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CONGRESSIONAL OVERSIGHT PANEL

MAY OVERSIGHT REPORT *

THE SMALL BUSINESS CREDIT CRUNCH AND THE IMPACT OF THE TARP

MAY 13, 2010.—Ordered to be printed

* Submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343

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EXECUTIVE SUMMARY*

Small businesses have long been an engine of economic growth and job creation in America. More than 99 percent of American businesses employ 500 or fewer employees, and together these companies employ half of the private workforce and create two out of every three new jobs. If the Troubled Asset Relief Program (TARP) is to meet its Congressional mandate to promote growth and create jobs, then it clearly must address the needs of small businesses.

The Secretary of the Treasury recently designated small business credit as one of the primary focuses of the TARP, and he pledged TARP funds "for additional efforts to facilitate small business lending." Because the Congressional Oversight Panel is mandated to review the Secretary's use of his TARP authority, oversight in this area is an important statutory role of the Panel.

Credit is critical to the ability of most small businesses to purchase new equipment or new properties, expand their workforce, and fund their day-to-day operations. If credit is unavailable, small businesses may be unable to meet current business demands or to take advantage of opportunities for growth, potentially choking off any incipient economic recovery.

Unfortunately, small business credit remains severely constricted. Data from the Federal Reserve shows that lending plummeted during the 2008 financial crisis and remained sharply restricted throughout 2009. Although Wall Street banks had been increasing their share of small business lending over the last decade, between 2008 and 2009 their small business loan portfolios fell by 9.0 percent, more than double the 4.1 percent decline in their entire lending portfolios. Some borrowers looked to community banks

*The Panel adopted this report with a 5–0 vote on May 12, 2010.

to pick up the slack, but smaller banks remain strained by their exposure to commercial real estate and other liabilities. Unable to find credit, many small businesses have had to shut their doors, and some of the survivors are still struggling to find adequate financing.

Treasury has launched several TARP initiatives aimed at restoring health to the financial system, but it is not clear that these programs have had a noticeable effect on small business credit availability. The largest TARP program, the Capital Purchase Program (CPP), provided hundreds of billions of dollars in new capital to banks, but Treasury did not require recipients to use the money to improve credit access. In fact, after receiving the money, most recipients decreased their lending. The Term Asset-Backed Securities Loan Facility helped to restore liquidity to the securitized lending market, but because relatively few small business loans are securitized, the program had little impact on small business lending. Although the Public-Private Investment Partnership program remains in its early stages, it has not targeted and will likely not target the smaller financial institutions that often serve small businesses.

Looking forward, Treasury has announced several new initiatives to improve credit access for small businesses. Two programs, the Community Development Capital Initiative (CDCI) and the Small Business Administration Securities Purchase Program, are proceeding under Treasury's existing TARP authority, but their effects are likely to be limited. The CDCI will serve only a limited number of very small institutions, while the Securities Purchase Program would affect only loans guaranteed by the Small Business Administration, which make up a small percentage of the small business lending market.

The administration has also proposed a much larger and broader lending program, the Small Business Lending Fund (SBLF), which would provide $30 billion in low-cost capital to small and mid-sized banks, along with incentives to increase lending. The SBLF's prospects are far from certain. The program would require legislative approval, and even if it is established by Congress immediately, it may not be fully operational for some time. It could arrive too late to contribute meaningfully to economic recovery. Moreover, banks may shun the program for fear of being stigmatized by its association with the TARP, or they may wish to avoid taking on SBLF liabilities at a time when their existing assets, such as commercial real estate, remain in jeopardy. The SBLF also raises questions about whether, in light of the CPP's poor performance in improving credit access, any capital infusion program can successfully jump-start small business lending. Supply-side solutions that rely on bank balance sheets, such as the CPP and the SBLF, may not increase lending.

Even if Treasury succeeds in increasing the supply of credit, its efforts may still come to naught if the demand for credit fails to keep pace. In the fourth quarter of 2008, net 57.7 percent of the respondents to the Federal Reserve Board's Survey of Senior Loan Officers reported that demand had fallen for small business loans—a figure that rose to 63.5 percent the following quarter. Even now, net 9.3 percent of the survey respondents continue to report falling

demand, suggesting that some of the reduction in small business lending may be the result of a lack of demand.

