULLO. Anybody else want to take a stab at that? Well, okay.

What we should do is meet some other time, but I just—just the thought of somebody getting a bank loan, I mean obviously the SBA rate on the credit card would be less than conventional credit cards which are about 24 percent. And you know, is it the Express loan where you have to have the guidance along with the money? Which program is that? That is the microloan where the guidance of professional counselors is coupled with the distribution of the money on it.

But I just do not—I would be very careful where you a going with this thing, and I would not waste a lot of time at the SBA because if it gets anything near making it easier to spend money for unintended purposes, in fact, I have instructed counsel to put it right into the reauthorization that this will be strictly prohibited.

Mr. BEW. David may be able to address that better than I since he is working in a bank now. But I think the blocks on some of these credit cards—I assume your bank has an active credit card program to small business?

Mr. BARTRAM. Yes. Yes. We are a very large. But we do not through the SBA program, we do not utilize credit cards for first loans.

Chairman MANZULLO. No, that is just a conventional credit card.

Mr. BARTRAM. Right. Ours is a conventional product.

Chairman MANZULLO. Okay. All right.

Let me ask this question. On the manufacturing issue, well, it is not to manufacture credit cards, but that is not what we are talking about. But on the manufacturing issue, anybody here will be welcome to join in, when somebody wants to enlarge his or her factory or to take over an existing facility, and says, you know, I need X amount of dollars.

How do they know which loan to use? John, why do you not start because of the recent—what happened with Kaiser Westrand and Byron, and then I would like to see how these programs weave in and out with each other, and how the experts would advise which way to go.

Mr. PHELPS. Thank you, Chairman.

I think most of the activity we see is referred to us by a bank, and the bank will, I think, generally and structure it conventionally without assistance because it is the past of least resistance, and they are there to serve their client. And in those situations where there may be inadequate collateral or some other reason that they are looking for some credit enhancement they may call us for a 504 if it fits the project, it is a long-term fixed asset, or they may structure it as a 7(a), and there are advantages certainly to banks structuring some of these loans as 7(a).

As Mr. Bew has referred to, under the 504 we see that 7(a) has increase for manufacturers. I think a lot of that is a result of the type of credit needs those companies need that are not 504 eligible, but also the interests of the bank to structure it in a way that may be serving their interest better than the clients for structuring a 7(a), giving their credit enhancement but not necessarily the terms that 504 offers.

Chairman MANZULLO. Anybody else?

Mr. FINKEL. Yes, I would like to comment about working capital. When a manufacturing facility is looking at expanding, acquiring working capital needs, they are looking to a senior facility, but in the lower, middle markets in small manufacturing businesses, you know, the amount of senior debt is, you know, inadequate in a lot of transactions in expansion, and they will seek capital to the cost of capital in contrast.

So equity being the most expensive capital, they may look to—in fact, John and I were talking off-line about the company he is looking at, and potentially having us refer a subordinated debt source that can fill the gap of that structure. But you know, an owner will look at what are the alternatives and look for the cheapest capital available. But given the state of banking right now, the capital that will allow for the most flexibility is the most desirable capital.

Mr. BARTRAM. Yes, I would like to comment if I could, Mr. Chairman.

We would look at both the 504 and 7(a) loan programs and see what best fits the need of the—what best fits the need of the customer. Some of the uses are not going to be something that could be put within the 504 program. There might be some equipment that is not long term, might be some working capital needs, but it is one that you really needs to be hands-on with, and these are typically larger types of transactions so they would not fit into like an SBA Express product. You would need to basically learn the story, learn what you could really do for that client, and perhaps both programs need to be utilized.

Or as John mentioned, it might be in the bank's best interest and the customer's best interest to put it into one loan package, but these are typically larger types of transactions.

Chairman MANZULLO. Have any members on the panel here, including Mr. Bew, because you obviously hear from the field, an indication that the people involved in manufacturing, that there is just not enough money available at the SBA?

I am sure you hear that all the time, Mr. Bew, but you know, the complaint is there is not enough money, right?

Mr. BEW. Most people want more.

Chairman MANZULLO. Right. That is correct. That is correct.

Mr. Finkel, do you have a comment on that?

Mr. FINKEL. Yes. Well, there is clearly a shortage of capital. You know, I would argue there is a shortage of people who can lend that capital, especially in our markets. It takes 10 years of mentorship to get good enough to allocate the dollars properly in the risk allocation model.

So regionally, and I would argue the midwest, there is a significant shortage of that capital that is necessary to go under the banks.

So, yes, I hear manufacturing companies all the time, that is why, you know, in the private markets the supply/demand is so off right now.

Mr. BARTRAM. Mr. Chairman, we just went through a time when we had a loan cap, and we are also in a time where conventional credit is very difficult to obtain. And with the trend we are seeing in the 2004 budget, I think we will see a cap again.

So I just think that runs in conflict with the goals that we are trying to obtain here.

Chairman MANZULLO. Mr. Phelps.

Mr. PHELPS. Mr. Chairman, what I am seeing in Rockford is the companies that now are seeing some new contracts materialize are in such poor financial condition, and they are burdened with so much debt that the banks do not want to lend them the money.

And one of our proposals under 504 is if we are going to help these companies expand we need to deal with restructuring that existing debt on affordable terms, perhaps stretching it out as allowed under 504 to match the debenture term, to position them for additional debt, and those new contracts that are out there, because if you do not work with the existing debt, I do not blame banks for not wanting to put new debt in. The companies cannot support it based on historical or even——.

Chairman MANZULLO. So what would your suggestion be then?

Mr. PHELPS. Our suggestion?

Chairman MANZULLO. Right.

Mr. PHELPS. Would be under a 504 allow for us to restructure a certain amount of existing debt along with new debt to help stretch out those amortization schedules; put it on more affordable terms, and mitigate some of the bank's risk by putting that on a subordinated basis.

So it is really a win/win for everybody, the borrower, the bank, and the economy.

Chairman MANZULLO. Now, you are here in March. Are you meeting with some of the folks at SBA to go over those plans?

Mr. PHELPS. It is in our legislative agenda, and certainly are discussions with——

Chairman MANZULLO. Okay.

Mr. PHELPS [continuing]. SBA on the proposal.

Chairman MANZULLO. With your organization. All right.

They would handle—well, let us get back to the situation with W.A. Whitney. Esterline wants to spin it off, and it is 125 jobs in Rockford. It is state of the art.

Is there any idea as to what the asking price is, at least something that could be disclosed publicly?

Mr. PHELPS. I am not at liberty to disclose those details.

Chairman MANZULLO. Okay, fine.

Mr. PHELPS. We would be happy to in private. But the rest of your question?

Chairman MANZULLO. Well, I guess my point is if they need X amount, and apparently none of the resources that you have can come up to that level. I think you stated that in your—what would you do by restructuring any of the loan programs working with SBA to be able to allow either an employee buy-out or a new company or another company acquiring it in the best of the worlds of John Phelps?

Mr. PHELPS. Our legislative proposal asks for a higher ceiling for 504 for manufacturers in particular, and it is a result of the need to modernize and buy very expensive equipment, must of this specialized equipment. It is a little risky, and when the banks look at they go through an underwriting process that says what is his collateral worth in a worst case scenario, what can his business support based on their historical cash flow and projected cash flow. And if it does not meet those tests, they are not likely to lend on a conventional basis.

Where we can help in a case like this or where companies need to buy very expensive large pieces of equipment, by increasing the amount of subordinated debt we reduce the bank's risk because they do not need the collateral protection as much anymore. They are not advancing as much money. We are stretching out the terms with long-term fixed rate debt, and we are making it more affordable for those companies to modernize.

So we would be looking for a higher dollar amount under 504 as a special exemption for manufacturers.

Chairman MANZULLO. Yes, when banks take a look at the value of that machinery, we have seen the auction sales where it goes for 5 and 10 percent on the dollar.

One of the folks who testified here today talked about putting some emphasis on character loans. Was that on—had you testified to that on microloan? There is a new emphasis on that, or there is proposed change, or are character loans are already part of the microloan system?

Mr. GAST. That is part of what we do. One of the conditions we have through the legislation is for a loan of $20,000 or more, we have to have a letter in hand in saying a bank will not make a loan. Typically, that is for lack of collateral.

Our primary considerations are cash flow and characterization.

Chairman MANZULLO. Let me ask this question. I appreciate that. What we are seeing in the manufacturing sectors are companies that may not really have a lot of debt, but business has been bad in the past year. The equipment is—you cannot rely upon equipment as sufficient collateral. I mean, machine equipment is—you know, there is an abundance of machinery equipment.

But somebody comes along and says, look it, I have got this contract, and it is guaranteed an X amount of money. Is there any way to take a look at the contract and factor it and enter into an agreement with the person on the other side of the contract, the procuring person, to have the money come directly to the lender, to

work that way in a three-way partnership so that the contract becomes the main source of collateral?

Mr. BARTRAM. The answer to that is yes. I mean, you can do that basically on a conventional basis, or even the SBA program there is a program within the SBA and the 7(a) cap program where you can go ahead and take assignment of that contract. It comes into a lock box basically.

Chairman MANZULLO. Okay.

Mr. BARTRAM. And you fund a certain percentage back to the consumer.

Chairman MANZULLO. And that is at the conventional 7(a) limits, up to that amount?

Mr. BARTRAM. I believe so.

Chairman MANZULLO. Okay, is that being frequently—obviously there appears to be more risk to it because you do not know the solvency of the third party.

Mr. BARTRAM. It takes an awful lot of servicing both from a conventional and also the SBA to protect the SBA guarantee back to the bank. It is a highly intensified servicing.

Chairman MANZULLO. Okay. Mr. Bew, did you have a comment on that because I know that continuously you are kicking around different ways to make more money available?

Mr. BEW. Right. I think these working capital lines that we have talked about earlier under this cap program, and one particular one is an asset-based lending where you do file, for example, a monthly borrowing base. You list your level of inventories. You advance against the inventory level. You lend against the accounts receivable level, and it is a lot—as David said, it is very paper-intensive, and I do not think it is that popular, quite frankly.

Chairman MANZULLO. Okay.

Mr. FINKEL. Mr. Chairman?

Chairman MANZULLO. Yes.

Mr. FINKEL. If I may make a comment, because one of the things that you are describing is lending to assets and not to businesses, and that is the shortfall that specifically debenture SBICs fill, and there are painfully few in the midwest.

In Illinois, for instance, there are two or three, and those are the lenders that, you know, after the asset lenders you are talking about are a necessary component of some of that expansion that you are describing.

Chairman MANZULLO. Okay.

Mr. PHELPS. Mr. Chairman, one other comment too, I think, that addresses your concerns. One of our proposals from the 504 industry is to allow a separate borrowing cap under 7(a) and 504. Our Austin Western Case and Byron, they maxed out their borrowing ability under the 504 program. They now have bought another company, consolidating those to make it more efficient, and they have no ability to borrow, and these are largely working capital assets, inventory, supporting accounts receivable, but they have no more borrowing ability under SBA lending authority.

If they had a companion piece that allowed them to borrow up to 1.3 or even a million under 7(a), this would help that particular company.

We see that as a real gap because as these companies expand and utilize their borrowing authority for hard assets, there is not a supporting mechanism to support the working capital assets if they exhaust their borrowing authority with 504 financing.

Chairman MANZULLO. Okay. Anybody else have any more questions?

Ms. VELAZQUEZ. Mr. Chairman.

Chairman MANZULLO. Go ahead.

Ms. VELAZQUEZ. Thank you.

Mr. Bartram or Mr. Phelps, when you make a loan to manufacturers, are these generally small loans or large loans?

Mr. BARTRAM. They are typically larger transactions.

Ms. VELAZQUEZ. Yes?

Mr. PHELPS. I would say these are larger than—when Mr. Bew when talking about the average size loans, the smaller loans he was talking about would not generally be manufacturing loans because of the need for equipment.

Ms. VELAZQUEZ. So I want for the Chairman to listen to this answer. I just asked him to please tell me whenever they make loans to manufacturing firms are they large or small, and they are telling me that they are large.

Chairman MANZULLO. You mean large.

Ms. VELAZQUEZ. Large loans.

Mr. PHELPS. Dollar size.

Mr. BARTRAM. Dollar size.

Ms. VELAZQUEZ. If the committee in the reauthorization works to improve the loan programs to help manufacturers, how do you think that will fit with the agency's big push for smaller loans?

Mr. BARTRAM. Larger loans and manufacturer loans are going to be a much high touch. There is much more of a story behind what the needs are especially for companies that have feel in some hard times.

Smaller loans, especially SBA Express, are very low touch. They are credit scored in most cases. So you would not be able to really help a company that is having harder times because they would not score out. And typically again, these are larger transactions.

Ms. VELAZQUEZ. So we have here two different priorities.

Mr. BARTRAM. There is a confliction there, yes.

Ms. VELAZQUEZ. Okay. Mr. Bew, in your testimony you cite BLS statistic that smaller loans, loans less than $50,000, create more jobs dollar to dollar than larger loans. That is what you said in your testimony.

So I am going to ask the agency again, given these figures that the agency is touting about small loan creating more jobs, why have you left the MicroLoan Program so underfunded?

Mr. BEW. I think the microloan funding is in line with what it was last year.

Ms. VELAZQUEZ. Mr. Gast, would you comment on that?

Mr. GAST. Over the past four years, microloan technical assistance funding has fallen more than 30 percent.

Ms. VELAZQUEZ. So we have a discrepancy here.

Mr. BEW. I believe last year we did $16 million in direct loans in the MicroLoan Program, and that is what we expect this year. We have done a couple of enhancements, and you will see in the

legislative package that we are proposing reallocation of the technical assistance. And we have also set some standards for some of the micro lenders, and feel that some of them are leaving the program, which will allow us to have more money to lend. It will be adequate.

Ms. VELAZQUEZ. What we have here is that the funding for the MicroLoan Program is inadequate. And my question to you is, what kind of message are you sending to the 7(a) lenders?

You are constantly asking them to provide and to make more smaller loans when you are cutting the MicroLoan Program in half.

Mr. BEW. There are many programs in the 7(a) program in addition to the micro lending that make small loans.

Ms. VELAZQUEZ. Well, the mission of the 7(a) loan program was to provide for long-term loans, not microloan, was it not?

Mr. BEW. I thought the mission was to make as much capital available or as many loans as available to small businesses, whether it is long term or short term.

Ms. VELAZQUEZ. Long-term loans. On 40 percent of all long-term loans have been provided through the 7(a) loan program. That is the statistic that you provided to us.

This is my—and I am sorry that we are running out of time, and I know, Mr. Moncrief, that you have been dealing with your own situation here, about the fact that there is no coordination between the new market venture capital, ability to raise capital. There has been a lack of coordination between the New Market Venture Capital Program and the new market tax credit, right?

Mr. MONCRIEF. That is correct. There has been a huge out of synchronization methodology. For example, the new markets tax credits were not announced until just this past week whereas the New Markets Future Capital Program has been, the companies now have been conditionally approved since July 9 of 2001. And the whole purpose of the tax credit was to help the new markets companies raise the funds. So consequently it has been a very difficult program. Even the different mechanisms within the two are not harmonized.

Ms. VELAZQUEZ. Do you think that you have been getting the kind of support that you need from the administration to make this program work?

Mr. MONCRIEF. It has been challenging. It is a new program that has been very challenging.

Ms. VELAZQUEZ. I applaud the agency's effort and move to make smaller loans, but to tell us that you want to make more smaller loans, and offer short-term capital line, and even a credit card is inconsistent to me. And to say all that, and then we hear from the Chairman that he wants the programs to do more lending to manufacturers, to cut the MicroLoan Program that makes the very loans that you claim is a priority for the agency is ridiculous.

And to be honest, it makes the work of this committee very hard and very difficult, and it makes it difficult for me to take it seriously.

So I will say that if you are going to say that small loan is a priority, then put the funding in the MicroLoan Program. So do not try to make the 7(a) program something that it is not, because it

is not for just providing smaller loans. You have a specific program for that and that is the MicroLoan Program.

Chairman MANZULLO. All right, I would join in that. You know, coming from our end, I guess coming from your end perhaps it looks good to show that you are servicing larger numbers of people, and I am not critical of that because everybody wants to get involved in the business, but there is mission creep whereby the programs start to blend one into the other on it, and the people that get caught on that are the people that have high capitalization needs, such as restaurants and manufacturing as opposed to service.

I mean, if you wanted to start a law firm, if somebody came to you for a loan, which probably would not happen, you could start a law firm, a one-person law firm for $5,000. Well, no, I am serious. I am serious.

I mean, you know, you could buy a printer and a word processor, and everything there for about a grand; some filing cabinets, and you know, some used furniture, and end up making a pretty good living at that.

But it does not involve—I have got to watch what I say here because we are both attorney, but it does not involve something such as manufacturing where you dig stuff out of the ground and you create more jobs on both ends of it, and you need that increased amount of capitalization.

And I guess the point is that the reason we are spending so much time on manufacturing is—and we are to have probably about seven or eight hearings—is that I do not believe that this economy will ever recover until manufacturing is reestablished in this country period.

I can, you know, in the time that I have been here, and my dad has worked at Roper. John, you recall that. No, you do not, I am older than you, but it was during World War II. Dad started out as a machinist, then he became a master carpenter, and then he went into the grocery store business, and into the restaurant business. He was not a good SBA model because he never believed in debt.

And I mean, he borrowed very little. Once in awhile he would—I think in his entire lifetime he bought maybe three or four pieces of equipment. But he was always in that—because he was a master machinist and a master carpenter, he could always fix something for himself, and be able to do that.

But what we are seeing now, it is good to start service industries. I mean, that is fine, it is important. But the key here to recovery is in the manufacturing.

And, Bob, you are shaking your head. If you could——.