A small business loan is, at its heart, a contract between two parties: a bank that is willing and able to lend, and a business that is creditworthy and in need of a loan. Due to the recession, relatively few small businesses now fit that description. To the extent that contraction in small business lending reflects a shortfall of demand rather than of supply, any supply-side solution will fail to gain traction. Treasury should be mindful of this concern and should consider creative solutions that engage banks, state-based lending consortia, and other market participants. The debate over whether small business lending is constrained by supply or demand is a reminder of the absence of high-quality data about current lending practices. Such poor data have made it far more difficult to pinpoint the causes of today's problems and, as a result, to find effective solutions. Treasury should take active steps to gather more detailed and dependable data about small business lending, and put data-reporting requirements in place so that in the future policymakers will not be forced to make decisions with too little information about what is actually happening.

Because small businesses play such a critical role in the American economy, there is little doubt that they must be a part of any sustainable recovery. It remains unclear, however, whether Treasury's programs can or will play a major role in putting small businesses on the path to growth.

SECTION ONE

A. Introduction

Credit is often described as the "lifeblood" of an economy. The financial shocks of September and October 2008 and the ensuing credit freeze not only pushed down asset prices and increased the cost of credit, they also impaired consumer and business confidence. In the absence of confidence and credit, economic growth suffered and continues to suffer. Notwithstanding Treasury's efforts through the Troubled Asset Relief Program (TARP) to spur lending in general and smaller business lending in particular, lending continues to contract. This report addresses the continued contraction in lending in the context of Treasury's announced plans to re-focus the TARP on encouraging small business lending.

Whether Treasury's solutions for small business lending are likely to be effective depends on its assessment of and approach to the problem: why, in the face of the TARP and other efforts to increase small business lending, is such lending still contracting? One explanation is that the continued recessionary environment, with soft demand for goods and services, is inhospitable to business expansion and lending generally. Other explanations proffered for the contraction include: low credit supply and low credit demand caused by capital weakness, other alternative uses of funds, more stringent regulatory requirements, and the potential for further regulation, among other reasons. Differences of opinion about the problem matter; after all, whether a solution is likely to work depends on whether it accurately targets the problem. Existing government programs or initiatives largely attempt to increase credit supply, and use, variously, guarantees, capital infusions, secondary market solutions such as securitizations, and, in very limited cases, direct lending. Treasury's proposed approach also focuses on credit supply and involves a capital infusion program to shore up the supply of capital for banks that lend to small businesses, reducing the cost of capital as the bank lends more. By focusing on incentives—primarily a "carrot" approach—and separating one of the new small business programs from the TARP, Treasury hopes to alleviate some of the concerns that smaller banks have had with taking money from TARP programs. Treasury hopes that these banks will then lend to the smaller businesses that, without access to the debt capital markets, must depend on banks for credit.

This report examines the ongoing lending contraction and discusses the government programs or initiatives that have affected bank lending and liquidity, both before and after the crisis. It presents the arguments for the source of the contraction—supply, demand, economic conditions, and regulation, among others—in the context of past, current, and future government efforts to increase lending. The report then evaluates Treasury's plans for the TARP as a spur to small business lending in light of Treasury's assertion that the TARP, as currently constituted, is not restoring adequate lending levels. Treasury argues that participation in the TARP has been unattractive for the smaller banks that do a majority of their lending to smaller businesses and that this is a reason for the shortfalls in small business lending. As a consequence, Treasury has designed a capital infusion program for smaller banks—those

of $10 billion or less in assets—in hopes that this will spur lending where prior capital infusion programs, which provided the majority of their funds to larger institutions, did not. Treasury's reliance on capital infusions for these institutions may, however, be misplaced: not only are smaller banks still under substantial stress and unable to shoulder the burden of leading the economy into recovery, but there are also poor data underlying the proposition that capital infusions increase lending.

The subject of small business lending falls under the Panel's mandate to examine the Secretary of the Treasury's use of authority under EESA and the impact of the TARP on the markets.[1]

B. Background

1. The Heterogeneity of Small Businesses and Associated Data Problems

The credit crunch of 2008 affected different economic sectors in different ways, and the Panel has addressed the effect of the crisis on a variety of sectors.[2] In May 2009, the Panel addressed small business lending and evaluated the impact of the Federal Reserve Bank of New York's (FRBNY) and the Treasury's Term Asset-Backed Lending Facility (TALF). The report examined the design of the TALF, which was intended to restart securitization markets, and questioned whether any securitization program could help meet the credit needs of small businesses. The report also examined other sources of small business credit, including credit cards and informal credit sources, such as angel investors, family, and friends. The report noted Treasury's assertion that restoring access to credit has multiplier effects throughout the economy, and examined the difficulties that small businesses were having, in May 2009, in obtaining credit of any kind.[3] A year has passed since that report, but despite a variety of government programs and initia-

[1] *See* EESA Section 125(1)(A)(i) and (ii).