Mr. FINKEL. I could not agree more, and you know, in many of these loans to manufacturing companies the senior debt that we have been discussing, you know, while very important, a critical layer, will only take it so far. You have got to have a risk layer of capital underneath to get those loans.

In fact, both debenture and equity are enabling capital for that senior debt. And if you are looking for other constructive ideas, I know that the Small Business Capital Access Act was also—you know, I think will come before the committee, I assume. It is H.R.

739, which will remove the disincentives for UBTI for some of these debenture licenses and create more capital flow from the private markets. I would encourage its support as well.

Chairman MANZULLO. We are working on it.

Anybody else? Yes.

Mr. PHELPS. Mr. Chairman, it is not just businesses being touched by SBA either. It is the job creation aspect that really affects manufacturers. As we see in our metal working community, companies will have to buy a machine center and maybe spend hundreds of thousands of dollars that actually cause jobs to be displaced. And it is the only way you can retain the existing jobs, the base that is there, and remain competitive. Because if they are burdened with hiring with more people long term, all of those jobs will be at risk.

Chairman MANZULLO. Okay. Mr. Moncrief?

Mr. MONCRIEF. Mr. Chairman, I would like to just support Bob's comment about that risk layer that is so important in leveraging manufacturing.

In our business the majority of what we do, the vast majority of what we do is indeed manufacturing, small manufacturers. These people are not located urbanized areas, high-growth areas. They are in very desolate, off-the-road sorts of places.

The whole testimony regarding—I had prepared for the New Markets Venture Capital Program—is that all the 7–8 programs, the 504 program, traditional band debt, et cetera, is fine and well unless there is an underlying layer of risk money that supports that first lane money that is sitting out there.

Consequently, the traditional SBIC programs, the traditional venture capital does not go into these low income impoverished areas and invest. That is why this New Markets Venture Capital Program is so important to push traditional sorts of equity financing into low income area, and it is targeted to do low income census tracts.

So consequently I agree with Bob that all these debt programs that we are talking about are totally essential to the growth of manufacturing, but it does not happen without a layer of equity. No matter what you are doing it has to have a layer of equity in there.

Chairman MANZULLO. Mr. Moncrief, is it your company that financed the military tend manufacturing company?

Mr. MONCRIEF. Yes, sir.

Chairman MANZULLO. Would you take a note back to them to make sure that nobody slaps a Berry waiver upon them?

Do you know what the Berry waiver is?

Mr. MONCRIEF. I do indeed, sir.

Chairman MANZULLO. It is whenever you have any material that involves cloth or canvas or specialty metals, this is what happened to the manufacturers when DLA decided to buy 2.5 million berets offshore, and we stopped that cold. But it also applies to canvas materials which is in tents.

But if you hear of anybody involved in the defense department that is buying tents offshore, would you contact me immediately?

Mr. MONCRIEF. I would, Mr. Chairman. I will tell you that there are issue around that. For example, there are certain cloth items

that are being purchased Mexico in defiance of the Berry Amendment.

Chairman MANZULLO. We would like to pursue that with you. Is this from the company in Kentucky?

Ms. JONES. It is, sir.

Chairman MANZULLO. And whose congressional district is that?

Mr. MONCRIEF. Mr. Rogers.

Chairman MANZULLO. Mr. Rogers?

Mr. MONCRIEF. Hal Rogers.

Chairman MANZULLO. Well, great.

[Laughter.]

Chairman MANZULLO. You have got it. He is the other Mr. Rogers here to us.

Mr. MONCRIEF. Indeed.

Chairman MANZULLO. We would like work with you very closely. You are evidently very close to these people?

Mr. MONCRIEF. I am, sir.

Chairman MANZULLO. And if you could—do you know if they have been able to work with Mr. Rogers or contact him on this yet?

Mr. MONCRIEF. They have. They have spoken to his chief of staff.

Chairman MANZULLO. Okay. Is that something recent that has gone on?

Mr. MONCRIEF. It is. It is very recent. As a matter of fact——.

Chairman MANZULLO. Could you get us involved in that fray, please?

Mr. MONCRIEF. I would be delighted, Mr. Chairman.

Chairman MANZULLO. Okay, who would it be on—Nelson? Nelson Crouther from our staff. Anytime, anywhere, if you could organize that meeting with Mr. Rogers, and actually myself and your constituent, I guarantee you we can help, otherwise they will be up here in a month for a hearing.

If there is anybody out there in the defense department that is thinking about getting a Berry waiver on this, you will be here in 30 days also.

Ms. VELAZQUEZ. Mr. Chairman, and also I would to recommend to Mr. Moncrief to talk to the Chairman because he realizes today the kind of help and assistance in terms of venture capital that you are providing for manufacturing.

Chairman MANZULLO. That is correct.

Ms. VELAZQUEZ. So maybe you can help him get more cooperation from the administration so that we could help this type of venture capital to become more successful.

Chairman MANZULLO. Appreciate that.

Listen, thank you all for coming. You are very kind. All of the written statements will be made a permanent part of the record.

And Mr. Bew if you and T. could meet with—I guess it would be Phil from the staff, who is the policy director, and see if we are talking plastic/plastic or something else. I think somewhere something got lost in the definitions, and we may been on different tracks on that, but I certainly want to come to the meeting of the minds before we do something that we should not do.

And thank you again for coming. Appreciate it.

[Whereupon, at 12:18 p.m., the committee was adjourned.]

House Committee on Small Business

"Changes to SBA Financing Programs Needed for Revitalization of Small Manufacturers"

March 20, 2003

Prepared Statement of Chairman Don Manzullo

Good afternoon and I would like to welcome everyone to the Committee's first in a series of hearings on the most important legislative initiative that the Committee will consider this year – reauthorization of SBA programs. I look forward to working with the Committee, the Administration, and the small business community to draft a reauthoritzation bill that addresses the concerns of small businesses and small manufacturers in particular.

Fifty years ago, America was engaged in a great ideological conflict with communism. President Eisenhower created the Small Business Administration to ensure that America's small business industrial base would be healthy enough to assist in that great ideological conflict. Fifty years ago, America's small manufacturers provided many of the high-paying jobs that thrust this country into an era of unprecedented economic growth and security.

Fifty years later America again is faced with a great struggle – for a secure America for ourselves and our posteriority. A key force in this battle will be America's small businesses. Unlike fifty years ago, America's small manufacturers are not in the same position to provide the high-paying jobs to help this country secure its economic future. While others believe this great struggle for economic security can be won in a post-manufacturing society, I respectfully disagree. Only through a healthy manufacturing sector and small manufacturing sector, in particular, will America be able to provide the high quality jobs that allow people to buy homes, cars, eat in restaurants, travel, and purchase consumer goods that create true economic growth and security.

During this reauthorization process, I will be examining each SBA program to determine whether it maximizes assistance to small manufacturers. This does not represent anything new; rather it returns the SBA to its original purpose – maintaining a sound small business industrial base. Even though at least one survey of America's Small Industrial businesses showed that they were optimistic, the fundamental question remains are we in Congress and the government doing enough to ensure that optimism comes to fruition.

At today's hearing, we will examine the various financing programs operated by the SBA – 7(a), 504, microloans, SBICs, and New Market Venture Capital Companies. These programs have proven useful in providing financing to hundreds of thousands of small businesses. But are they designed to truly help America's small manufacturers? Do they provide the right type of financing and make sufficient funds available to meet the needs of America's small manufacturers? If not, what changes are needed to these programs? Or are offshoots of these programs needed that are targeted to small manufacturers in the same way that the SBA has targeted financial assistance for exporters?

Let me make it clear. This is only the first step in a long process. The Committee remains open to any suggestions from anyone that will help focus the SBA programs on small manufacturers. What has been said here today may be forgotten, but the actions this Committee takes during the next six months may well be long-remembered by the owners of America's small manufacturers and their children and grandchildren.

Now I will recognize the ranking member of the full committee, the distinguished Gentlelady from New York, for her opening statement.

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
107th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

STATEMENT
of the
Honorable Nydia M. Velázquez
Ranking Member, House Committee on Small Business
Changes to SBA Financing Programs
March 20, 2003

Thank you, Mr. Chairman.

As the Committee begins the process of reauthorizing the Small Business Administration today, we look at one of the most critical challenges facing small business – access to capital.

When small businesses can't find capital, they can't survive. With the current economic downturn, finding capital is becoming harder and harder for small firms. Many are forced to use credit cards, or depend on family and friends to fill this financing vacuum.

Thankfully, the SBA loan programs were created to fill this gap. Last year, these programs provided $21 billion in capital, accounting for 40 percent of all long-term small business lending to this nation's entrepreneurs.

These programs play a valuable role in helping our nation's small businesses. And in today's hearing, we will look at how the SBA loan programs can be improved to meet the financing needs of small businesses.

This year has been a difficult one for the SBA loan programs. Higher fees, lack of funding, and problems with subsidy rates have plagued some of the SBA's most important lending programs like the 7(a), 504 and SBIC.

Given this, the reauthorization we are about to undertake will be all the more difficult. Because of the very complex issues surrounding the SBA loan programs, I believe we should only authorize the agency for one year at a time, while the problems are sorted out. This would be in the best interest of the agency – and the small business owners it serves.

Aside from these "nuts and bolts" problems, we also need to answer some more philosophical questions surrounding the mission of the loan programs. The agency has been so focused on other things – including making more small loans and offering short-term credit – that it seems to have lost sight of the reason the SBA loans programs were created in the first place – to provide long-term capital to this nation's small businesses. This was their original purpose.

In keeping with this spirit, we need to find new and creative ways to make the SBA programs into the premier lending tools of the 21st century that they could be – and should be. By opening up avenues of capital, we open up opportunity for small business.

First and foremost, we need to drastically reduce the paperwork burden of the lending programs. There is simply too much red tape. Right now, lenders must assemble 120 documents that comprise 1,000 pages to make a loan. This discourages them from making loans and small businesses from using the programs.

If we can streamline the programs and make them more user-friendly, then more lenders and small businesses will tap into them. What we want to avoid is lenders and small businesses sitting on top of a mountain of paperwork when using the SBA's loan programs. This is not an INCENTIVE, but rather a DISINCENTIVE. In offering more incentives to entice lenders and small business owners to use the programs, we can get capital where it belongs – into the hands of small business owners.

Much like our nation, the SBA – and its loan programs – are at a crossroads. Right now the SBA loan programs make up almost half of all financing, both public and private. Imagine what they could do if they were adequately funded and operating under new and innovative policies. These programs could finance the next Microsoft or Fedex, which have revolutionized the way we do business.

Working together, I know that we can make the lending environment more conducive to small businesses. Given the current economic situation, small businesses need our help now more than ever. And it is the SBA loan programs that can make a real difference.

Thank you.

Opening Statement of Congresswoman Juanita Millender-McDonald

Small Business Committee Hearing

"Changes to Small Business Administration Programs Needed for Revitalization of Small Manufacturers"

2360 Rayburn House Office Building
March 20, 2003 – 9:30 a.m.

Mr. Chairman and Ranking Member, I am please to have an opportunity to listen to this distinguished panel offer their expertise on the lending programs administered by these Small Businesses Administration, and how

these programs can possibly be modified to provide the best assistance to small businesses nationwide.

I would like to thank all of the witnesses for being here today, including my fellow Californian, David Bartram, President of the US Bank/SBA Division, from San Diego.

One of the most important roles of the Small Business Administration is providing start-up, venture capital, and debt financing for small businesses and entrepreneurs. In fact, the SBA provides about $20 billion in loans and guarantees annually.

In the last fiscal year, the agency approved 116 loans for almost $42 million dollars in my District.

While I am proud of the agency and its dedication to providing financing fuel to the small business engine that drives our economy, I have a few concerns with the President's proposed budget for the agency.

Overall, the President's request would result in a loss of $4 billion dollars in lending opportunities due to a combination of budget cuts and unfair policies, such as inflated subsidy rates for the agency's 7(a) and 504 lending programs.

As the agency's primary business loan vehicle, the 7(a) loan program addresses the needs of small firms unable to secure financing from other sources. The program offers partial guarantees to lenders and is used by

borrowers for all types of business purposes.

While the Administration's budget request of $94.9 million dollars to support $9.3 billion loan level is a ten percent (10%) increase over last years budget, it actually represents a $3 billion decrease in lending authority since fiscal year 2002. This lower loan level may result in small businesses not being able to secure 7(a) loans.

Additionally, the subsidy rate for the 7(a) program still does not reflect the true cost of the program to the American taxpayer. According to a recent General Accounting Office report, small businesses have been overcharged $1.5 billion in fees over the past ten years.

The SBA has announced plans to drop the subsidy rate for the 7(a) program 70 basis points (1.77% to 1.07%), but this rate is still too high for the program.

Similarly, the subsidy rate for the 504 program is inadequate, and is resulting in higher loan fees for small businesses.

Mr. Chairman and Ranking Member, I know that we will hear testimony today concerning all of the SBA's lending programs, and I look forward to the panel's opinion on how to improve the agency's 7(m) microloan, SBIC and New Markets Venture Capital programs.

Testimony of

Ronald E. Bew

Associate Deputy Administrator for Capital Access

U.S. Small Business Administration

Before

Committee on Small Business

U.S. House of Representatives

March 20, 2003

Mr. Chairman, Ranking Member Velazquez, I appreciate the opportunity to appear before the Committee today to discuss SBA's proposals regarding the reauthorization of SBA's financial programs.

President Bush recognizes the vital role that small businesses play in creating opportunity for millions of Americans. One of the key items in the President's Small Business Agenda is empowering entrepreneurs. SBA's role in achieving that goal is to increase opportunity for entrepreneurs to start and grow small businesses by expanding access to capital and providing technical assistance.

Working on behalf of small business is a non-partisan issue. Both Democrats and Republicans know the impact of small business on our Nation's economy. When I came to SBA, my goals were clear: improve access to capital, expand economic opportunity, and help small businesses do what they do best - create jobs and stimulate our economy.

My role in overseeing the Office of Capital Access is to help expand economic opportunities for all Americans. Small businesses create two-thirds of all new jobs in the United States.

This Administration is committed to reaching more small businesses while using the same amount of taxpayer resources, and I'm proud to say that we've achieved that goal. We've reduced the average loan size and are on target to assist more small businesses than ever in our history. We've also created or retained more jobs than ever in our history. In Fiscal Year 2002, SBA guaranteed 51,666 loans, which we estimate in turn created or retained 370,000 jobs. Our goals for Fiscal Year 2004 are to guarantee 72,000 loans, and increase the number of jobs created or retained. We believe that we will far exceed our job creation goal. Historically, we have calculated that one job was created or retained for every $32,000 lent. However, SBA recently partnered with the Department of Labor's Bureau of Labor Statistics to better understand how our loan programs affect job creation and to obtain some better information. That study reveals that our smaller loans are the best job creators. They are creating more jobs dollar for dollar than the larger loans. In fact, loans under $50,000 have the greatest return on the number of jobs created – requiring only $14,700 to create or retain one job. Loans between $1 million and $2 million require $140,000 to create one job. Clearly, these numbers prove that we get more impact on job creation from smaller loans. This is one more indication that our performance goals will continue to create greater employment opportunities to assist in the recovering economy.

SBA additionally found that the smaller loans are helping more emerging small businesses, including minorities and women. While the dollar amount lent to minorities has remained un-changed or increased slightly, the number of loans has increased dramatically over the past year. After 5 months, we are 43% ahead of last year's numbers for lending to minorities and 35% ahead for women. We believe that reducing the average loan size has provided increased economic opportunities to more small businesses, particularly emerging small businesses, and created or retained more jobs, thus improving the effect our programs have in helping the economy.

Now let me be clear, we are not ignoring small businesses that need larger loans in order to make smaller loans. We exist to help all small businesses, regardless of the size of their financial needs. This Administration aims to maximize the economic effect of our loan programs. That means job creation and retention. Our marketing focus on small loans is meant to do precisely that, nothing more or less.

As part of our goal to make smaller loans, SBA has made further revisions to the SBAExpress program. When I arrived at SBA a little over one year ago, I found a program that was not being used to its full potential. The idea behind SBAExpress is that SBA will only guarantee 50% of the loan and, in exchange, the lenders can use their own processes and forms. As you can imagine, there are as many different processes and forms as there are lenders; thus there are many ways to make this program work more effectively. We are still evaluating aspects of the pilot. The most important task is to find the right balance between allowing lenders to use their own forms and processes

while still maintaining adequate oversight of the program. I know there is some concern over how an increase in smaller loans might affect the subsidy rate. SBA has preliminarily reviewed this issue, and the results are positive. Holding everything else equal, SBAExpress loans tend to have a lower probability of default.

Let me address the 7(a) funding request for FY 2004 by saying that the request is in line with historic levels. In FY 2002, SBA had a lending level of $9.4 billion in 7(a) loans. Additionally in FY 2002, SBA guaranteed $1.8 billion under the STAR program. The STAR loan program, which expired in January, was specifically designed to assist small businesses that had been negatively affected by the September 11th terrorist attacks. Some have suggested that SBA's baseline for 7(a) should include the STAR amounts. However, because STAR was specifically designed for 9/11 relief, we cannot assume that those borrowers would have sought out a 7(a) loan if there had not been a terrorist attack. We are confident that we can meet the demand of small businesses that seek 7(a) loans in Fiscal Year 2004 with the funds requested and that those same small businesses will help improve the economy.

As you know, SBA is celebrating its 50th Anniversary this year. We feel this is an excellent opportunity to take a look back and reflect on our successes, and then move forward with renewed vision.

Administrator Barreto and I are very happy with these results, but we know that we can do more. We are putting forward a package of legislative proposals for your consideration. All of the proposals are designed to improve existing SBA programs so that this Administration can better serve America's small businesses and stimulate our economy. I would like to highlight four of SBA's legislative proposals that specifically affect the Capital Access programs.

1. Improving oversight of Small Business Lending Companies (SBLCs). SBA currently has broad, general regulatory authority with regard to overseeing our lenders. Most of our 7(a) lenders are depository institutions that are regulated by one of the Federal financial oversight agencies. Our SBLCs are different. They are specialized companies and are typically not depository institutions. Thus, they are not federally regulated. Our proposal will allow SBA to regulate these SBLCs, in a manner consistent with other Federal regulators, in order to better safeguard taxpayer dollars and to ensure that all SBA lenders are operating in a safe and sound manner. We view this as a matter of fairness as well as oversight. All our lending partners should meet appropriate standards for operating soundness. This proposal is in response to recommendations from the SBA Inspector General, the General Accounting Office, and the Congressional Committees.

2. Improvements to the Microloan program. We are proposing changing the eligibility requirement for participation in the Microloan program and

allowing intermediaries more flexibility in determining how to best serve their customers with technical assistance.

Microloan technical assistance is currently limited to 25% of the amount of the loan. SBA proposes removing that restriction to allow intermediaries to apportion technical assistance based on the individual needs of the borrowers. This amendment will make the program more effective and efficient.

Also, applicant organizations must now have a minimum of one year of experience making and servicing microloans, and one year of experience providing integrated technical assistance, before they are eligible to participate. That experience is now measured in terms of the existence of the organization rather than the expertise of the employees. We propose judging eligibility by looking at the employees and their experience rather than solely at that of the organization. This change will allow SBA to take advantage of the proficiency of the individuals within the organization and will give a more fair and accurate view of the skills in a prospective intermediary.

3. Changes to the loan loss reserve applicable to the 504 Preferred Certified Lending Program (PCLP). SBA recognizes that the original statutory formula is unduly restrictive and burdensome. The Administration is proposing a less strict, more flexible, graduated system to protect against program losses. The specific proposal will allow the PCLPs to establish a loss reserve

commensurate with their individual portfolio, using a loan grading procedure similar to those found in the banking industry. It is our hope that this will encourage our 504 partners, many of whom are avoiding the PCLP lending program to the high reserves currently required.

4. A statutory change to allow the SBIC program to remain at a zero subsidy. The legislative proposal changes the maximum amount of the fee.

Finally, Mr. Chairman, I'd like to take the time to address the questions you posed to SBA in your letter of invitation concerning financing for small manufacturers. All of our programs are available to small manufacturers and will continue to be. Some of them, including 504 and SBIC, may be better suited to manufacturing expansion than others. I can tell you that in Fiscal Year 2002, SBA provided financing of over $2.7 billion to small businesses in the manufacturing sector, as the chart reflects. However, in the 504 program our loans to manufacturing businesses have dropped over the last 4 years. As you are aware, SBA just completed the comment period for an ANPR for the 504 program. We are looking forward to working with you to come up with some creative solutions to assist small manufacturers and to discuss those needs with you and the other witnesses here today. I think your ideas about manufacturing are another example of how we might improve SBA services and the results for the economy.

Thank you for your time, and I am happy to answer any questions you may have.

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program

Proposed 504 Reauthorization, Industry Legislative Request, & Expanded Manufacturing Initiatives

Submitted to the

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

Mr. John Phelps
Executive Director
Rockford Local Development Company
Rockford, IL.

February 26, 2003

The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Committee on Small Business concerning the SBA 504 program reauthorization for FY 2004 through FY 2006, as well as a review of several program enhancements we ask the Committee to consider this year. NADCO is the trade association for SBA 504 Certified Development Companies (CDCs). We represent 250 CDCs and more than 175 affiliate members, who together provided 99% of all SBA 504 financing to small businesses during 2002. NADCO's mission is to serve as the key advocate for the 504 program, and to provide program technical support, marketing assistance, strategic planning, and professional education to our membership.

504's objective is to promote community economic development through job creation and business expansion by providing long term capital funding to successful, growing small businesses. No other Federal economic development program can claim to have created over 1,100,000 jobs, as the 504 program has done. Additionally, 504 was responsible for creating and retaining over 125,000 needed jobs this past year, and we expect to create over 150,000 during 2003. Our mission is more important today than ever before, with the economy stuck in neutral at best, and moving back into recession at worst. 504 is a critical economic stimulus program designed to enable growing small businesses invest in their communities.

NADCO would like to thank Chairman Manzullo, Ranking Member Velazquez, and the entire Committee, for continued support of the 504 program. Your Committee has worked closely with the Congressional leadership, SBA, and our industry to ensure the availability of capital to small businesses through the 504 program.

We have three objectives in providing this testimony to the Committee. First, NADCO will comment on the need for the Congressional re-authorization of 504. This includes the Administration's 504 authorization level, as well as the proposed borrower fees and subsidy model assumptions by SBA. Passage of our re-authorization bill by Congress before September 30, 2003 is required for the program's continue existence.

Second, we will comment on a package of legislative proposals we are submitting to the Committee for your consideration. These program modifications will enhance the program's impact on small businesses, and substantially expand access to long term capital, a major priority the Administration has set for in 2004.

Third, we are proposing a series of extraordinary program changes to address the special capital needs of small and medium manufacturers that have either seen their cost of credit increase in the last two years, or have been completely shut out of the capital markets due to restrictive and costly credit terms by conservative lenders.

PROPOSED 504 PROGRAM RE-AUTHORIZATION

1. 504 PROGRAM AUTHORIZATION LEVEL

SBA has proposed that the authorization level for the 504 program be set for FY 2004 at $4.5 billion. Most SBA programs, including the CDC Program, are authorized for three fiscal years.

Current law authorizes a CDC program level of $4 billion in fiscal year 2001, $4.5 billion in fiscal year 2002, and $5 billion in fiscal year 2003.

Although approvals were approximately one-half of this authorization level ($2.5 billion) in fiscal year 2002, they have increased in the first two months of this fiscal year by more than 25 percent over the first two months of fiscal year 2002 and our expectations are that this increase will continue into the future.

We recommend the following:

- **$5.0 billion for FY 2004**
- **$5.25 billion for FY 2005**
- **$5.5 billion for FY 2006**

As the program continues to fund itself through borrower, CDC, and first mortgage lender fees, there is no cost to the Federal government, nor any Congressional appropriation. With program growth up, we are concerned that, should banks continue their tight credit for small businesses, 504 demand may grow at an even greater rate than anticipated today. Further, if the Committee accepts our program changes, we believe demand for 504 will continue to increase as more small businesses are able to access this program.

The benefits to the country are numerous. New 504 projects provide new jobs in their communities by expanding the plants, equipment, buildings, and employment levels for our borrowers. In turn, this expansion leads directly to new tax bases, including:

- City & County real estate taxes from new construction projects
- State & local sales taxes from increased business revenues
- Federal & State income taxes from new and expanding businesses
- Federal & State payroll taxes from new employees.

It is clear that businesses assisted by this no-cost program are contributing to the tax revenues received by all levels of local, State, and Federal governments. We encourage this Committee to support this authorization level during this economic downturn when every job we create is putting an American back to work.

2. 504 PROGRAM USER FEES

Effective with fiscal year 1997, legislation imposed user fees in amounts sufficient to reduce the subsidy rate or cost of the CDC Program to zero. The necessity for annual appropriations to support the program was eliminated. These fees are derived as follows:

a) lender fee. The first mortgage lender pays a one-time upfront fee of 0.5 percent of the amount of the first mortgage;

b) CDC fee: the CDC pays an annual fee of 0.125 percent (or 1/8 of 1%) of the outstanding amount of the debenture; and

c) borrower fees: the borrower pays miscellaneous minor fees to cover matters such as the initial administrative cost of issuing the debenture and an annual fee to cover the cost of a central

servicing agent. In addition, the borrower pays an annual fee based on the outstanding amount of the debenture. The exact amount of this fee is determined by SBA in order to maintain a zero subsidy rate for the program. It has ranged from a high of 0.875 percent in 1997 to a low of 0.410 percent in 2002. The fee for 2004 is 0.393 percent, based on OMB and SBA subsidy model projections.

All of the above fees are sunset October 1, 2003. Without this reauthorization of fees, the 504 program will cease operations on September 30, 2003.

NADCO requests that this sunset be extended for three additional years until October 1, 2006 in order to provide for continuation of the 504 program even absent appropriated funds.

3. 504 BORROWER FEE DECREASE

SBA's proposed FY 2004 budget decreases the annual fee charged each 504 small business borrower from 0.425% to 0.393%.

While several factors influence the program cost model, I would like to focus on only one: the program's recovery rate on defaulted loans.

SBA's forecast of their recoveries on defaulted loan collateral again declines – to an abysmal 17% from last year's 20% forecast. We do not understand this forecast, given the clear results of two on-going SBA programs. One program, the Congressionally-mandated 504 liquidation program, has had very positive results. With virtually all loans accounted for, the average recovery rate for both CDC and SBA staffed efforts has easily exceeded 45% of the outstanding 504 loan balance.

Additionally, three years ago, Congress mandated that this pilot liquidation program be made permanent and expanded (P. L. 106-554). It had clearly demonstrated that the liquidation staffs of CDCs could recover effectively as much or more outstanding project amounts as SBA staff had historically done. Given the declining SBA budget and staff size, our industry felt then, and continues to believe, that more resources must be brought to bear on collection of defaulted loans.

The other program, the SBA asset sale program, has resulted in sale of about 1,000 504 loans for over $200 million. Again, we have been told for some time that the recovery rate for the asset sales program has exceeded 45%. Even the Administration's own budget last year noted that **"the Agency implemented a highly successful asset sale program and will continue to strategically sell our loan portfolio."** If a 17% net recovery is the definition of highly successful, SBA should seriously consider allowing more private lenders and CDCs to perform the recovery process. Neither the Administration nor this Committee should accept this low recovery rate as the norm.

NADCO requests that Congress reinforce to the Administration the need to fully implement the legislative intent of P. L. 106-554 by immediately issuing regulations.

PROPOSED 504 PROGRAM ENHANCEMENTS

1. PCLP LOAN LOSS RESERVE

In 1994, Public Law 103-403 established the Premier Certified Lenders Program on a pilot basis as section 508 of the Small Business Investment Act of 1958.

Under this program, proficient CDCs could receive delegated authority to approve debentures on behalf of the Agency (and to foreclose defaulted ones) providing the CDC agreed to reimburse SBA for 10 percent of any loss sustained by it on debentures approved by the CDC under the pilot program. The benefit to the CDC would be much faster loan approval and for the Agency, it would stretch limited resources. The program was deemed a success and in 2000 it became a permanent program pursuant to Public Law 106-554.

In order to assure that there would be funds available from which the CDC would reimburse SBA for losses, the CDC is required to establish a loss reserve fund in an amount equal to 10 percent of the CDC's exposure to SBA under the PCLP program.

Some CDCs, particularly those who entered the pilot program, are processing a large volume of their debentures through the PCLP program, and loss reserves of several companies are at the $1 million level and growing, while others are approaching this same magnitude.

(a) Basic Reserve

When the PCLP program was established, the statute did not recognize that the amount of SBA's risk of loss decreases as the debenture ages. Debentures are issued for either a ten or twenty year term and are amortized, i.e., the borrower repays part of the financing every month just as most home owners do on their mortgage, but the amount of the CDC's loss reserve or security never decreases until the debenture is fully paid off. Thus as the principal on the debenture decreases each year and the amount of the reserve remains constant, the reserve percentage actually increases.

For example, a 20 year debenture for $414,000 with an interest rate of approximately 4.8 percent would require a CDC to contribute $4,140 to the loss reserve.

By the end of year 5, the principal would be reduced to approximately $344,000, but the loss reserve which was originally 1 percent would be 1.2 percent.

By the end of year 10, the principal would be reduced to approximately $255,000, but the original loss reserve of 1 percent would have increased to 1.6%.

By the end of year 15, the principal would be reduced to approximately $143,000, but the loss reserve of $4,140, which was originally 1 percent, would have increased to 2.9 percent.

And it continues to grow so that by the end of year 19, a reserve of 1 percent has increased to more than 14 percent.

In other words, after 19 years the CDC is maintaining a reserve of $4,140 to assure that it will pay 10 percent of any loss and yet the principal has been paid down to $29,000 and the CDC's share would be only $2,900 or less than the amount in reserve.

Finally, however, the debenture will be completely paid, and then and only then is the CDC permitted to withdraw from the reserve the entire $4,140.

It appears much more logical to amortize the amount of the loan loss reserve the same as the debenture amortizes, thereby reducing the amount of the required reserve as the borrower re-pays the indebtedness.

NADCO requests that the mandatory reserve be reduced annually as the debenture is repaid and the CDC be permitted to withdraw a proportionate amount of the reserve but maintaining the minimum amount of the reserve throughout the life of the debenture at the initial requirement of 1 percent.

(b) Alternative Loan Loss Reserve

When Congress was considering establishing the PCLP program, there was concern that the CDC (to whom SBA would delegate decision making authority) should have a financial stake in approving the loan and not simply act as a rubber approval stamp with SBA bearing all the liability. Thus the CDC was required to agree to assume 10 percent loss exposure and to establish a loss reserve of 10 percent of this exposure.

Although some 25-30 CDCs have elected to seek designation as Premier Certified Lenders, many have not done so due to the required assumption of risk and the excessive amount of the mandatory loan loss reserve. Some have voiced the opinion that the amount of the reserve is completely arbitrary and is not based upon any loss study.

Other industries, such as the banking industry, have already moved from a "loan-by-loan" reserve to a "pool" reserve to cover their exposure to loss.

Obviously the goal would be to establish a more accurate computation of the necessary reserve which would be based upon the actual loss experience of each individual CDC. The reserve would be established in an amount sufficient to protect the Government and the taxpayers from risk of loss due to default, but the amount would not be excessive and would free funds which the CDC could use to help provide additional assistance to small business.

Due to the complexity of establishing a loss reserve for each CDC, there would be cost involved to the CDC. Not all CDCs would elect to conduct the necessary study and they should not be required to do so. Instead, they would continue to fund a 1 percent loss reserve without regard to their actual loss experience, but it would be in proportion to the amount of the debenture remaining unpaid as is discussed above.

Other CDCs, however, especially those with higher loan volume, might elect to do a loss study, anticipating that it would show that an adequate loss reserve would be in a lower amount based on that CDC's actual loss experience. We believe this option should be provided.

NADCO requests that CDCs who elect to participate in the PCLP program be allowed to establish a risk-based reserve to protect the Government against loss as an alternative to the 1 percent loss reserve requirement. This alternative would be available to a CDC only if (1) the CDC voluntarily elects to participate, (2) the CDC has experience as a PCLP participant and has a loan loss reserve of at least $25,000, (3) the CDC contributes such additional amounts as are determined necessary by a third-party auditor employed by the company to protect the Federal Government from the risk of loss associated with the portfolio of PCLP loans of the company and (4) the SBA determines that the CDC has established a process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan made by the company on the basis of the risk of loss associated with such loan.

(c) Reserve Account Investments

The authorizing legislation for the loan loss reserve also restricts investment of the funds. The CDC is given a choice of either placing the funds in a Federally insured depository institution or obtaining an irrevocable letter of credit.

In the early years of the pilot program, these restrictions on investments did not present much of a problem. Recent increased use of the program, however demonstrates that CDC loss reserves can build to very large balances and can easily exceed the current Federal deposit insurance limit of $100,000. This has required CDCs to open more and more local bank accounts to protect their deposits through the FDIC insurance.

Given the sophistication of many CDCs and the U.S. financial markets, it appears that there are good and safe alternatives to limiting deposits solely to accounts directly in insured institutions. For example, funds could be deposited with a securities broker, who would invest them in government bonds, or in bond funds that invest exclusively in appropriate Federal, State, or municipal debt instruments.

NADCO requests that CDCs be authorized to invest their loan loss reserve funds, either directly or through a broker, in Federal debt, securities issued by Government Sponsored Enterprises, mutual funds which are limited to investments in money market securities consisting of Government securities and commercial paper rated not below the top tier and investment grade corporate bonds.

2. DEBENTURE SIZE

Existing law imposes a maximum debenture guarantee of $1 million for a 504 project, unless it is one of the nine statutorily enumerated public policy goals which may include a guarantee of up to $1.3 million. Since the debenture generally is for 40 percent of the cost of the project, a 504 project generally will not exceed $2.5 million unless it is a public policy project which generally will not exceed $3.25 million.

504 is an economic development program, and each CDC is required by statute to achieve a job creation or retention ratio, either on each project or in some cases only on its overall portfolio. SBA has set the amount of debenture eligibility at $35,000 per job.

Particularly in today's economic times, it is clear that access to capital for growing small businesses has become a major concern. Without capital, even successful firms cannot grow and will

not bring new jobs to their communities. Long term, reasonably priced capital is essential to fund expansion and job creation - - - the core of the 504 program. Moreover, the businesses that create the most new jobs are those that have grown beyond simply needing daily working capital to pay bills, salaries and cost of goods. These growing businesses need larger plants, more equipment, and more stability in their occupancy costs. Their increased need for larger plants and more fixed assets leads to a new and higher level of job creation. Additionally, these jobs created by successful, growing businesses are frequently better paying and provide improved employee benefits.

This economic need is particularly acute for manufacturers that oftentimes are the lifeblood of our small cities and towns. Unless these job providers are afforded sufficient capital to modernize and expand, they will wither and die and with their demise, many small towns will also cease to exist.

The current business size standard for SBA access includes those firms that have an annual net income not to exceed $2.5 million and a net worth of up to $7 million, but this is an alternative to the regular size standard for manufacturers that is generally 500 employees (and more in certain specified industries).