[2] *See, e.g.,* Congressional Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability,* at 54, 75, 80 (Feb. 10, 2010) (online at cop.senate.gov/documents/cop-021110-report.pdf) (hereinafter "COP February Oversight Report") (explaining that the commercial mortgage-backed securities market was "virtually frozen from July 2008 to May 2009," making it difficult for borrowers to finance and refinance commercial real estate loans, and expressing concern about future commercial real estate defaults); Congressional Oversight Panel, *September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry,* at 3 (Sept. 9, 2009) (online at cop.senate.gov/documents/cop-090909-report.pdf) (noting that the financial crisis turned American automakers' "long-term slump into an acute crisis" by reducing demand and constricting the credit they needed to conduct day-to-day operations); Congressional Oversight Panel, *Special Report on Farm Loan Restructuring,* at 8 (July 21, 2009) (online at cop.senate.gov/documents/cop-072109-report.pdf) (finding that the farm sector's strong position at the outset of the crisis helped it weather a downturn in commodity prices and a modest tightening of farm credit, but cautioning that the situation was not yet stable); Congressional Oversight Panel, *March Oversight Report: The Foreclosure Crisis: Working Toward a Solution,* at 16–23 (Mar. 6, 2009) (online at cop.senate.gov/documents/cop-030609-report.pdf) (describing how the recession exacerbated the foreclosure crisis caused by the mortgage market's shift to riskier, less affordable mortgage products). *See also* Congressional Oversight Panel, *April Oversight Report: Assessing Treasury's Strategy: Six Months of TARP,* at 27–35 (Apr. 7, 2009) (online at cop.senate.gov/documents/cop-040709-report.pdf) (summarizing metrics).

[3] *See generally* Congressional Oversight Panel, *May Oversight Report: Reviving Lending to Small Businesses and Families and the Impact of the TALF* (May 7, 2009) (online at cop.senate.gov/documents/cop-050709-report.pdf) (hereinafter "COP May Oversight Report").

tives designed to add liquidity and spur lending, commercial lending has continued to contract.[4]

One problem in trying to analyze small business lending, or in identifying and designing programs for spurring small business lending, arises from the difficulty in determining what, precisely, constitutes a small business. "Small business" has been variously defined by Congress and various agencies, including the Small Business Administration (SBA), the Federal Reserve Board of Governors (Federal Reserve), and others.[5] These definitions depend on sector, assets, number of employees, and revenue.[6] The myriad definitions not only complicate any discussion of small business but also make it difficult to compare data and results across studies and surveys in a field in which, as an added complication, data are notoriously hard to obtain.[7] As an example of the difficulties, the most comprehensive source for information about small business fi-

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[4]Although this report focuses on commercial and industrial (C&I) loans, institutions report declining loan and lease balances across many types of loans. *See generally* Federal Deposit Insurance Corporation, Quarterly Banking Profile (Feb. 1, 2010) (online at www2.fdic.gov/qbp/2009dec/qbpall.html). The FDIC defines C&I loans as "loans for commercial and industrial purposes to sole proprietorships, partnerships, corporations, and other business enterprises, whether secured (other than by real estate) or unsecured, single-payment or installment," in the form of either direct or purchased loans, for domestic offices only. *See* Federal Deposit Insurance Corporation, *Schedule RC–C—Loans and Lease Financing Receivables* (online at www.fdic.gov/regulations/resources/call/crinst/605rc-c1.pdf) (accessed May 11, 2010). This data is reported by commercial banks annually. There are three classifications of commercial & industrial (C&I) loans with original values below $1 million that this report generally uses as a proxy for small business lending: C&I loans with original values less than $100 thousand (Call Report line RCON 5565); C&I loans with original values between $100 thousand and $250 thousand (Call Report line RCON5567); C&I loans with original values between $250 thousand and $1 million (Call Report line RCON5569). The number of these loans can be found on Call Report lines RCON5564, RCON5566, and RCON5568 respectively. Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income for A Bank With Domestic and Foreign Offices—FFIEC 031,* at 26 (online at www.ffiec.gov/PDF/FFIEC__forms/FFIEC031__201003__f.pdf) (accessed May 11, 2010).

[5]In the Small Business Act of 1953, Congress defined small businesses as those that are: (1) independently owned and operated; (2) not dominant in their field of operation; and (3) under a certain size. Small Business Act of 1953, Pub. L. No. 85–536 (codified at 15 U.S.C 632(a)).

[6]Within the parameters of this definition, the SBA sets industry-specific size standards. The criteria are based on either revenue streams or number of employees, resulting in wide variation among industries. *See* U.S. Small Business Administration, *Summary of Size Standards by Industry* (online at www.sba.gov/contractingopportunities/officials/size/summaryofssi/index.html) (accessed May 6, 2010). For example, a retail company is a small business if it has less than $7 million in annual revenue, while a construction company is a small business if it has less than $33.5 million in annual revenue. Similarly, to qualify as a small business under the SBA standards, a manufacturing company must have fewer than 1,500 employees, but a wholesale company must have fewer than 100 employees. U.S. Small Business Administration, *Size Standards FAQ's* (online at www.sba.gov/contractingopportunities/officials/size/SIZE__STANDARDS__FAQS.html) (accessed May 6, 2010). In addition to the variation in the SBA size standards, various government agencies use means and methods of defining small businesses that differ from those used by the SBA. For example, the Internal Revenue Service has developed a definition that designates partnerships and corporations (including S corporations) with assets of $5 million or less—as well as all sole proprietorships—as small businesses. *See* Government Accountability Office, *Tax Administration: IRS Faces Several Challenges As It Attempts To Better Serve Small Businesses,* at 3 (Aug. 2000) (GAO/GGD–00–166) (online at www.gao.gov/archive/2000/gg00166.pdf). In one study, the Federal Reserve defines a small business as a non-farm entity with fewer than 500 employees. *See* Traci L. Mach and John D. Wolken, *Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances* (Oct. 2006) (online at www.federalreserve.gov/pubs/bulletin/2006/smallbusiness/smallbusiness.pdf) (hereinafter "Financial Services Used by Small Businesses"). The Small Business Act also states that "[u]nless specifically authorized by statute, no Federal department or agency may prescribe a size standard for categorizing a business concern as a small business concern, unless such proposed size standard" is approved by the SBA Administrator. Small Business Act of 1953, Pub. L. No. 85–536 (codified at 15 U.S.C.§ 632(a)(2)(C)). This report will not rely on a specific small business definition, but will instead specify the definitions used according to the discussion.

[7]Small businesses obtain credit from formal and informal sources and may keep informal accounts. Even in a more formal credit application, success can depend in part on relationships between the parties. Katherine Samolyk, *Small Business Credit Markets: Why do We Know So Little About Them?*, FDIC Banking Review, Vol. 10, No. 2, at 16 (1997) (online at www.fdic.gov/bank/analytical/banking/1998mar/small.pdf) (hereinafter "Small Business Credit Markets").

nances was the now-discontinued Federal Reserve's Survey of Small Business Finances (SSBF). The final SSBF was published in 2006 based on 1998–2003 data collected between June 2004 and January 2005.[8] Even without the time lag the SSBF has been viewed as incomplete,[9] and of course it does not take into account the credit crunch and the market turmoil of 2008–2009.[10]

The lack of data, however, does not reflect the importance of small business for the economy. Small businesses of less than 500 employees are, among other things, America's largest new job producers, with the majority of these new jobs created in the start-up phase of the cycle. These businesses comprise one half of the private sector, while large businesses comprise the other half, a dynamic that has been relatively stable for several decades.[11] Small businesses collectively employ approximately 50 percent of all private-sector workers.[12] Since the mid-1990s, small businesses have created 60 to 80 percent of jobs.[13] Moreover, small businesses produce about half of the nation's private, nonfarm real gross domestic product (GDP).[14] Further, many of the businesses commonly encompassed by definitions of "small business" can be quite large, for example, one definition captures all businesses with annual sales of up to $50 million.[15] The vast majority of the businesses that fall under the SBA definition are, however, very small businesses.[16] Their health and ability to enjoy economic recovery are critical to the overall economy. If a small business needs and can-

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[8] Financial Services Used by Small Businesses, *supra* note 6, at A167. This survey was discontinued because the broad variety in small businesses rendered it very expensive.

[9] Among other things, the SSBF provides information about a firm's most recent credit application, but does not include data about the prospective borrower's options at the time of the loan application. Further, the survey only captures a firm's situation—employment, balance sheet, income statement, and so forth—in conjunction with an application for credit if the firm applied for credit in the survey year. *See* Small Business Credit Markets, *supra* note 7, at 20.

[10] The primary data sources upon which this report relies are the SSBF, the National Federation of Independent Businesses (NFIB), the SBA Office of Advocacy, the National Small Business Association, the Federal Reserve's Senior Loan Officer Survey, which has a category for small businesses and the National Bureau of Economic Research with the recognition that these sources may not fully capture the circumstances of small business lending now. Where studies or surveys may not fully capture present circumstances, the report attempts to identify the issues.