While SBA seeks to serve such "mid-size" small businesses, the current debenture limits on 504 do not enable the program to reach these small businesses. They frequently need plant expansions that cost up to $5 - 10 million, but have great difficulty obtaining such credit on a long tem basis from traditional lenders. Clearly, there is an unmet demand for plant expansion capital from this size of small businesses which is effectively precluded from using the 504 program due to the limit on debenture size.

For example, a North Carolina building products distribution company with 50 employees needs a new site for warehousing and distribution. This project would cost approximately $1 million and would increase employment by 10-12 individuals. The company could seek private financing, but the conventional down payment would eliminate too much working capital and would constrain growth. The company is not eligible for 504 funding, as it already has outstanding debentures on other projects and is thus ineligible for another debenture of this size.

Another North Carolina manufacturer has an existing plant with 50 employees and needs a new $10 million plant which would add 25 and perhaps more employees. Although this example would exceed the proposed debenture limit, it is possible it could be re-structured if the disparity between need and statutory limits were not so great.

Another example is a Massachusetts silver refinery which was seeking $7 million to finance an employee buyout of a division of a big business which was in financial difficulty.

There are other numerous situations where a small business has already obtained the maximum amount of financing under the 504 program. A California aquarium manufacturer who needs additional expansion funds, a small business which owns two existing gas station/convenience stores but cannot acquire a third, and a restaurant with four locations which wants to grow and add additional locations.

Of particular concern are those businesses Congress has recognized as being so important as to be designated a public policy goal, such as minority or woman owned. Such firms clearly have had even greater difficulty in raising long term growth capital and thus Congress has provided a higher debenture guarantee. These firms also are constrained even by the higher maximum.

For example, a provider of air radar systems that detect clear air turbulence/wind shear could expand and employ another 60 or more employees. The firm already has a maximum $1.3 million in debentures and thus is ineligible for additional debenture guarantees. If additional expansion monies were available, the firm estimates that it would be able to add approximately 60 new positions with Phd or masters' qualifications.

Commercial real estate and construction costs continue to increase as our economy expands. Land, materials, and labor costs have all increased as new businesses are established and existing firms seek more or larger locations. Additionally, the costs of constructing a typical office, manufacturing plant, or retail building have grown with the advent of new technologies and increased zoning or safety needs. For example, twenty years ago, no facility would have had the sophisticated computer and communications technologies installed that today are viewed as normal construction needs. While 504 doesn't pay for the specific technologies, the capital costs of new electrical, plumbing, heating, cooling, and dedicated floor space are all absorbed by the construction financing. Additionally, government-mandated infrastructure, zoning minimums, and safety requirements have all advanced substantially as local building codes evolved and government sought to improve protection for citizens and employees. All of these changes have added costs to every commercial construction project.

NADCO requests that the maximum size of a 504 debenture be increased to $2 million under the general program, that the maximum size of a debenture directed towards a public policy goal be increased to $2.5 million, and that a new debenture limit of $4 million be authorized for manufacturers.

3. JOB CREATION OR RETENTION

As was noted at the outset, to be eligible for funding each individual project must meet a specified job creation or retention test, unless it is directed towards either improving the economy of the locality or the achievement of one or more of nine public policy goals, in which case it is sufficient if the overall portfolio of the CDC provides the requisite jobs benefits.

The statute does not prescribe the test, but has left it to SBA's discretion. Originally, SBA regulation required one job per $15,000 in debenture guarantees. This was increased to $35,000 in 1990 and it has remained unchanged for over the past thirteen years.

During the interim, increases in the Consumer Price Index make $35,000 in 1990 equate with approximately $50,000 today.

The cost of manufacturing equipment has increased even more, particularly for computer related manufacturers.

NADCO requests that a project be deemed to satisfy the job creation or retention requirements if it creates or retains one job opportunity for every $50,000 guaranteed by the Administration. Further, NADCO recommends that the same amount be required for the CDC's portfolio average, except that a CDC be permitted to have a portfolio average of $75,000 in higher cost geographic or targeted areas (such as Alaska, Hawaii, State-designated urban or rural jobs and enterprise zones, empowerment zones and enterprise communities and labor surplus areas).

NADCO further requests that a new jobs test be provided for manufacturers. We believe that this should be established at $100,000 in financing eligibility for each job created or retained.

Finally, NADCO requests that both amounts should be adjusted annually to reflect changes in the Consumer Price Index.

4. RURAL DEVELOPMENT

The definition of "rural" has two important ramifications for CDCs and the 504 program. First, a project which is directed towards one of nine public policy goals is authorized higher maximum debenture funding ($1.3 million instead of the $1 million allowed for regular debentures) and individual rural projects need not meet the individual jobs test as long as the CDC's outstanding portfolio meets the test. Second, a CDC which is in a rural area may contract with another CDC to provide the requisite full-time professional staff and professional management ability rather than being required to have these qualifications in-house.

SBA historically has utilized the definition of rural utilized by the Department of Agriculture which was population of under 20,000. This definition was updated, however, by the 2002 Farm Bill.

Section 6020 of the Farm Security and Rural Investment Act of 2002 (P.L. 107-171) inserted a new definition of "rural" and "rural area" into Section 343(a) of the Consolidated Farm and Rural Development Act (7 U.S.C. 1991(a)): a population of 50,000 or less.

We believe that SBA should continue to parallel the Department of Agriculture in defining the areas which are deemed to be "rural" for the 504 loan program.

NADCO requests that the CDC program utilize the Department of Agriculture's definition of "rural", namely any area other than a city or town that has a population of greater than 50,000 inhabitants and other than the urbanized area contiguous and adjacent to such city or town.

5. STOCK PURCHASES

Under existing law, the 504 program may be used to finance the construction of a new plant or it may be used to acquire an existing plant. SBA strictly construes the term "plant acquisition" to mean fixed assets only; the Agency does not permit the program to finance either inventories or goodwill if the borrower is acquiring an operating business. But, under current tax law, businesses must carry their buildings, land, and large fixed assets at cost (for land) or at depreciated value for buildings and other assets. Frequently, the actual value of seller assets has grown far beyond the cost or book value.

In addition, a seller of a business may be reluctant to structure a purchase deal in which he sells only the assets. The seller may insist on making a "clean deal" by selling the entire business as a single on-going entity. For most acquisitions, this is accomplished through purchase of all of the privately-held company stock, with the purchaser assuming all debts and current obligations of the business. This allows the purchaser to begin operations with the complete business, and enables him to properly value acquired fixed assets at true market value.

The ineligibility of the 504 program to be used in appropriate circumstances to finance the acquisition of an existing business by the purchase of the stock in the seller company frustrates the economic development/job creation purposes of the program. It has adversely impacted the purchase of a California title and escrow company which would have created eight new jobs, a Texas textile plant whose expansion ultimately would have created at least 15 new jobs, and an Illinois bowling alley which anticipated adding 7 additional employees.

We believe that the sale of an existing business sometimes involves the purchase of more than fixed assets and that eligibility for 504 financing should recognize this business reality, providing that most of the purchase price reflects the purchase of fixed assets. This will enable 504 to continue its core mission of financing fixed assets, but allow the program to satisfy those unusual business acquisitions that occur in everyday business dealings.

NADCO requests that the eligibility criteria for 504 financing be expanded to allow acquisition of an existing plant by the purchase of the stock in the corporation that owns the plant, as long as the valuation of the fixed assets being acquired is at least equal to 50 percent of the cost of the acquisition.

6. DEBT RE-FINANCING

Under existing law, the 504 program cannot be used to re-finance any existing business debts. The first mortgage lender, however, may add to his 50 percent share of the project an additional amount to provide consolidation of existing debt on the land. Even if this occurs, the interest rate will probably be higher than the blended rate on the project (bank rate plus debenture rate) and the term will not be as long.

The ineligibility of any debt re-financing through the 504 program greatly restricts the program's use for many small businesses that are seeking expansion of existing buildings that were constructed in the last ten to twenty years at a previous stage of business growth. Experience indicates that it is very unusual for a small business to be completely debt free as it grows. Many times, this debt is associated with a building, plant, or store that it completed years ago, and continues to have some outstanding mortgage balance. Frequently, this may be at a high rate of interest and thus be restricting further business expansion and job creation.

Thus, application of the prohibition caused rejection of a project involving a mid-western motel, and resulted in projects with higher first mortgages plus additional injection of borrower funds in the case of a project involving a soccer arena and another involving a fast food franchise.

It should also be noted that the actual value of the current structures and land may have substantially appreciated. The business thus has real market value "locked up" in its assets that it cannot easily leverage for further growth. We believe that the 504 program restrictions against re-financing business debt unnecessarily inhibit the program from assisting such borrowers. These growing small businesses are not simply seeking to reduce their debt cost by re-financing an existing mortgage. They are frequently very successful and are addressing their growing markets by adding new plant and jobs. However, to accomplish such expansions, current mortgages must usually be paid off. Besides unlocking tied up capital for the business to enable expansion, use of the 504 program often means the business can stabilize its debt cost with the fixed rate twenty-year 504 mortgage. This provides increased financial strength for the business and improves its opportunity for success.

We continue to believe that the purpose of the 504 program is economic development, but we believe that this purpose can be better accomplished if there is recognition that re-financing of existing debt on fixed assets is appropriate as long as it is secondary to business expansion.

NADCO requests that in addition to allowing the first mortgage lender to re-finance existing debt by adding to the first mortgage, a 504 project should be allowed to re-finance existing debt used to acquire fixed assets providing that the amount of the debt does not exceed the cost of the expansion and providing that the debt has been current for the past year and re-financing it as part of the project will provide better terms or rate of interest than exists on the current debt.

7. COMBINATION LOANS

In previous times, both 504 financings and 7(a) loans were subsidized by appropriated funds to pay losses. It was thus appropriate to restrict small businesses to a choice between the two programs. This mandated choice, however, has caused problems for larger small businesses which need funds from both programs but are limited to a combined amount not to exceed $1 million under 504, or $1.3 million if the borrower is filling a public policy goal, or $1 million under 7(a).

Government financial support for these programs has been substantially reduced. The 504 program became self-supporting in fiscal year 1997 and the 7(a) program currently has a subsidy rate of only 1%. It thus appears that the mandated choice of one or the other is no longer necessary and imposes unneeded restrictions on small business borrowers.

NADCO requests that a small business borrower be allowed to receive 504 financing up to the maximum amount permitted under the statute plus 7(a) financing up to the $1 million permitted for these loans.

8. SIMPLIFIED APPLICATION

The application information and paperwork required from small businesses that apply for a 504 loan has been steadily growing. This is unfortunately true of other loan guaranty programs as well.

Congress addressed it in the 7(a) loan program more than a decade ago and SBA responded by establishing a LowDoc or low documentation loan program for smaller loans, originally $100,000 or less but now up to $150,000.

Last year Congress also addressed the problem for the B & I Program of the Department of Agriculture. Section 6019 of the 2002 Farm Bill (P.L. 107-171) directed the Department to provide to lenders "a short, simplified application form for guarantees" of $400,000 or less.

Our experience has shown that many 504 loan applications have so much financial and business material in them that the loan "packages" are actually delivered to SBA District Offices in fairly large boxes. We believe that much of the data contained in a loan package is of little or no value to Agency personnel that review and approve a new 504 loan. Most of the business financial, historical, and general business history information is gathered and closely reviewed by both the bank issuing the first mortgage and the CDC that issues the 504 second mortgage.

Given the extreme pressure that most SBA loan officers are under, and with shrinking Federal budgets and staffs, it is clear that SBA must continue to reduce the time spent on loan approvals. This will enable SBA personnel to spend more time on outreach to small businesses, as well as closer supervision and oversight of lenders such as CDCs and banks. This can best be accomplished by providing only the optimal amount of business data needed to approve a smaller 504 loan.

NADCO requests that SBA be required, within 180 days, to develop and make available to CDCs a short, concise, simplified application form for loan guarantees of $250,000 or less.

9. DEBENTURE PREPAYMENT EXPENSES

Debentures under the 504 program include a prepayment penalty if the borrower voluntarily prepays the debenture. There have been several occasions when SBA prepaid a debenture because Agency personnel erred. For example, issuing a 10-year debenture when the borrower was approved for a 20-year debenture.

Under existing law, administrative expenses in connection with issuance of a debenture are paid from program fees. We believe that any prepayment penalty triggered by SBA prepayment due to errors or omissions by Agency personnel should be treated as such an administrative expense and paid from the program fees.

NADCO requests that any premium payment due on a debenture prepaid by SBA on account of an error or omission by its personnel to be an administrative expense and be paid from program fees as are other administrative expenses involved in issuing the debenture.

ENHANCEMENTS FOR MANUFACTURERS

NADCO believes that a return to a growing economy must include a revitalization of America's core manufacturing industries. Given the connectivity of international markets, our small and medium manufacturers must achieve extraordinary new levels of productivity to compete on both price and quality. Doing this requires additional capital expenditures for plant and equipment.

The National Association of Manufacturers, one of America's largest and most respected trade groups for the manufacturing industries, completed an extensive survey and research last year into the issue of credit rationing by lenders. They concluded:

- Even with record low interest rates, 43% of small manufacturers stated their overall cost of borrowing had INCREASED, due to lender fees and interest charges
- Restrictive lending has directly affected capital spending and new hiring for 37%.

Given the record low interest rates, and favorable downpayment and loan terms offered by the 504 program, we can have a substantial impact on the availability of expansion capital required by small to medium manufacturers who are expanding their markets, products, and most importantly, their employment levels.

Our request to the Committee is to provide an extraordinary series of changes to immediately address the capital needs of small and medium manufacturers. As listed above, these include:

- Rural definition to assist rural manufacturers that have no supportive banks
- Debt refinancing to enable them to immediately lower their borrowing costs
- Combination with 7(a) to allow greater financing for both plant and inventory
- Special limit of $4 million to reach more capital-starved manufacturers
- Special job ratio of one job per $100,000 to address the high cost of new machinery.

For the most part, manufacturers would be identified as those industries classified as sectors 31-33 of the North American Industrial Classification System or NAICS, which SBA has utilized for purposes of determining a firm's eligibility as a small business.

Not all "manufacturers", however, are in these categories. New technologies have resulted in the establishment of new manufacturers such as the producers of records, tapes, and videos. The NAICS places them not in the manufacturing sectors, but in sector 51: information.

We believe that these new age producers are manufacturers and should be afforded access to those new provisions designed to assist traditional manufacturers.

NADCO requests that expanded debenture eligibility and higher job creation criteria be applied to both traditional and new style manufacturers by defining the term in three ways with reference to NAICS:

first, those manufacturers enumerated in sectors 31-33,

second, those manufacturers of sound and video recordings under subsector 511, and

third such other industries classified elsewhere as the SBA may deem appropriate.

11. REGULATIONS

In order to fully implement new legislation, SBA must frequently issue regulations in order to provide for good program management and guidance to participants. Sometimes the press of other business causes a delay in formulation and publication of the necessary regulations. For example, Public Law 106-554 (December 21, 2000) made the Premier Certified Lenders Program permanent, thereby triggering the necessity of regulations. More than two years have now elapsed and regulations have yet to be proposed.

We believe that it would be appropriate for the Congress to stress the importance of issuance of timely regulations by providing deadlines, while at the same time allowing the customary 60 days for public comment on proposed regulations.

NADCO requests that SBA be required to publish proposed regulations implementing the bill within 180 of the date of enactment and to issue final regulations within an additional 120 days.

SUMMARY

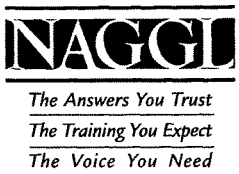
Our industry has proposed an extraordinary series of 504 program enhancements for this year. Today's economic conditions demand extraordinary measures to keep small businesses growing and creating new jobs. We believe that these changes are badly needed to expand access to long term, reasonably priced capital for more small businesses.

Nowhere is this more evident than in America's manufacturing industries. Many are unable to obtain new capital at any cost, having been shut out of their traditional banking sources. Other manufacturers are struggling to restructure debt by taking advantage of today's record low interest rates. They need to refinance existing debt, but banks simply won't deal with them. Still other manufacturers need new machinery and equipment to increase plant productivity and remain competitive in worldwide markets, yet they have limited cash to put down on expensive tooling.

SBA's loan guaranty programs must step up to meet these needs now. We must fill the vacuum left by conservative lenders who are focused on reducing their long term exposure. Without expansion of outreach by SBA's programs, we may find it nearly impossible to provide the capital to help American industry regain it world leadership role in manufacturing.

In short, SBA, its lending partners, and Congress must all reach farther than ever before to break this economic cycle America is stuck in. Our industry urges action now for the benefit of our borrowers, their employees and families, our Federal, State, and local governments, and for our economy.

Thank you for allowing us to provide our comments. NADCO will be pleased to work with the Committee and the Administration to improve the program and help America's small businesses lead the way to increased job creation.



Testimony for the House Committee on Small Business

David H. Bartram

Vice Chairman
The National Association of
Government Guaranteed Lenders, Inc.

And

President - SBA Division
US Bank

March 20, 2003

Thank you for the opportunity to testify. I am David H. Bartram, President of the SBA Division of US Bank. The SBA Division of US Bank currently has an outstanding portfolio of approximately $1.6 billion and over 5,500 SBA loan customers. I have been active in SBA lending for more than 20 years, working in both large and small banks.

I am also the vice chairman for government relations of The National Association of Government Guaranteed Lenders, Inc. ("NAGGL"). NAGGL is a trade association for lenders and other participants who make approximately 80 percent of the Small Business Administration ("SBA") section 7(a) guaranteed loans. The SBA's 7(a) guaranteed loan program has proven to be an excellent public/private partnership. Over the last decade, the SBA has approved more than 450,000 loans for almost $100 billion. We thank the Committee for the opportunity to comment on the SBA 7(a) program.