[11] Brian Headd, Small Business Administration Office of Advocacy, *An Analysis of Small Business and Jobs,* at 3–4, 7–8 (Mar. 2010) (online at www.sba.gov/advo/research/rs359tot.pdf). Small businesses create and eliminate new jobs at faster rates than large businesses, but the greater share of net new jobs are created by small businesses. Many small businesses do not add substantial numbers of jobs after the initial start-up phase, and therefore the majority of the job creation occurs at the outset. With job creation, of course, comes job destruction, as 95 percent of start-ups are firms with fewer than 20 employees—and firms with fewer than 20 employees account for 95 percent of closures.

[12] *See Id.,* at 4; Financial Services Used by Small Businesses, *supra* note 6 (defining small businesses as those with less than 500 employees). *See also* U.S. Small Business Administration, *Small Business Profile* (online at www.sba.gov/advo/research/profiles/09us.pdf) (accessed May 6, 2010). For state-specific small business employment statistics, *see* U.S. Small Business Administration, *Small Business Profiles for the States and Territories* (online at www.sba.gov/advo/research/profiles) (accessed May 6, 2010).

[13] In 2008, there was a net loss of 3.1 million jobs, many of which may have been lost in small businesses: in the first three quarters of 2008, the United States lost approximately 1.7 million jobs, of which 60 percent were from small businesses. U.S. Small Business Administration, Office of Advocacy, *The Small Business Economy: A Report to the President,* at 9 (July 2009) (online at www.sba.gov/advo/research/sb__econ2009.pdf) (hereinafter "Small Business Economy Report").

[14] *Id.,* at 1.

[15] Board of Governors of the Federal Reserve System, *January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices* (Feb. 1, 2010) (online at www.federalreserve.gov/boarddocs/snloansurvey/201002/default.htm) (hereinafter "January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices").

[16] Financial Services Used by Small Businesses, *supra* note 6, at A167.

not obtain credit, it may be unable to finance its operations and be forced to close.[17]

2. Sources of Small Business Lending

At present, banks are the most important source for small business credit. Before the credit crunch, small businesses had access to a variety of sources of credit, many of which have since been reduced or eliminated.[18] One important distinction, however, between smaller and larger businesses is access to the public credit markets.[19] Although some businesses that fall under the SBA's definition of small have publicly traded debt, the vast majority of smaller businesses do not. This increases smaller businesses' reliance on the forms of credit to which they have access, in particular bank credit.

The landscape for small business financing in the last decade, not surprisingly, reflects the boom and bust that characterizes the markets overall.[20] During the early and middle part of the last decade, small businesses used a basic set of products—traditional bank credit (loans or credit lines), credit cards, business mortgages, and owner financing—but did so at rapidly increasing rates. From 2003, year-over-year growth in small business debt rose to about 12

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[17] Congressional Oversight Panel, Written Testimony of Paul Smiley, president, Sonoran Technology and Professional Services, *Phoenix Field Hearing on Small Business Lending,* at 2 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-smiley.pdf) (hereinafter "Testimony of Paul Smiley").

[18] Consistent with the variety in small businesses themselves, small businesses use a variety of financial services: liquid asset accounts, credit lines, loans and capital leases, and financial management services. Liquid asset accounts constitute checking and savings accounts; credit lines, loans and capital leases include lines of credit, mortgages used for business purposes, motor vehicle loans, equipment loans, capital leases, and other loans; and financial management services involve transaction services, credit card and debit card processing services and other similar services. *See* Financial Services Used by Small Businesses, *supra* note 6, at A173. Suppliers of financial services include depository institutions, which consist of banks, thrifts and credit unions, and non-depository institutions, which include finance companies and factors, leasing companies, and insurance and mortgage companies. Small businesses also use additional non-depository sources, including credit cards, family, individuals, business firms, government sources, and venture capital firms. The exact volume of small business financing that comes from each of these sources can be difficult to determine beyond the rough sketches that survey results provide. For example, a loan from an angel investor, friend, or family member will not appear on a bank's call report, nor will drawing down on personal savings in order to finance small business activity. COP May Oversight Report, *supra* note 3, at 12. Similarly, trade credit is a significant, if informal, source of small business financing. Trade credit can take many forms, depending on the business or industry, but is business-to-business and generally involves a delay between the date services or goods are provided and the payment date. The NFIB observes that there are counterbalances to the impulse to tighten trade credit during a recession because tightening trade credit terms can depress sales. The NFIB reports, consistent with this observation, that about 44 percent of small businesses surveyed said that there had been no change in the availability of trade credit, although 27 percent said that terms had tightened, of which 12 percent said that terms had tightened significantly. Similarly, 65 percent of small businesses reported making no change in their trade credit policies, and 29 percent reported they had tightened their trade credit policies, of which 13 percent reported that they had tightened their policies significantly. The effect of tightening trade credit can be to send small businesses to more formal sources of credit, such as credit cards. National Federation of Independent Businesses, *Small Business Credit in a Deep Recession,* at 17 (Feb. 2010) (online at www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf) (hereinafter "Small Business Credit in a Deep Recession").

[19] Although this is an important distinction in access to credit, data typically used in this field, such as the Federal Reserve's Survey of Senior Loan Officers, does not distinguish between businesses that can and cannot access public credit markets. *See generally* Board of Governors of the Federal Reserve System, *April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices* (May 3, 2010) (online at www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/fullreport.pdf) (hereinafter "April 2010 Senior Loan Officer Opinion Survey").

[20] Unless otherwise sourced, data in this paragraph is from the Board of Governors of the Federal Reserve System, *Report to the Congress on the Availability of Credit to Small Businesses,* at 10, 14, 16, 19, 31 (Oct. 2007) (online at www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf) (hereinafter "Federal Reserve Report to Congress").

percent in 2005; growth continued in 2006 and 2007, but at lower rates. Credit standards for small businesses eased during the same period. The net percentage of National Federation of Independent Businesses (NFIB) survey respondents reporting difficulties in obtaining credit, as well as the short-term loan rate, were historically low. Demand for commercial and industrial (C&I) loans peaked in 2004 and 2005, with nearly 40 percent of banks reporting increased demand for C&I loans by small firms. Business credit card use grew quickly, possibly because of aggressive marketing on the part of business credit card companies, and in 2003, 48 percent of small businesses used business cards, up from 34 percent in 1998.[21] Small businesses used credit cards, however, as a cash-management or convenience tool: in a study published at the beginning of 2008, before the crisis, NFIB found that 76 percent of small business owners typically paid off their credit card balances every month.[22] Finally, by the end of 2005–2006, home equity extraction had exceeded $60 billion, and many start-ups were funded through home equity loans.[23]

Since the crisis, small businesses have generally used the same types of credit as they did during the boom, but they experience less availability. One recent survey found that as of July 2009, 46 percent of small business owners relied on bank loans to finance their business operations and that bank loans were the most common source of financing, followed by earnings from the business, and credit cards.[24] Although more than half of small businesses continue to use personal and business credit cards, a relatively steady 70 to 80 percent of those small businesses still do not carry a balance on the card, and, despite the more limited availability of other credit, use the cards for transactional convenience.[25] In addi-

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[21] *See* Financial Services Used by Small Businesses, *supra* note 6, at A181.

[22] National Federation of Independent Businesses, *National Small Business Poll: Credit Cards,* Vol. 8, No. 3, at 6 (June 2008) (online at www.411sbfacts.com/files/SBP_V8I3_CreditCards_4%20(3).pdf) (hereinafter "National Small Business Poll"). Of course, the contrary point is also true: before the crisis nearly one in four small businesses with a credit card was rolling over that debt in order to create longer term financing.

[23] U.S. Small Business Administration and U.S. Department of the Treasury, *Report to the President: Small Business Financing Forum,* at 45 (Nov. 18, 2009) (online at www.financialstability.gov/docs/Small%20Business%20Financing%20Forum%20Report%20FINAL.PDF) (hereinafter "Small Business Financing Forum Report") (citing the "Federal Reserve Board, Case/Shiller").

[24] National Small Business Association, *2009 Year-End Economic Report,* at 8 (Jan. 20, 2010) (online at www.nsba.biz/docs/10eoy_survey.pdf) (hereinafter "2009 Year-End Economic Report").