Since the beginning of "Credit Reform" in 1992, the SBA 7(a) subsidy rate has fallen from a high of 5.21 to the budget level for FY 2004 of 1.02. This represents a more than 80% reduction in the estimated cost of the program to the government. This reduction in subsidy costs has been achieved by improved underwriting guidelines, establishment of lender review procedures, and fee increases on both borrowers and lenders.

There are many positive attributes of the SBA 7(a) loan program, including:

- SBA loan programs provide approximately 40% of all long-term loans (loans with maturities of three years or longer) to small businesses. The SBA is the largest single provider of long-term loans to small business.

- SBA estimates that recipients of 7(a) loans in 2002 created or retained 370,000 jobs.

- SBA 7(a) loans that may not create new jobs, assist small businesses in becoming more efficient by allowing them to invest in new plant and equipment. This is especially true for manufacturers, thus retaining production and jobs in the United States by being more globally competitive.

- SBA 7(a) loans have significantly longer maturities than conventional loans to small businesses. The average original maturity of an SBA 7(a) loan, according to the Office of Management and Budget ("OMB"), is 14 years. By comparison, only 16% of conventional small business loans have maturities in excess of one year, and of those loans, the average maturity is less than four years.

- Longer maturities mean substantially lower monthly payments for borrowers. For example, the difference in monthly payments for a 10 year SBA 7(a) loan compared to a five year conventional loan (which would be above the average maturity for conventional loans), would be 35-40%. This is a significant monthly cost savings for the average SBA borrower who tends to be a new business startup or an early stage company. Companies like manufacturers, which purchase capital equipment, have a cash flow benefit from the longer loan maturities offered by SBA 7(a) loans.

- Small businesses do not have the same access to debt-capital as do large businesses. The SBA programs bridge that capital gap.

- The SBA 7(a) appropriations are leveraged almost 99 to 1 by the private sector, making this one of the governments' best and most affordable economic development instruments.

- The SBA 7(a) loan program is just that – a loan program – which helps qualified small businesses obtain the long-term loans they need for growth and expansion. This means jobs, and a "net return on investment" for our local communities and the US Treasury.

Fiscal Year 2004 Budget Request and STAR Loans

STAR Reprogramming. We are deeply disappointed to learn that the SBA will NOT re-score STAR loans, using the new econometric model, made this fiscal year before the expiration of the program on January 10, 2003. Clearly, STAR loans are 7(a) loans, since the terms and fees are identical to 7(a) loans made this fiscal year, and S. 141 provides for the econometric model to be used ***retroactive to October 1, 2002***. We believe these loans should be re-scored, and we ask Congress to vigorously pursue this issue, in order to free up much needed budget authority that could be used to fund loans for the balance of this fiscal year. Without the re-scoring of STAR loans made this fiscal year, there is a strong likelihood that the SBA will not have sufficient 7(a) loan funds to meet demand for the balance of this fiscal year.

FY 2004 Budget Request. The Administration has requested only a $9.3 billion program level for FY 2004. The requested level is far below the estimated level of demand of $12.5 billion. The level of SBA 7(a) program usage (including STAR loans) the last several years is as follows:

1999	$9.5 Billion
2000	$9.7 Billion
2001	$9.1 Billion
2002	$11.1 Billion
2003	$11.8 Billion (estimated)
2004	$12.5 Billion (projected)

The Administration's requested FY 2004 program level would be more than 25% below the projected level of demand. A $9.3 billion program would most likely result in the SBA rationing credit, something that the leadership of this Committee has already objected to for the current fiscal year. Chairman Manzullo recently stated "the $500,000 cap, installed last October, has prevented many small businesses from securing the capital they need to expand and create new jobs." We agree. A FY 2004 SBA 7(a) loan program of only $9.3 billion would likely lead SBA to impose loan size caps again next October.

Small businesses continue to need access to long-term capital. NAGGL requests your support of sufficient appropriations to fund a $12.5 billion 7(a) program for FY 2004. Loan volume for FY 2003 is running ahead of the FY 2002 pace, even though a $500,000 loan cap has been in place (See Attachment A). Given the nature of our economy, we believe that the increase in borrower demand will continue into FY 2004. The Administration's proposed program level of $9.3 billion will be insufficient to meet borrower demand. With your support of a $12.5 billion 7(a) program in FY 2004, we hope to avoid the need to put loan size caps in place again.

For whatever reason, the Administration continues to say that the FY 2004 requested 7(a) program level is "in line with historical usage." We all know that "history" changed on September 11, 2001. The SBA, in response to Committee questions, says 9/11/2001 "was a one-time event that was funded through a supplemental appropriation." Clearly, the impacts of 9/11/2001 continue to have an impact on small businesses. Today, the economy continues to operate at a level far below the economic levels prior to 9/11/2001. Lenders have tightened their conventional credit standards. Many small businesses that used to be able to qualify for conventional credit now find they must turn to the SBA loan programs for assistance.

As a result, 7(a) loan volume has been increasing. During FY 2002, $11.1 billion in 7(a) loans were made. For FY 2003, 7(a) lending is slightly ahead of the FY 2002 pace, even though there was a $500,000 7(a) loan cap in place for the first five months of the fiscal year. Absent the cap, loan volume this fiscal year would be farther ahead of last years.

The relevant history for borrowers, who will need access to long-term credit through the 7(a) program, is post 9/11/2001. Loan demand last fiscal year was $11.1 billion, and we anticipate as much as $11.8 billion this year and $12.5 billion in FY 2004.

Subsidy Rate Impact. In another answer to a Congressional question, the SBA stated that replacing large/longer maturity loans with SBA Express loans would not impact the subsidy rate. We disagree. Since loans over $700,000 pay substantially higher guarantee fees (currently 1% on loans up to $150,000, but 3.5% on loans over $700,000), eliminating large loans from the mix of 7(a) loans puts upward pressure on the subsidy rate. Without larger loans, the subsidy rate will either rise and more money will have to be appropriated to cover the estimated income not collected by loan fees, or costs/fees to borrowers would have to rise. Knowing that the OMB has already overcharged users of the 7(a) program well over $1 billion in the last ten years, further fee increases on borrowers would be unconscionable.

Loan term also plays an important role in the subsidy rate. Longer term loans (15-25 years) have much lower repurchase or default rates than do loans with shorter maturities (7 years or less). Smaller loans are most likely short term loans, while many of the large loans are real estate loans with longer maturities. From data provided by the SBA Chief Financial Officer (CFO) as of 11/30/2002, the following repurchase or default rates highlight that larger/longer maturity loans have much lower purchase rates than do smaller/lower maturity loans:

Cohort	Maturity < 7 years Purchase Rate	VS.	Maturity > 15 years Purchase Rate
1992	19.68%		9.65%
1993	16.87%		6.85%
1994	19.02%		5.12%
1995	20.65%		5.17%
1996	20.71%		6.44%
1997	20.09%		5.31%
1998	19.33%		5.47%
1999	14.46%		5.66%
2000	7.55%		3.55%

Loans made prior to FY 1999 have gone through the "peak of the default curve", meaning a significant portion of the defaults in any given cohort has occurred. For every cohort since 1992, the default or repurchase rate on longer term loans has been less than one-half of default rate of shorter term loans.

Because larger loans pay the highest guarantee fees, and because the longer maturity loans have lower repurchase rates, ***larger and/or longer term 7(a) loans subsidize the cost of smaller, shorter term loans***. Any time the SBA says they want to concentrate on smaller loans (as they do in the FY 2004 budget) or perhaps move 7(a) real estate loans to the 504 program (as they did in the FY 2003 budget), they should also disclose to Congress that those actions will cause the subsidy rate to rise. Properly funding this program is equally important to small 7(a) borrowers as it is to borrower seeking larger loans. The fees of smaller borrowers would likely have to rise if the fees/lower repurchase rates of larger/longer maturity loans are not part of the 7(a) mix.

Credit Crunch. The National Association of Manufacturers is already indicating its members are being faced with a credit crunch. Many times, manufacturers need sizable loans for plant and equipment needs, as well as for working capital. For example, Schilke Music, an established Chicagoland-area musical instrument manufacturer recently borrowed $1,275,000 under the SBA 7(a) program for plant and equipment. Due to the financing package, the borrower was able to preserve 20 high-quality jobs, and was able to obtain loan terms that better fit their cash flow.

R. Scheinert and Sons of Philadelphia, PA repairs industrial motors, generators, pumps and transformers. The company sells to large manufacturers, mechanical contractors, steel plants and food processors. The normally profitable company was negatively impacted by the events of 9/11 and the subsequent soft economy. Thanks to an $825,000 SBA 7(a) loan the company was able to refinance their debt, consolidate accounts payable and provide working capital. The business is now back on track, and 25 jobs were retained.

This would be the wrong time to limit small business financing. The Administrations' inadequate budget request could cut off the borrowing capabilities of many businesses, like manufacturers, who will need larger SBA 7(a) loans next year. In order to preserve jobs and avoid loan caps next fiscal year, a $12.5 billion program level will be needed in the SBA 7(a) program.

Reauthorization Bill

Legislative Request. The National Association of Government Guaranteed Lenders (NAGGL) recommends enactment of legislation to make the following changes in the 7(a) loan guarantee program administered by the Small Business Administration (SBA).

1. **Loan Program Authorizations** - - - Authorize the SBA to carry out a 7(a) guaranteed loan program in the following amounts: $16 billion in fiscal year 2004, $16.5 billion in fiscal year 2005, and $17 billion in fiscal year 2006.

2. **Pilot Programs** - - - Limit new loan pilot programs to 3 years duration and to 5% of annual loan program dollars but allow any existing pilot to continue for 3 years for up to 15% of the program.

3. **Secondary Collateral** - - - Limit the amount of a lien placed on secondary collateral owned by a borrower (e.g., a residence) to the amount needed along with the amount of the lien on business property to fully secure the loan.

4. **SBA Fees** - - - Make permanent the current fee structure (now sunset October 1, 2004). Borrowers would pay SBA a one-time fee of 1%-3.5% based on loan size and lenders would pay 0.25% annually on the amount of the loan outstanding during the life of the loan.

5. **Alternative Size Standard** - - - Direct SBA to establish a simple alternative size standard which 7(a) lenders could use to determine eligibility for 7(a) loans (as now exists for use by 504 program) rather than requiring the use of complicated industry standards under NAICS. Because of the different size standards, a borrower may be able to obtain fixed asset financing under the 504 loan program, but not be eligible for a working capital loan under the 7(a) program.

6. **Commercially Reasonable Fees** - - - In addition to late payment fees now authorized, allow 7(a) lenders to charge borrowers normally imposed bank application and commitment fees and fees for specific loan servicing actions requested by the borrower.

7. **Secondary Market** - - - Allow the sale to investors of shares in pools of 7(a) loans with different interest rates in addition to pools with identical rate loans. Pools of loans with similar interest rates would have a weighted interest rate.

8. **Combination Loans** - - - Allow a small business borrower to fully participate in both the 7(a) and 504 programs up to the maximum loan limits for each program.

9. **National Preferred Lenders Program (PLP)** - - - Direct SBA to establish a national program to permit PLP lenders to operate in any state. Minimum eligibility criteria would include making a minimum number of loans over at least three years in at least 5 states, and other demonstrations of proficiency as set by SBA.

Thank you for the opportunity to testify. We look forward to working with the members of this Committee and Committee staff on the upcoming SBA re-authorization bill.

Attachment A

SBA –7(a) BUSINESS LOAN APPROVAL (Gross $) YTD FY 2001 VS 2002 VS 2003

PERIOD ENDING: 02/14/03

AMOUNTS ROUNDED TO NEAREST $1,000

	---- FY 2001 YTD ----				---- FY 2002 YTD ----				---- FY 2003 YTD ----			
	# LNS	%	$ APPV	%	#LNS	%	$ APPV	%	#LNS	%	$ APPV	%
7 (a) Loans	13,660		3,132,471		15,184		3,647,269		21,230		3,702,416	
Minority	3,509	26	942,470	30	3,943	26	1,104,191	30	5,660	27	1,126,965	30
African American	648	5	118,994	4	608	4	116,713	3	1,040	5	102,373	3
Hispanic	1,023	7	191,641	6	1,154	8	222,417	6	1,614	8	219,233	6
Asian	1,647	12	597,302	19	1,936	13	717,611	20	2,587	12	747,981	20
Native American	161	1	25,923	1	179	1	37,579	1	221	1	29,758	1
Undetermined	23		9,762		65		25,155	1	179	1	44,958	1
Women	2,980	22	535,375	17	3,124	21	592,069	16	4,309	20	598,140	16
Pre-Qual												
Int. Trade	251	2	86,139	3	208	1	74,738	2	358	2	88,154	2
EW/IT/EE	151	1	59,598	2	137	1	52,786	1	112	1	31,206	1
Veterans	1,492	11	327,733	10	1,618	11	397,604	11	2,159	10	359,405	10
Under $150K	8,394	61	618,979	20	9,378	62	682,271	19	15,269	72	874,328	24
LowDoc	2,824	21	226,934	7	2,913	19	247,974	7	3,052	14	271,120	7
PLP Loans	4,491	33	1,705,882	54	4,841	32	1,979,940	54	4,988	23	1,952,112	53
SBA Express	3,338	24	183,507	6	4,323	28	222,684	6	9,753	46	434,068	12
CLP Loans	451	3	182,947	6	427	3	190,561	5	395	2	158,235	4

Testimony of L. Raymond Moncrief
Chief Operating Officer of Kentucky Highlands Investment Corporation and
Chairman of the General Partner of Southern Appalachian Fund,
a Conditionally-Approved New Markets Venture Capital Company

Before
Small Business Committee
Of the United States House of Representatives

SBA Re-authorization Hearing
March 20, 2003

Introduction
Chairman Manzullo, Ranking Member Velazquez and members of the Small Business Committee, thank you for this opportunity to testify before you today on behalf of a very important investment program, the New Markets Venture Capital Program. My name is Ray Moncrief and I am the Chief Operating Officer of the Kentucky Highlands Investment Corporation. I am also the Chairman of the General Partner of the Southern Appalachian Fund, a conditionally approved New Markets Venture Capital Company.

I am also here today on behalf of the Community Development Venture Capital Alliance – a national trade association of which I am a founding member - to support the New Markets Venture Capital program. CDVCA is the voice for the growing community-based venture capital industry which manages some $525 million committed to the dual bottom line of both a social as well as a financial return by targeting investments to benefit low-income people and communities in urban and rural America. 49% of investments by community development venture capital funds are invested in the manufacturing sector.

First, let me begin by expressing deep appreciation on behalf of myself, CDVCA and the six other conditionally approved New Markets Venture Capital Companies to Chairman Manzullo and Ranking Member Velazquez for your steadfast commitment to ensuring the Small Business Administration implemented the NMVC program as Congress intended. Your support for technical legislative adjustments and your insistence that the conditionally approved NMVC companies be given adequate time to raise the private regulatory match required under the statute has been absolutely essential to the success of the program thus far. I deeply appreciate your leadership and your staff's hard work on our behalf.

I am here to urge this Committee to re-authorize the New Markets Venture Capital Program. Congress enacted the New Markets Venture Capital Program for three reasons: 1. Many low-wealth towns and cities across the country missed out on the infusion of equity capital and business wealth generated during the nineties economic boom; 2. 98% of traditional venture capital is invested in metropolitan counties, the majority of which are along the two coasts; and, 3. SBA does not operate a similar program targeted to

equity investing in low-income communities: the majority of investments made by SBICs are made in middle to upper income communities.

Historically, the majority of traditional venture capital financing is provided to high technology sectors, such as bio-tech or information-based technologies. However, small businesses located in rural and low-income urban areas, with their economies primarily in retail and natural resource-based industries, generally do not benefit from the enormous support for technology-based development.

I'd like to offer some background on my experience in small business investing and some of the accomplishments of my firm, the Kentucky Highlands Investment Corporation. I have over twenty-five years experience in providing small businesses with capital and technical expertise to help them succeed. Kentucky Highlands Investment Corporation owns a Small Business Investment Company (SBIC) named Mountain Ventures, which was licensed in 1980, and is a SBA micro-lender. I served on both the Board of Governors and the executive committee of the National Association of SBICs and am currently a board member and treasurer for the Community Development Venture Capital Alliance. I have spoken to scores of audiences on how to succeed and make a profit by investing in businesses in very poor communities.

KHIC was founded in 1968 to create businesses and jobs in a nine county area in southeastern Kentucky, the heart of Appalachia. Based in London, Kentucky, KHIC works in some of the poorest counties in the country where the unemployment rate stays consistently above the national average. Since 1968, KHIC has invested more than $100 million in over 200 business ventures and helped create or maintain 8,000 jobs in our service area. We have access to over $30 million of business investment capital at any given time, $11 million of which is for equity investing. We have invested successfully in several manufacturing enterprises, including a houseboat manufacturer, a tent maker, and an electronics fabricator. In fact, approximately 85% of the investments we make are in manufacturing firms. We also manage one of the most successful rural empowerment zones in the country: The Kentucky-Highlands Empowerment Zone.

As you can see, Kentucky Highlands Investment Corporation has a great deal of experience in raising capital from both the public and private sector and investing it in businesses – small and large – in an area of the country where most investors tend not to invest. And we have been quite successful doing it.

When the opportunity arose to work with Congress to develop a program that could provide equity capital to small businesses in low-wealth communities, I seized it. When we succeeded in passing the New Markets Venture Capital Program, I immediately prepared to apply for it. In partnership with Technology 2020 Finance Corporation in Tennessee, we created the Southern Appalachian Fund as a NMVC Fund to invest in small businesses throughout the southern tier of Appalachian counties in five States: Kentucky, Tennessee, Georgia, Alabama and Mississippi. We submitted an application May of 2001 and July 9th of 2001 we received conditional approval by the SBA to become a NMVC, along with six other organizations.