[25] These numbers appear to be relatively constant over time. *See* Board of Governors of the Federal Reserve System, *2003 Survey of Small Business Finance,* at A181 (2003) (online at www.federalreserve.gov/pubs/oss/oss3/ssbf03/ssbf03home.html) (describing the 1998–2003 period). *See also* Federal Reserve Report to Congress, *supra* note 20 (discussing SSBF data); National Small Business Poll, *supra* note 22, at 6 (data from late 2007-early 2008); Small Business Credit in a Deep Recession, *supra* note 18, at 7 (citing data from 2008–2009 and stating that between 70 and 79 percent of small businesses pay the balance on their credit cards in full each month). The data for small business lending, however, captures the balances on the cards before they are paid off as part of the metrics on revolving debt. NFIB conversations with Panel staff (Mar. 18, 2010). Credit card debt is unattractive credit: it is high-cost and often variable at the option of the card issuer. Credit card availability is now also more restricted compared to before the crisis. In the most recent Federal Reserve Senior Loan Officer Survey, in a special question, respondents also indicated that they had tightened terms for business credit cards compared to before the crisis ("A majority of respondents indicated that their standards for approving . . . business credit card accounts are currently tighter than the longer-run average level that prevailed before the crisis. In addition, significant net fractions of respondents to these special questions indicated that their banks had tightened their terms on business credit card loans to small firms—for both new and existing accounts—over the past six months"). April 2010 Senior Loan Officer Opinion Survey, *supra* note 19. *See* Section E.3, *infra,* for further discussion of business credit cards.

tion, the use of home equity lines of credit has been severely curtailed: the fall in housing prices has drastically reduced the amount of equity extracted from homes, and it is no longer a significant source of financing for small businesses.[26]

Banks, small and large, are therefore currently the most important source for small business credit: according to the Federal Reserve, small businesses receive over 90 percent of their funding from banks.[27] Small businesses borrow from both large and small banks, and while large and small banks each represent approximately 50 percent of the dollar value of loans to small businesses, this equivalence obscures the involvement each sort of bank has with small business lending.[28] For example, relative to their assets, community banks have an outsized share of small business lending. According to the Federal Deposit Insurance Corporation (FDIC), community banks account for 38 percent of small business and farm loans, despite representing only 11 percent of bank industry assets.[29] Medium and larger banks, however, still have over 50 percent of the market, even if it is a smaller share relative to their assets. Large banks' share of the market grew substantially over the course of the last decade, and although their market share may now be shrinking, they still have substantial influence.[30]

Small businesses borrow from depository institutions through a variety of mechanisms. The first is a conventional loan, through which a bank provides capital to a small business in exchange for regular interest payments and collateral. A small business can also seek a loan from a bank with the assistance of the SBA. The SBA has two major small business loan programs. First, under its 7(a) program, the SBA is authorized to guarantee loans for working capital. For fiscal year 2010, Congress authorized up to $17.5 billion for the 7(a) loan program. Second, under its 504 program, the SBA is authorized to guarantee loans for the development of small assets such as land, buildings, and equipment that will benefit local communities.[31] For fiscal year 2010, Congress authorized up to $7.5 billion for the 504 loan program.

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[26] Small Business Financing Forum Report, *supra* note 23, at 45. ("Home equity extraction is no longer available for owner's investment.") The 2003 SSBF found that 15 percent of the total value of small business loans in that year was collateralized by personal real estate. In more recent data, of the small business owners surveyed by the NFIB, approximately 16 percent of small business owners have a mortgage that helps to finance the business or used the residence as collateral for purchasing business assets. Small Business Credit in a Deep Recession, *supra* note 18, at 18. However, the NFIB survey does not provide the time frame in which the small business owner took out the mortgage, and so the NFIB's numbers may reflect mortgages taken out when such credit was more widely available.

[27] Small Business Financing Forum Report, *supra* note 23, at 43.

[28] *See* Section E.3, *infra.* The smallest banks, with assets of under 100 million, by some measures do as much as two thirds of their lending to small businesses. Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress,* at 110 (Apr. 20, 2010) (online at www.sigtarp.gov/reports/congress/2010/April2010_Quarterly_Report_to_Congress.pdf) (hereinafter "April 2010 SIGTARP Quarterly Report"). Unlike this report, however, SIGTARP includes in its metrics certain farm loans. The proportion of loans to small businesses, even for small banks, is much smaller if only C&I loans are included.

[29] Congressional Oversight Panel, Written Testimony of Stan Ivie, San Francisco regional director, Federal Deposit Insurance Corporation, *Phoenix Field Hearing on Small Business Lending,* at 8 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-ivie.pdf) (hereinafter "Phoenix Field Hearing on Small Business Lending").

[30] *See* Section E.3, *infra,* for a more complete discussion.