In total, I have spent nearly five years developing and implementing the NMVC program. I am here today to declare that the program thus far is a complete success and meeting the expectations that Congress established for it under the statute.

New Markets Venture Capital Program is Working According to Plans
In December of 2000, Congress enacted the New Markets Venture Capital Program to address concerns that low-wealth communities across America did not benefit from the influx of equity capital that flowed to wealthier communities throughout the nineties and believed these communities represented market opportunities for business development and job creation. KHIC is proof that you can invest in these areas and succeed in establishing successful businesses and creating jobs. Congress also created the New Markets Tax Credit Program at the same time as the NMVC Program. The two programs were intended to work together – the tax credit was intended to be used as a tool to help raise the capital for the NMVC fund. However this has been difficult to do. The New Markets Tax Credit is administered by the Department of Treasury and I will discuss the lack of coordination between the programs and the problems this has presented later in my testimony.

NMVC: A Unique Program
The NMVC occupies a unique niche and purpose in promoting investments in small businesses in poor communities. The New Markets Venture Capital Program provides guaranteed financing to help capitalize venture capital funds and grant financing to provide operational assistance to portfolio companies. Congress passed the New Markets Venture Capital Program as part of the Consolidated Appropriations Act of 2001 (P.L. 106-554) and appropriated $22 million as subsidy for debenture guarantees and $30 million in grant financing to support up to fifteen NMVC Companies. These monies were enough to provide up to $300 million in investment capital to small businesses in low-income areas. Half of this money has been obligated to support seven NMVC Companies. Congress unexpectedly rescinded the remaining monies - $24 million - in the 2003 Omnibus Appropriations Bill and I urge this Committee to seek replacement of these funds as soon as possible.

The New Market program was part of a larger bipartisan initiative to target federal assistance to improve local economies in low-income urban and rural communities. Under the leadership of Representative Velasquez, the Congress included the NMVC program. The other elements, included in the Community Renewal Tax Relief Act, were the New Markets Tax Credits, additional empowerment zones and a new program -- Community Renewal Zones. The idea was to try a number of different approaches to alleviate poverty to better understand what works the best. With the exception of NMVC, all the other programs are going forward. We believe there is great potential in the NMVC approach and hope Congress will act to get the second round funded and underway.

The New Market Venture Capital economic development initiative is modeled after the SBA's other successful venture capital program called the Small Business Investment

Companies program. However, New Markets Venture Capital targets its investments to development of high-growth small businesses in our country's poorest urban and rural areas, and ties investments to the creation of local jobs with livable wages and benefits for individuals who historically have no opportunities for employment or who are the working poor. The hardest jobs to create are those in desolate rural areas, and yet three of the top community development venture funds have a record of doing it for $10,000 a job, versus other programs, such as the SBIC program, that cost anywhere from $35,000 and more to create a job.

There are two key elements to the NMVC Program that distinguishes it from conventional equity funds and from other SBA programs:
Targeting: The New Markets Venture Capital Program is the only federal program targeted specifically toward leveraging developmental venture capital for investments in small businesses located in low-income areas. Patient capital that equity investments provide to businesses is crucial for spurring economic development activity in low-income areas because this type of investment does not require immediate pay back by the small business.

Operational assistance: The NMVC program builds into it grants for operational assistance so that fund managers can work with portfolio companies to help ensure their success. Providing operational assistance to entrepreneurs in low-income communities is an essential aspect of the work of community development venture capital firms because it allows us to make investments in communities not served by conventional investors. CDVCs recognize that the entrepreneurs in whom we invest may struggle with developing a viable business plan, managing employees or aggressively marketing their products and services. However, the entrepreneurs most willing to operate a business in low-income communities are often likely to come from the community. By working with these individuals and providing some "how-to" guidance, the business is more likely to remain a viable business.

NMVC: Congressional Intent and Companies Selected
The NMVC statute requires that in order for an organization to receive final approval by the SBA to begin operating as a NMVC Company, a conditionally approved NMVC must raise a minimum of $5 million of private capital to match $7.5 million in SBA guaranteed debenture assistance, and an additional $1.5 million to match $1.5 million in grant assistance to support the operational assistance. A third requirement is that the NMVC Company must enter into a participation agreement with the SBA.

The statute allows SBA to grant up to two years to the NMVC Companies to meet these requirements (HR 5663 Sec. 354(d)). The two year time horizon was established by Congress and followed the prevailing industry standard which held that raising capital for a venture fund generally took between 18 to 24 months. Eighteen to twenty-four months was the prevailing industry standard when the Dow Jones hovered above 10,000 points daily and prior to the terrorist attacks of 9/11! Today, the economy is dramatically different than December 2000.

The two year time frame would have also allowed time for the Small Business Administration and the Department of Treasury to coordinate implementation of the New Markets Venture Capital Program and the New Markets Tax Credit Program. Unfortunately, SBA did not provide the full two years to the conditionally designated NMVC Companies. This caused considerable challenges to the program and much of our initial efforts in getting the program fully implemented were to persuade the SBA to grant a sufficient period of time to raise the private capital match. SBA finally extended the deadline to its current date of March 31st.

Despite not having the full two years as Congress intended, the conditionally approved Companies succeeded in raising the required capital. Collectively, these companies raised a total of $70 million of private investment capital in less than eighteen months – despite the poor economy. We did this in one of the most difficult fundraising environments the venture capital industry has ever faced. In the year 2000, the venture capital industry raised $106 billion in new capital, and in 2001 it raised only $26 billion. However, in 2002--the year in which the primary fundraising for the new NMVC companies occurred--the venture capital industry was able to raise only $6 billion. In the economic environment in which we were operating, our ability to raise our full requirement for a private capital match for funds operating in some of the most economically distressed parts of our nation was truly extraordinary.

Due to the NMVC program, approximately $175 million of venture capital will be available for small business development in targeted low-income communities in sixteen States. These dollars promise to provide a critical economic stimulus to areas of the country that are just holding on and create as many as 12,000 jobs!

In addition to my NMVC Company, six companies and the areas in which they intend to invest are:

- Adena Ventures, LP, headquartered in Athens, Ohio and affiliated with Ohio University and the University of Charleston, plans investments in Kentucky, Maryland, Ohio and West Virginia.

- Dingman New Markets Growth Fund, affiliated with the University of Maryland Smith School of Business, is targeting Baltimore City, Maryland and the District of Columbia for its investments.

- Murex Investments, LP, an affiliate of University of Pennsylvania's Wharton School of Business, will target investments in Delaware, southern New Jersey and southeastern Pennsylvania;

- Pennsylvania Rural Opportunities Fund, a partnership of Ben Franklin Technology Partners and Zero Stage Capital Company, plans investments solely in central Pennsylvania.

- CEI Community Ventures Fund, LLC (CEI stands for Coastal Enterprises, Inc., the parent organization), based in Wiscasset, Maine is targeting investments in Maine, New Hampshire and Vermont.

- Southwest Development Fund, LP, located in Phoenix, Arizona and affiliated with Arizona Multibank Community Development Corporation and Magnet Capital. It plans investments in low-income communities and tribal reservations located in Arizona.

March 31st is the established deadline for all these Companies to receive final approval and to begin investing in small businesses. However, one NMVC Fund closed in April of 2002 and has already begun making investments: Adena Ventures has already invested $1.6 million in three early-stage companies and has provided operational assistance to sixteen.

The three companies in which Adena has invested are located in West Virginia and include two software companies and one healthcare plan provider: Butterfly.net, Inc is a Martinsburg, WV based software development company that provides a unique grid infrastructure for multi-layered online games; SecureMethods, Inc. is also based in Martinsburg and is a security software company that specializes in the design, implementation and deployment of advanced secure network applications for commercial, healthcare and government clients; and, Vested Health, LLC is a Charleston, WV based provider of consumer directed health plans for employer groups with 10-2,000 employees. Together with fourteen additional central Appalachian companies that have received operational assistance, Adena's funding has helped create, maintain and enhance employment prospects for more than 200 individuals.

The Dingman New Markets Growth Fund closed earlier this month on March 5th and is preparing to make its first investments. In fact, Dingman reports that without any advertising, it receives on average four calls per day from small businesses seeking investment capital and assistance under the program.

Final Approval Nears

As this final deadline approaches, the NMVC Companies are working hard to process the documentation requests of the SBA. Due to the paperwork and legal documentation required, I and my partners have spent in excess of $300,000 alone in legal fees, accounting fees and staff time just on document preparation and review – and the attorneys I have hired have years experience with generating documents for the SBIC program.

As the program goes forward, I urge the SBA to develop a standard set of documents that conditionally approved NMVC companies can use so that paperwork and document costs can be minimized.

The New Markets Tax Credit and the New Markets Venture Capital Program

As I mention throughout my testimony, these programs were designed to work together – the New Markets Tax Credit was intended to be a tool to help the New Market Venture Capital Company raise the private investment capital. Unfortunately making these programs work together has not been easy and I urge this Committee to support changes in the law that would make these programs work better together and to urge the SBA to better coordinate with the Department of Treasury.

The following is a list of key areas in which these programs diverge:
1. Special CDE Status: In order to apply for an allocation of a NMTC, an organization must receive certification as a Community Development Entity. The New Markets Tax Credit statute grants automatic CDE status to SSBICs and to Community Development Financial Institutions (or CDFIs). New Markets Venture Capital Companies should also receive this special status. Special status would eliminate one extra application process that we must submit and it would encourage more NMVCs to use the NMTC program.

2. Metropolitan census tract definitions are different under both programs: Targeted investment census tracts in metropolitan areas are also defined differently: Under the NMVC program, investments are limited to census tracts where the poverty rate is 20% or more, or if the census tract is within a metropolitan area, where 50% or more of the households have an income of 60% of the area median income; Empowerment Zones and Communities and HUBZones automatically qualify. Under the NMTC program, a census tract qualifies if it contains at least 20% poverty rate or if median household income is up to 80% of the area or statewide median. We urge this Committee to conform the definition of a qualifying metropolitan census tract under the NMVC program to that under the NMTC program.

3. Administrative measures: I urge this Committee to work with the SBA to urge them to better coordinate with the Department of Treasury on the implementation of the NMVC and NMTC program. The Department of Treasury, on its own, granted a 'look back' whereby investments made to qualified entities prior to the date credit allocation decisions were announced but after April 2001 could still receive a tax credit as long as requirements under the NMTC program were otherwise met. This would allow taxpayers making investments in a NMVC Company after July 2001 the ability to use the credit, even though credit allocations were made at a later date. The Department of Treasury did this on their own and demonstrated a willingness to be as flexible as the legislation allows them to be to accommodate the NMVC Companies. We urge the SBA to also identify ways in which the administration of the NMVC program can be better coordinated with the NMTC program.

Recommendations for Re-authorization:
We strongly urge Congress to re-authorize the New Markets Venture Capital Program for several reasons: one, it's the only federal investment program designed to provide venture capital financing to low-income areas; second, it is also the only venture capital program that provides operational assistance to companies in which investments are made; and third, it works: All seven of the conditionally approved NMVC Companies

are on track to win final approval from the SBA by March 31st and over a dozen small businesses are already receiving the benefits of the program.

We also strongly urge the Committee to work with Appropriators to restore the $24 million in rescinded funds so that SBA can move forward on a second round of funding as soon as possible. Several organizations across the country were gearing up to apply for a second round of funding when these monies were rescinded.

Raising the capital in this economic climate was not easy and it indicates that there is an appetite and need for this type of investment capital. In fact, due to the NMVC program, we can expect to see investments of up to $175 million to promote small business development in low-income communities throughout the east coast and in parts of the southwest and up to 12,000 jobs created.

We do offer some recommendations for strengthening the program:
1. Debenture rate: limiting the interest rate charged on the debenture to a fixed rate of 4% or less would enable the investments to target higher risk sectors, such as manufacturing, and still ensure an adequate return to investors.

2. Definition of equity capital: allow subordinated debt with some amortization features to qualify as an equity capital investment. The current definition used by the statute is the same definition used by the SBIC participating security program which is a different investment instrument than the debenture. Unlike a participating security, the debenture requires repayment according to a pre-established schedule rather than according to company profits.

3. Operational assistance: Allow conditionally approved NMVC Companies to receive some early grant assistance up to $100,000 at the point to initial designation so that they can cover out of pocket expenses necessary to establish the fund. If the Companies fail to win final approval, the grant would be repaid to the SBA. In addition, we urge the Committee to work with SBA to administer the operational assistance grant program in a way that provides broad and flexible services to the companies receiving assistance.

4. Metropolitan census tract: Adjust the definition of a metropolitan census tract to conform to that contained in the NMTC program.

Conclusion:
Congress passed the New Markets Venture Capital Program in December 2000 because it recognized that many poor communities do not have the ability to generate private wealth sufficient to grow a small business community. It also recognized that equity capital - patient capital that doesn't require an immediate pay-back – is critical to many small businesses. These two points are as true today as they were in 2000 – perhaps more so given the current economy.

The New Markets Venture Capital Program is working and can work better if given a chance. We hope Congress continues its commitment to helping low-income communities grow small businesses that can thrive and prosper well into the future.

Again, thank you for the opportunity to testify and for your help through these past two years in making this program work for America's small business community. I look forward to working with you on re-authorization to ensure its continued success.

Testimony before the House Small Business Committee
Ceyl Prinster, Executive Director
Colorado Enterprise Fund

Thursday, March 20, 2003

Thank you, Mr. Chairman, Ranking Member Velazquez and members of the Committee for the opportunity to testify before you today. My name is Ceyl Prinster. I serve as Executive Director of the Colorado Enterprise Fund, an SBA Microloan Intermediary serving 15 Counties along the Front Range Area of Colorado, plus selected areas state-wide on a case-by-case basis. I am here to testify on behalf of my organization and as a member of the Association for Enterprise Opportunity – the national association of more than 450 microenterprise development programs around the United States.

I would like to provide you with some quick background about my organization before I begin to talk about the SBA Microloan Program.

Colorado Enterprise Fund has been in operation for 27 years making commercial loans to support small businesses that cannot get financing from banks. Our program originally served only the inner city areas of Denver, but now has expanded to a regional entity serving an area comprising over 85% of the people of Colorado. Incorporated in 1976, our mission is to foster economic opportunity by encouraging business ownership and small business development. We began our microlending activities in 1990, and since then, we have made 374 loans totaling over $5.5 million, with an average loan size of $14,750. We have a cumulative repayment rate of over 95% on our loans.

Colorado Enterprise Fund was selected for the SBA Microloan Program in the first round in 1992. Our clients are typically low-to-moderate income entrepreneurs who cannot get bank loans to fund their businesses for a variety of reasons: they may not have been in business long enough, not have enough acceptable collateral, not have a high enough personal credit score, or just be too small to make it worthwhile for a bank to service. We make about 35% of our loans to minorities and 51% of them go to woman-owned firms. Our loans have assisted approximately 1,400 jobs, or approximately 4 jobs per loan. We also have a child care business loan program which has made 38 loans since it started in 1998 and has assisted 543 child care slots.

In 2002, we closed 59 loans valued at $1,009,600 for an average loan size of $18,354. We had 169 loans under management during the year. These loans were made to businesses from all sectors, including manufacturing, service, retail, wholesale distribution and contractors. In addition, we assisted 1,465 individuals with training, technical assistance and business counseling.

The SBA Microloan Program, which was created as a demonstration program during the Bush Administration, is unique because it was created with the needs of a specific target market in mind – entrepreneurs that need both access to capital and intensive

management assistance. The SBA Microloan program provides two types of funding to non-profit intermediaries around the country:

- Loan capital, repayable over 10 years to the SBA, on slightly concessionary terms. This capital is then loaned out by the non-profit intermediary to microenterprises in loans of $35,000 or less. To receive any loan capital, an intermediary must provide an up-front cash match that the SBA holds as collateral along with an assignment of all the loans made with the funds.

- Operational grants to provide intensive marketing, management and technical assistance to assist Microloan borrowers. This assistance is the key to successful outcomes for the businesses that access the SBA Microloan program.

While some have suggested that the SBA Microloan program be replaced with guaranteed bank loans, I would reiterate: Microlending does not serve bankable clients, but works to build businesses – creating revenue, income and jobs – with those individuals to which the banks can not provide loans. In a few cases, the loan sizes may be the same, but across the board, the target market is very different. Most borrowers from the Microloan Program would fall under the bank's criteria, even with a guarantee.

Why is it important to work with this group of clients? In today's economy one can not simply go out and find a job – this is particularly true for the individuals we work with. Some have started microenterprises while others dream of doing so. We are enabling entrepreneurs to increase revenue, generate personal income and create jobs. Recent estimates put the return on investment in microenterprise development at $2.06 to $2.72. Is the federal government willing to invest $1 dollar to receive more than $2 in return?

I would like to offer some additional statistics to detail the work of the Microloan Program. In Fiscal Year 2002, the last year for which public data is available, the SBA Microloan program:

- Closed 2,580 loans, with an average loan size of $14,238, for a total of $36,732,972
- 44% of these businesses were startups
- More than half were minority-owned
- Nearly half were women-owned

You heard at your budget hearing in February that recent research has demonstrated that Microloans are our most effective tool in creating jobs. In addition, I would emphasize to members that the Microloan industry is more effective now than ever. Last year's loans account for nearly 1/6th of the programs historical loans – an amazing figure indicating the increasing demand for the program by small businesses across the nation.

I would now like to address the microenterprise industry's suggested changes to the authorizing legislation. We continue to think about ways to improve the program, but would offer the following thoughts today.

As the microenterprise industry has become more advanced, many SBA Microloan Intermediaries have begun to see the need to develop more sophisticated loan instruments to match the needs of our clients. Intermediaries are developing lines of credit and other loan terms that more closely match the cash flow and capital needs of microentrepreneurs across the country. AEO is recommending that the SBA Microloan program be modified to allow these financial instruments to be used within the program.

Likewise, a similar evolution has occurred in the provision of technical assistance. Intermediaries and National Technical Assistance Partners are increasingly being asked to provide more specialized assistance for entrepreneurs – moving beyond generalized technical assistance to sector-specific and technical issues. Intermediaries are meeting this challenge by remaining flexible. Two changes to the SBA Microloan program would facilitate this process. First, the cap on pre-loan technical assistance should be lifted. Second, the limit on out-sourced technical assistance should be increased from 25 to 35 percent.

Like many SBA loan programs, the SBA Microloan Program subsidy rate has received increased attention over the past two years. The Association for Enterprise Opportunity looks forward to working closely with the SBA to determine if changes to the model used to determine this subsidy rate are necessary.

Finally, there are a few technical corrections to the Microloan authorization that AEO supports. I would like to thank you for the opportunity to testify and would be glad to answer any questions at the appropriate time.

NASBIC
America's Small Business Partners

Statement
of
Robert Finkel
President

Prism Capital
Suite 1910
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Before The

United States House of Representatives
Committee on Small Business

March 20, 2003

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Chairman Manzullo, Ranking Member Velázquez, and members of the Committee

It is an honor to be here to testify on behalf of the National Association of Small Business Investment Companies on important issues that the Small Business Committee will consider as it works on reauthorization of the Small Business Investment Company (SBIC) program. By way of introduction, my name is Robert Finkel. I am the founder and Managing Partner of the Prism Opportunity Fund, a Chicago, Illinois Participating Security SBIC with six professionals managing $50 million in capital assets. In addition to Chicago, we have offices in Seattle, Washington; Englewood, New Jersey; and Milwaukee, Wisconsin. We received our SBIC license for Prism Opportunity Fund in 1999 and I am happy to report that we have been given the green light by SBA to form our second SBIC. It will be a Debenture SBIC, Prism Mezzanine Fund, focusing on manufacturing and distribution companies in the Midwest. Before founding Prism, I had spent nine years in the private equity business with four of those as an investment manager at Wind Point Partners, also in Chicago. Before turning to investment management, I had been an investment banker specializing in mergers and acquisitions with Paine Webber.

At Prism, one of the two lines of investment opportunities we focus on is that of traditional manufacturing companies, of particular relevance given the focus of today's hearing. We look for small manufacturing companies that have potential for growth, whether internal or by way of acquisitions. The common denominator in all our investments is a driven, entrepreneurial management team coupled with a market-proven product, technology, or service. Prism is committed to backing exceptional entrepreneurs who have the vision, drive, and talent to be leaders within their industry. We understand the enormous effort required to create a successful business and stand ready to provide our portfolio companies with assistance in strategic planning, customer acquisition, business management, executive recruiting, and raising additional capital. We strive to provide entrepreneurs with all the tools they need to succeed.

At Prism, we are focused on long-term value creation for our limited partners, including SBA. We understand that growing an exceptional business is a lengthy, complex process with many unexpected twists in the road to success. Thus, we are a patient investor, investing with a horizon of between three and seven years depending on the requirements of the small businesses we invest in. We also invest with the mindset that growth requires additional capital and reserve for follow-on investments. We maintain an extensive network of contacts in the private equity community and can assist small companies by bringing additional investors into a transaction.

With that introduction, I turn to issues related to reauthorization of the SBIC program. I will summarize my testimony, but ask that the full written version be included in the record of this hearing. I want to particularly draw the Committee's attention to several points that I make at the close of my testimony that underscore the important role the SBIC program is playing in the current economic recovery that we all hope will take hold in America this year.

Reauthorization Period & Maximum Leverage Levels

Among other items, the Committee will address the period for which the reauthorization will apply and the maximum leverage levels that will be apply in each of the years for which the program is reauthorized. In this regard, we recommend that the program be reauthorized for three years as has been the general rule in the past.

As to maximum leverage levels, we support those proposed in the President's budget for FY 2004: $3.0 billion for Debenture leverage and $4.0 billion for Participating Security leverage. Those amounts should be sufficient to meet the requirements of existing SBICs and newly licensed SBICs that will rely on that authority to make investments. If the reauthorization period is three years, we suggest that authority be increased by $250 million in each of the programs in each of the additional years (FY 2005 and FY 2006) to which the reauthorization would apply. Thus, Debenture authority would increase to a maximum of $3.5 billion in FY 2006, Participating Security authority to $4.5 billion. Under current conditions, that authority should be sufficient to meet demand. What we hope we will never see is maximum authority serving as a cap that would keep new private capital from being invested in new SBICs.

For the Debenture program, §303(b) of the Small Business Investment Act (SBIA) provides that one of the fees is annual interest to be paid directly to SBA for leverage drawn with respect to an applicable year's leverage authority. The interest rate varies from year-to-year as required to keep the subsidy rate at "zero" for Debenture appropriation purposes; provided, however, that the rate may not exceed 1.0% per annum. For Debenture leverage to be drawn against FY 2004 authority, that rate required to maintain the zero subsidy rate will be 0.855% per annum, down slightly from the FY 2003 rate of 0.887% per annum. No change in the law will be required.

SBIA §303(g)(2) provides the per annum counterpart for the Participating Security program. The section provides that a prioritized payment rate of not to exceed 1.38% per annum on any outstanding leverage related to the annual leverage authority in question shall be paid directly to SBA's account to keep the subsidy rate at "zero" for Participating Security appropriation purposes. For leverage related to FY 2003 authority, the required rate is 1.311% per annum. For FY 2004 leverage authority the required rate will be 1.454% per annum, 0.074% greater than current statutory authority. Thus, for implementation of the President's budget as submitted, the authority of SBIA §303(g)(2) must be increased legislatively by 0.074% at a minimum.

The reason the §303(g)(2) rate must be increased this year has nothing to do with assumption of increased losses in the program. Rather, it is because the profit sharing rate that Participating Security SBICs must pay SBA falls as the 10-year Treasury bond rate falls. At current projections for the 10-year rate, the profit share rate is at its lowest point. In essence, all that is happening this year is a reduction in one rate element and a related increase in another.

We suggest increasing the §303(g)(2) "not to exceed rate" to 1.5% per annum as part of the reauthorization process later in the year. That is the same level we suggested in FY 2002. It is well within the ability of SBICs to pay given current market conditions and would not in any way increase the amount paid by small businesses for Participating Security SBIC financing. The latter are set by market conditions; there is no direct correlation between the cost of leverage to a Participating Security SBIC and the amount it can charge a small business. Total annual cost of leverage has been much higher historically than it is today. The estimated total cost of Participating Security leverage for the next year is approximately 6.5% per annum. This compares to the average for the life of the program of 7.84% per annum. Participating Security SBICs using FY 2004 leverage will be well positioned to contribute to the economic revival so important to our country.

Suggested Changes In the Small Business Investment Act of 1958 That Will Increase Support Of Manufacturing Companies By SBICs

SBICs already provide significant support to manufacturing companies. In FY 2002, SBICs invested $737 million in 434 small U.S. manufacturing firms located in 41 states. That was 28% of all SBIC dollars invested in FY 2002 and 22% of all companies that received SBIC financing that year. SBA reports that 21,050 jobs were created and, using average employment numbers for SBIC-financed companies, over 68,000 manufacturing employees were supported by those investments. However, we believe there are several steps that would improve those numbers.

1. To make more funds available to invest in manufacturing companies we suggest a targeted change to SBIA §303. The changes would allow SBICs investing in small U.S. manufacturing companies to exceed current maximum leverage amounts set by the SBIA (currently $113.4 million) but would not permit them to exceed the maximum 3:1 leverage ratio contemplated by the SBIA. By keeping the maximum permissible leverage ratio no greater than that contemplated by the SBIA, the risk to the SBA would not be increased above that contemplated by the SBIA, although the exposure to any one SBIC or group of co-managed SBICs would be increased.

   Supporting capital-intensive manufacturing companies takes substantial capital resources. These might be held by a single SBIC or a group of co-managed SBICs. The SBIA limits the maximum amount of leverage available to any one SBIC or group of co-managed SBICs no matter how much private capital the SBIC has been able to raise. The current limit is $113.4 million. While the limit does increase annually by a percent equal to the increase in the Consumer Price Index, it is constraining for those SBICs that have substantial private capital under management—SBICs that would invest more in manufacturing companies but for the leverage limit. Providing a reasonable exception to the limit would increase investments by those SBICs with substantial private capital and a focus on manufacturing companies and would also stimulate the creation of new SBICs focused on investing in small U.S. manufacturing companies.

   Specifically, we suggest adding a new subparagraph to SBIA §303(b)(2):

   > "(D) INVESTMENTS IN MANUFACTURING COMPANIES. — In calculating the outstanding leverage, whether represented by a debenture or participating security, of a licensed company for the purposes of subparagraph (A), the Administrator shall not include the amount of any leverage included in an investment made by the company in a small business concern or smaller enterprise that meets the definition of a manufacturing company under the industry classification system used by the U.S. Government; provided, however, that the total of leverage not included in the calculation shall not exceed 100% of the company's private capital and provided further that total leverage outstanding shall at no time exceed 300% of the private capital of the licensed company."

   In addition to the above, a conforming amendment to SBIA §303(b)(4)(A) is required to reflect the targeted exceptions to maximum leverage levels. Specifically, we suggest amending the section to read as follows:

"(A) IN GENERAL — Except as provided in subparagraphs (B), (C), and (D), the aggregate amount of outstanding leverage issued to any company or companies that are commonly controlled (as determined by the Administrator) may not exceed $90,000,000 as annually adjusted for increases in the Consumer Price Index."

2. To give managers of very large SBICs the time they need to work with large portfolio companies and to reduce the risk that such managers invest in companies outside of their focus area, we suggest elimination of the mandatory requirement that those SBICs invest a substantial portion of their dollars in companies that are defined as smaller enterprises by the SBIA. The mandate is 20% of all investments made until the SBIC has used $90 million in leverage, and then 100% of any investments made with leverage exceeding $90 million. The impact of the law is to require larger SBICs to make many more investments than they would normally make under other controlling provisions of the SBIA (smaller enterprises generally require smaller amounts of capital) and to make them in companies that may not fit the investment focus and expertise of the SBICs involved. The result is that SBIC managers have less time to work with portfolio companies (particularly important in the U.S. manufacturing environment) and may have to invest in companies with profiles that do not match the expertise resident in the SBIC making the investment. This latter impact increases the risk of return to both the SBIC and the SBA.

   We propose exempting SBICs with private capital equal to or more than $50 million from the requirement of SBIA §303(d)(1). Only 14 of 353 leveraged SBICs (4.0%) meet this criterion at present. The average leveraged SBIC has approximately $20 million in private capital. The purpose is to encourage larger SBICs to focus on (specialize in) investing in larger businesses that still meet the SBIA definition of "small business concern." Capital-intensive manufacturing businesses will make up the large percent of such opportunities. SBICs that invest in companies that do not meet their investment profile increase the risk to both the SBICs and SBA, as SBA recognizes fully in its SBIC licensing and monitoring processes.

   Specifically, we suggest amending §303(d) to read as follows:

   "(d) INVESTMENTS IN SMALLER ENTERPRISES –

   (1) IN GENERAL – The Administrator shall require each licensee with private capital less than $50,000,000, as a condition of approval of an application for leverage, to certify in writing that not less than 20% of the licensee's aggregate dollar amount of financings will be provided to smaller enterprises.

   (2) MULTIPLE LICENSEES – Multiple licensees under common control (as determined by the Administrator) shall not be excused from the requirement of subsection (1) by the fact that combined private capital of any one or more of the commonly controlled licensees is equal to or exceeds $50,000,000."

   The suggestion would continue mandatory support for smaller enterprises by over 90 percent of SBICs, but would allow the few larger SBICs to focus on a smaller number of larger small businesses, although still a number meeting SBIA portfolio diversification requirements.

Suggested Changes In The Small Business Investment Act Of 1958 That Will Increase Support Of Private Investors And The Ability Of SBICs To Raise Private Capital

3. To clarify congressional intent and to encourage more private investors, particularly institutional investors, to invest in the SBIC program, we suggest an amendment to SBIA §303(e), the section of the Act that deals with Capital Impairment. The section requires that SBA, as a condition of approving a request for leverage by any SBIC, make a determination that "the private capital of the licensee has not been impaired to such an extent that the issuance of additional leverage would create or otherwise contribute to an unreasonable risk of default or loss to the Federal Government." SBA has construed §303(e) as requiring not only that a finding of capital impairment (as defined by SBA) might preclude advancing additional leverage, but also that it is a violation of SBA promulgated regulations that can lead to imposition of operating restrictions, denial of the right to use remaining capital for investment purposes, and actual liquidation of the SBIC at the direction of and upon terms set by SBA—even in cases where there has been no other violation of the law or regulations and the SBIC has done nothing other than invest in accordance with the provisions of the business plan approved by SBA during the licensing process. Among the potential conditions that can be imposed is a requirement that the SBIC call any remaining private capital for the sole purpose of retiring outstanding leverage rather than supporting investments in small businesses.

   While capital impairment may be a permissible reason for rejecting a leverage request, we do not believe it was congressional intent that, absent other regulatory violations, it be a reason to shut down an SBIC or deny the use of private capital for investment purposes. Other than the reference to capita impairment in §303(e), there is no other reference to capital impairment in the SBIA. We believe the intent was to give SBA a tool to use to help judge whether or not it would advance more leverage to an SBIC, but not one that would permit SBA to punish the SBIC for simply having its capital eroded by investment losses. Those potential losses relate to investments in small businesses. While the money may not be returned to the SBIC, it nevertheless was put to its intended purpose. Whether or not the losses will be realized over time cannot be known only by looking at a value at mid-point in the life of an SBIC. SBIA §301(c)(3)(B)(iii) and §302(a)(3)(B) stress SBA's right to make the judgment during the licensing process and upon leverage requests as to whether or not to support an SBIC. However, we believe no section gives SBA the explicit authority to anticipate that an SBIC will be unable to meet its obligations with respect to leverage that has already been issued and to declare this unilateral anticipation a condition of default that justifies restricted operations or liquidation. Failure to pay Debenture interest, a prioritized payment due from a profitable PS fund, or the actual principal of a security *when due* are conditions of default that should (and do) permit SBA action, but SBA-defined arbitrary capital impairment ratios should be exclude from that list.

   In Participating Security SBICs, and in Debenture SBICs to a lesser degree, the very nature of investing can create significant conditions of capital impairment during the life of the fund. Depending on the type of investments made by a fund (e.g., start-up, later stage, technology, debt, or equity—all approved by SBA in the licensing process), capital impairment can be considerable in a fund that will ultimately prove to be very profitable. If SBA becomes the judge able to make a unilateral decision on when to shut down a fund in

advance of the due date of outstanding securities, private investor support of the program will begin to erode since it will be seen as a repudiation of the venture capital model upon which the program is based and a transfer of investment decisions from the private fund managers to the SBA. Some funds will lose money. Bad things can and do happen to good people. However, SBA is an investor in hundreds of SBICs. Over time, dollar cost averaging will work to the advantage of SBA just as it does for institutional investors. Licensing requirements are strict, private capital is at risk first, and SBA can refuse to issue new leverage based on calculation of capital impairment. All of that is reasonable in the context of the program. However, if SBA severely restricts or liquidates SBICs in mid stream simply because of capital impairment ratios, private investors will have little reason to support the program, particularly the Participating Security program. This is particularly true if SBA couples restrictions with a call of private capital to pay itself rather than to see the money invested in the small businesses that make up the SBIC portfolio. Private investors can accept losing their money if it has been invested in small businesses. They cannot accept simply paying their capital directly to SBA.

To clarify congressional intent, we suggest that SBIA §303(e) be amended to include a new subsection (3) which would read as follows:

> "(3) Notwithstanding the Administrator's right under subsection (2) to refuse to grant additional leverage to a licensee based on the degree to which the licensee's private capital has been impaired, that degree of impairment shall not be the basis, in whole or in part, for any action by the Administrator to restrict the operations of the licensee or to direct the use of the licensee's remaining capital to any purposes other than the investment purposes for which the licensee was licensed. This provision shall not prevent the Administrator from taking actions to restrict the operations of (or liquidate) a licensee for failure to comply with any other provision of the law or regulations promulgated by the Administrator under authority of this Act."

We believe that the above clarification will make the SBIC program a very attractive program for institutional investors who, for the most part, have not invested heavily in SBICs. Coupled with what we hope will be passage of H.R. 739, the "Small Business Company Capital Access Act," the bill that will remove UBTI disincentives applicable to Debenture SBICs, we believe that the program will attract significant new sources of capital, capital destined to be put to work supporting U.S. small business entrepreneurs.

Suggested Changes In the Small Business Investment Act of 1958 That Will Strengthen SBA's Position With Respect To Leverage Advanced To Participating Security SBICs

4. Although we are still considering the issue in discussions with SBA, our belief is that the risk of loss to the government can be reduced by amending SBIA §303(g)(9). That section of the law governs both the percent of distributions made by Participating Security SBICs from income, after tax distributions and repayment accrued prioritized payments that may be due, that must be paid to SBA and how those distributions are to be characterized by SBA. The goal we share with SBA is to reduce the risk of loss to the government (thereby having a positive impact on the subsidy rate) without making the program less attractive to private

investors who are the foundation of the SBIC program. We believe that SBA and the SBIC industry will agree on the language necessary to achieve the shared goal by mid- to late April. That should leave sufficient time for the Committee to consider the proposal for inclusion in the final reauthorization bill.

The SBIC Program Is A Model Partnership Between SBA, SBIC Fund Managers, And Private Investors—One That Is Making A Real Difference For U.S. Small Business.

In closing, I would like to highlight several facts that I believe support the above caption.

1. SBICs are an important part of our national economic recovery. SBA estimates that SBICs currently account for 60% of all venture capital investments—by number of investments. For comparison, in 1997 the number was 38%. The increase is likely to grow in the face of the substantial and continuing contraction in overall venture capital. To illustrate, the number of all annual venture capital investment transactions has dropped by 60% since the high water mark of FY 2000, but the number of SBIC investment transactions has dropped by just 14% over the same period. This underscores the countercyclical nature of the SBIC program and the role it will play in the recovery.

2. SBICs are proving their value as steady and reliable sources of venture capital for U.S. small business entrepreneurs. For the fiscal year ended September 30, 2002, SBICs invested $2.7 billion in 1,979 U.S small businesses. While down 40% from the previous year, the total compares with a drop of 54% in all venture capital dollars invested for the period. The biggest drop in SBIC dollars invested was in those made by unleveraged bank SBICs—a 63% drop compared to only a 16% drop in investments made by leveraged funds. Bank SBIC investments have fallen because of economic conditions and because banks can now make venture capital investments out of funds established under Gramm-Leach-Bliley authority. Finally, and of the greatest importance, while SBIC dollars invested fell 40%, the number of companies financed dropped only by 12% (from 2,254 to 1,979), indicating that much of the dollar fall can be attributed to lower valuations of companies securing financing. Given the major contraction in the economy, a fall of just 12% in the number of companies supported by SBICs was a positive result.
3. SBICs are a significant source of capital for new businesses, with 48% of all FY 2002 investments made in companies less than three years old.

4. The average size of investments by all SBICs was less than $1.0 million, while investments by non-SBIC funds averaged about $9.0 million for the same period.

5. SBICs invest in areas that are traditionally underserved by non-SBIC venture capital firms. SBICs invest in virtually every state—48 of 50 in FY'02—and are an important source of capital for businesses located in Low- and Moderate-Income (LMI) areas as defined by the government. In FY'02, LMI investments by SBICs totaled $725 million—27% of all SBIC FY'02 investments. The 27% total was up from 22% in FY 2001—a percentage increase of 23% for LMI businesses.

6. Regarding employment, average employment at SBIC-financed companies in FY'02 was 157. The median number of employees was 29. Based on the average, SBIC-financed companies employed approximately 310,000 individuals in FY'02. With growing capital resources, SBICs are ready to build on that number in the years ahead.

7. Currently 441 SBICs are managing $20.6 billion in capital resources, up 10% from $18.8 billion at year-end FY 2001. The increase is significant given the contraction in all other sources of venture capital. During FY'02, private investors committed $800 million in new private capital to the 41 new SBICs licensed in FY 2002. The backlog of current license applications at SBA and the rate at which new applications are being received make it likely that as many as 50 new funds will be licensed in FY 2003. This will ensure the continued flow of critical venture capital to the fast-growing U.S. small businesses that are the foundation of U.S. job creation and economic growth.

8. What will FY 2003 results show? An extrapolation from investment data through January 2003 indicates that dollars invested will remain level or increase slightly, but that there will be a substantial increase in the number of companies receiving financing—perhaps as many as 2,500. All projections at this time are clouded by the uncertainty related to the situation in Iraq. What can be said with certainty is that the program is strong and that there is continued growing interest in the program among experienced venture capital management teams. That is good for the program and U.S. small businesses.

Thank you for your attention and for your consideration of our proposals for the SBIC program. We enjoy a very strong and positive working relationship with SBA and believe the program is on a strong footing. We believe the changes we have suggested will make the program stronger still and even more effective in supporting U.S. small businesses in the future, particularly small U.S. manufacturing businesses. I would be pleased to answer any questions you might have about the program in general or our proposals for the reauthorization bill in particular.

March 20, 2003

TO: The Honorable Donald Manzullo, Chairman
U.S. House of Representatives Small Business Committee

CC: The Honorable Nydia Velazquez, Ranking Member
U.S. House of Representatives Small Business Committee

FROM: Lynn Gellermann, President & COO
Adena Ventures, L. P.

RE: **Testimony Regarding the U.S. Small Business Administration's New Markets Venture Capital Program**

Dear Chairman Manzullo:

I am writing to you and your committee on behalf of Adena Ventures, the nation's first New Markets Venture Capital (NMVC) company to be approved by the U.S. Small Business Administration (SBA). Presently, Adena is the only NMVC fund with operating experience; therefore, my partners and I feel obligated to respectfully submit the following facts, comments and observations for the benefit of your committee's hearing on the NMVC program. We believe your committee's hearing and the NMVC program will benefit from Adena's story and experience, and ask that our written testimony be made part of the official record for this hearing.

Summary Statement

As the first venture fund approved and fully operational under the SBA's NMVC program, Adena Ventures, its partners and the companies it has funded serve as living proof that the NMVC program is working and can have a meaningful impact on underserved and low-income communities.

As a NMVC fund, Adena is unique in two important ways. First, our target market is central Appalachia, a large and attractive region in many ways, yet one where little or no venture capital activity has historically occurred. Secondly, Adena comes to this marketplace not only with

investment capital, but also with operational assistance resources with which to help small businesses realize their growth potential. These characteristics differentiate Adena and the SBA's NMVC program from traditional venture funds and programs that have come before us.

In only ten months, Adena has made equity investments totaling $1.6 million in three early-stage companies, all of which are located in low-income communities. Two of Adena's portfolio companies are well-positioned software development firms with market leading technologies; the other is an innovative consumer directed healthcare plan administrator.

Adena has also funded operational assistance services totaling $600,000 to an additional fourteen companies in central Appalachia. Nearly 90% of these companies are located in low-income areas, and they collectively employ over 200 people, 80% of whom live in low-income communities.

Adena believes that if the NMVC program can succeed Appalachia, then it can work anywhere in the nation. On that note, Adena is pleased to congratulate and welcome the NMVC program's second fund, the Dingman New Markets Growth Fund, which was just recently approved by the SBA. We know this fund's management team, and have every confidence that they too will succeed in having a meaningful impact in their region.

Now there are two professionally managed NMVC funds. Yet, as originally contemplated when the New Markets program became law, Adena believes that underserved regions and the nation at large will benefit in many ways from the formation of additional NMVC funds. To that end, we respectfully urge your committee to help restore funding for the second round of the NMVC program.

The original vision of the New Markets program also called for a tax credit component to complement the venture capital initiative. The tax credit program was intended to provide an incentive for private institutions to invest capital in NMVC funds operating in underserved regions of the country. While these programs have been implemented by the SBA and the U.S. Department of Treasury, respectfully - - they are not compatible. We strongly urge your committee

to help find solutions that will enable these programs work together as originally intended. We believe the New Markets Tax Credit program should be modified so it can allow NMVC funds and their institutional investors to participate.

Background

Adena Ventures is a $34 million venture capital enterprise that provides equity capital and operational assistance to small businesses in central Appalachia. Adena was formally approved as the nation's first New Markets Venture Capital company by the SBA on April 24, 2002.

The SBA's final approval of Adena Ventures received national, regional and local media coverage last spring and summer. The story of Adena Ventures and its mission captured imaginations and held great appeal for many people and organizations throughout the country, even before the fund made its first investment.

The period of time it took Adena to raise the necessary private capital for the fund and to concurrently gain conditional and final approvals from the SBA was approximately two and a half years. The SBA application, underwriting and licensing process was lengthy and challenging; however, going through the process actually made Adena a stronger and better prepared fund by the time it was ready to open for business. While the SBA was appropriately tough during the approval process, the relationship Adena now enjoys with the agency is helpful and productive.

Adena is headquartered in Athens, Ohio and maintains an office in Charleston, West Virginia. The location of Adena's offices at university campuses (Ohio University and the University of Charleston) reflects the uniqueness and importance of the fund's relationships with these universities, which is more fully described later in this report.

Legal Structure and Capitalization

Adena is structured as a private, for-profit limited partnership which is managed by a professional team of partners, each of whom has invested their own money in the fund. The legal life of the fund is ten years, with the first five years designated as the investment period and the

remaining five years designated as the harvest and wind-up period. This structure is consistent with most venture capital firms throughout the nation.

Adena is capitalized with $12.50 million of private investment from institutional investors, including financial institutions, universities, utility companies, foundations and state government agencies. Adena's private investors expect both a competitive financial return on their investment and that the fund will have a positive impact in terms of community and economic development. This private funding is leveraged with $18.75 million of funding from the SBA, which is provided in the form of discounted debentures. The Fund must repay the debentures plus interest in their entirety. The net amount ultimately available for investment purposes and fund operations is currently estimated at $26.5 million.

Adena has also capitalized an operational assistance program with a total of $7.5 million. One-half of this amount is provided in the form of grant funding from the SBA. This grant funding is matched in equal proportions with cash that Adena raised from universities and not-for-profit organizations, and in-kind time commitments provided by several prominent private sector firms, universities and not-for-profit organizations.

Marketplace

The target market in which Adena operates is a central Appalachian region that includes: southeastern Ohio, West Virginia, northeastern Kentucky and western Maryland. With a population of more than 4 million residents and roughly 22,000 small businesses with ten to one-hundred employees, this region is comparable in size to the Washington D.C. and Atlanta metropolitan areas, yet little or no venture capital activity has historically occurred in this market. This is precisely why Adena selected and defined this particular region - - to create a market opportunity out of a significant market gap. Adena's target region of central Appalachia is 75% rural and 25% urban. The region includes 43 two and four year colleges and universities, which educate nearly 200,000 students each year. Low-income households represent approximately half of all households in the region.

Adena sees this region as an underserved, but attractive market that has been historically depressed and subjected to the booms and exodus of major natural resource industries, including coal and timber. This is also a region that, to some extent, has become dependent upon the recruitment of branch plants from large manufacturers that reside outside of the region and, in some cases, outside of the United States. Too often, this strategy has left the region with closures of plants and increases in unemployed workers who are not ready to participate in the knowledge-based economy. In and of themselves, there is nothing inherently wrong with the aforementioned approaches to job creation and economic development. Yet, absent more diverse business activity, these strategies can leave communities with the challenges and deficits seen in Appalachia.

Adena believes that by funding and providing assistance to entrepreneurs and early-stage small businesses – and by linking this activity with universities, state and local governments and the private sector - that a culture of independence and entrepreneurship can be established over time, and that this culture will perpetuate itself in a knowledge-based economy.

Investment Activity

During the first ten months of operations, Adena made equity investments totaling $1.6 million in three early-stage companies as detailed below. Adena's investments in these companies range in size from $250,000 to $750,000. Adena co-invested with other venture funds in each of these companies. The co-investors included a private equity fund, two Small Business Investment Companies (SBICs) and one quasi-state government fund.

Butterfly.net, Inc. is a Martinsburg, West Virginia based software development company, which provides a unique grid infrastructure for massively-multiplayer online games. Butterfly's industry-recognized technology provides game developers and publishers with new solutions allowing the simultaneous delivery of games to millions of players worldwide. Butterfly employed ten people when Adena closed on its investment in the company. The company has grown to fourteen professional employees and is poised to add more in the coming months. Butterfly was

recently featured in the Wall Street Journal, New York Times and Washington Post when the company's partnerships with IBM and Sony were announced. Last summer, Adena's investment in Butterfly was named "Deal of the Week" by the Washington Post.

Vested Health, LLC is a Charleston, West Virginia based provider of consumer directed health plans (CDHP) for employer groups with 10-2,000 employees. Vested Health is the region's first of a new generation of health plan companies committed to giving consumers more involvement in their health care decisions while controlling employer premiums. This company provides a private sector solution to some of the critical healthcare issues facing our nation today. Vested Health employed five professionals at the time of Adena's funding, and has already added a sales professional to its staff.

SecureMethods, Inc. is a security software company that specializes in the design, implementation, and deployment of advanced secure network applications for commercial, healthcare and government clients. The firm relocated to Martinsburg, West Virginia from the Washington D.C./Northern Virginia area as part of the Adena-led investment. SecureMethods currently employs nine people and has plans to employ as many as thirty professionals in the coming year.

Adena served as a catalyst and leader in each of the investment rounds for these companies. Without Adena and the NMVC program, the investment rounds that funded these companies would not have come together.

Adena's portfolio companies each have strong founders and management teams, unique technological assets or products, and they are well-positioned for success in large and growing markets. These companies are all located in qualified low-income areas and, depending on their future success, will have ample opportunities and needs to grow their employment bases in the coming months and years. All three companies are excellent examples of the types of innovation and entrepreneurship that can occur in a "New Market" like central Appalachia.

Operational Assistance Activity

During the first ten months of operations, Adena provided $600,000 worth of operational assistance to 16 companies in central Appalachia. It is important to note that nearly 90% of these companies operate in low-income areas and that these companies employ more than 200 people, 80% of whom live in low-income areas. These services were provided at no-cost to Adena's client companies and included the following types of assistance: legal services, marketing, accounting and information systems, software engineering design and development, executive recruiting and business planning.

Adena provides operational assistance to current and prospective portfolio concerns through an impressive roster of strategic partners, including: Ohio University's Voinovich Center for Leadership and Public Affairs, the Entrepreneurship Center at the University of Charleston, the Mountain Maryland Entrepreneurial Development Center and a host of well-regarded private sector organizations, including three law firms, an executive recruiting firm, a technology development and testing firm, a marketing firm and an accounting firm. From this broad and growing menu of partners, Adena is able to tailor operational assistance services to each company's specific needs.

Under Adena's management, the operational assistance program is a market-based, company-driven program that is used solely for the benefit of entrepreneurs and small businesses that have compelling business and growth propositions in central Appalachia.

Recommendations for Improvement of the NMVC Program

While the above information tells the story of a NMVC fund and a NMVC program that are, in fact, working successfully to make an impact in an underserved region, Adena feels strongly that two major and fundamental improvements need to be made.

1) Restore Second Round Funding for the NMVC Program.

At inception, the NMVC program contemplated the establishment of 12 to 15 NMVC funds in both urban and rural areas. Adena believes the continuation of this original vision and funding is extremely important for following reasons:

Restoration of second round funding will ensure that more regions in the United States benefit and learn from this new resource, which represents a new approach to the marketplace, including the active participation of state governments and universities. It is worth noting that Adena and the NMVC program provided the West Virginia Economic Development Authority (WVEDA) with a new vehicle through which to bring venture capital to their state, and by which to leverage state dollars with federal and private sector dollars. This was a new experience for WVEDA that has since led to significantly more investment in venture capital funds. Additionally, Adena's relationship with Ohio University's Voinovich Center for Leadership and Public Affairs serves as a model for other universities interested in engaging students, staff and faculty in the economic future of their surrounding environments.

More learning will occur among NMVC funds and the SBA with a larger peer group of funds operating in different and distinct markets. This learning will not be limited to the NMVC funds, but will run to the benefit of all venture funds, entrepreneurs, universities, government agencies and private sector firms working in and around "New Markets" geographies.

While Adena is off to a strong start, we believe the power of this program lies in its applicability and replicability to other underserved and economically depressed regions of the country. The NMVC program and NMVC funds provide communities and regions with an important catalyst that serves as a focal point for collaboration among public and private stakeholders.

In this time of current economic downturn, we believe that private equity, entrepreneurship and innovative public/private partnerships are things the nation should be investing in -- not cutting back on.

2) Make the U. S. Department of Treasury's New Markets Tax Credit (NMTC) program compatible with the SBA's New Markets Venture Capital (NMVC) program.

At inception, the New Markets program was intended to provide a tax credit component to complement the venture capital resources which were designed for underserved, or "New Markets", areas. The New Markets program was implemented through the SBA and the U.S. Department of

Treasury, with responsibility for underwriting, licensing, monitoring and providing financial leverage to NMVCs running to the SBA. The U.S. Department of Treasury was given responsibility for designing and implementing the New Markets Tax Credit (NMTC) program.

Unfortunately, the two programs are presently incompatible. Treasury's regulations and restrictions on the NMTC program prohibit venture capital companies from participating because the program does not adequately address key fundamentals in the growth and risk capital marketplace.

There are a number of issues involved with the NMTC program that prevent NMVCs from participating, chief among these is the seven-year recapture provision whereby, if a venture firm exits an investment prior to seven years, a portion of the allocated tax credit would need to be returned. This would be a nightmare for venture funds and their institutional investors. Venture capital is all about exiting profitably, typically in period of time much less than seven years. While this provision may be suitable for not-for-profit organizations and real estate development firms, it runs counter to the interests of NMVCs, their investors and the marketplace. The NMTC program does include a "reinvestment" provision through which recapture can be avoided. However, this also does not work for the venture capital industry because institutional investors typically do not allow for reinvestment of proceeds – investors require investment proceeds to be distributed back to them for a measurable return.

Additionally, for small and private venture firms like Adena, which are responsible for managing to SBA requirements, state government requirements, external audit requirements, tax requirements and investor requirements, the NMTC program represents an overwhelming burden to which they would need manage and report. For the NMTC program to work in conjunction with NMVC funds, we strongly believe that one consistent set of rules and definitions should be followed, and we believe the overriding regulations should be those set forth and managed by the SBA (13 CFR 108).

For the NMVC program to continue attracting investors and to achieve success in underserved regions of our country, we respectfully ask your committee to review Treasury's NMTC program and find a way to make it compatible with the NMVC program.

Thank you very much for your time and consideration. We look forward to the results of your committee's hearing, to helping expand and improve the NMVC and NMTC programs in any way we can, and to continuing our mission of investing in the future of our nation.

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