[31] 504 projects are generally made up of a senior lien of up to 50 percent from a private lender combined with a junior lien of up to 40 percent from a certified development company with at least 10 percent equity from the small business. The junior lien is backed by a 100 percent SBA-

While SBA programs have helped promote lending to small businesses, SBA-guaranteed loans constitute only a small percentage of total small business lending.[32] In a recent survey of small business owners, only four percent reported using SBA-guaranteed loans in 2008.[33] Moreover, the Government Accountability Office (GAO) has calculated that, in recent years, only about four percent of the total value of outstanding small business loans is guaranteed through the 7(a) program.[34] As a result, any government strategy that seeks to promote small business access to credit from depository institutions must address conventional loans in addition to SBA-guaranteed loans. This report deals primarily with credit provided by depository institutions, in particular addressing C&I loans—which are in essence loans for commercial and industrial purposes that may be secured or unsecured, but are not secured by real estate.[35]

C. The Credit Crunch

By the time the U.S. economy was officially in recession in December 2007,[36] credit markets had been tightening for some time. Rating agencies' downgrades of mortgage-related securities that they had earlier called "low-risk," and the ripple effects of the downgrades, had weakened investor confidence. Investors feared

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guaranteed debenture. *See* Section D.2(b)(iii), *infra*, for a discussion of these programs during the crisis.

[32] 2009 Year-End Economic Report, *supra* note 24, at 8. The SBA approved $23 billion of loans in FY 2007, $20 billion in FY 2008, $15 billion in 2009, and $10.5 billion as of March 31, 2010. U.S. Small Business Administration, *Table 2—Gross Approval Amount by Program* (online at www.sba.gov/idc/groups/public/documents/sba_homepage/serv_bud_lperf_grossapproval.pdf) (accessed May 7, 2010). For FY 2007–2008, the last year for which such numbers are available, the SBA estimated that the total amount of small business loans outstanding was $711.3 billion. *See* U.S. Small Business Administration, *Small Business and Micro Business Lending in the United States, for Data Years 2007–2008,* at 4 (May 2009) (online at www.sba.gov/advo/research/sbl_08study.pdf).

[33] 2009 Year-End Economic Report, *supra* note 24, at 8.

[34] *See* Government Accountability Office, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance,* at 7 (July 2007) (GAO–07–769) (online at www.gao.gov/new.items/d07769.pdf). In an appendix to that report, GAO explains how this calculation was made: "To compare the number and amount of outstanding small business loans to 7(a) loans, we used the [FDIC call reports] for U.S. banks. . . . We considered the call report data on loans under $1 million to be a proxy for general small business loans, even though there is no attempt to directly link the loans to the size of the firm accessing credit in the call report data."

[35] Small businesses, typically larger firms, may also obtain a line of credit from a bank: these lines of credit are more likely to be used for flexible expenses, such as working capital. According to the NFIB, the vast majority of survey respondents reported that their credit lines were renewed, while roughly the same number of small businesses had credit lines as in the prior year. In 2009, relatively few small businesses reported that changes in their credit lines adversely impacted their business. Small Business Credit in a Deep Recession, *supra* note 18, at 6. A small business may also use a line of credit differently from a loan: for example, a predominantly contracting firm may use a line of credit for hiring, while others may use it for working capital. *See* Testimony of Paul Smiley, *supra* note 17, at 3. For all businesses, drawdowns on existing lines of credit count as additional loans on the balance sheets of U.S. banks, and therefore would be encompassed by the report's discussion of C&I loans. *See* Victoria Ivashina and David Scharfstein, *Bank Lending During the Financial Crisis of 2008,* at 13 (Mar. 8, 2010). However, such draw-downs do not technically increase the amount of credit available in the economy. *See* Lei Li, *TARP Funds Distribution and Bank Loan Growth,* at 4–5 (Mar. 1, 2010) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=1515349). Accordingly, the high rate of draw downs following the crisis (apparently done to increase cash reserves, *see* Victoria Ivashina and David Scharfstein, *Liquidity Management in the Financial Crisis,* at 2 (Nov. 2009)) may have had the effect of overstating the amount of credit available.

[36] National Bureau of Economic Research, *Determination of the December 2007 Peak in Economic Activity*, at 1 (Dec. 11, 2008) (online at www.nber.org/cycles/dec2008.pdf).

(correctly) that losses would spread.[37] Credit then tightened sharply with the bankruptcy of Lehman Brothers and the near-collapse of AIG in September 2008,[38] events that shortly led, according to Treasury's chief economist, to "a seizing up of financial markets and plummeting consumer and business confidence."[39] Credit markets froze and credit spreads rose to unprecedented levels, including the TED spread, which rapidly increased.[40] The stock market plummeted, and real GDP fell at a rapid pace.[41] By the fall of 2008, the U.S. economy was considered to be in a credit crunch.[42]

The credit crunch was accompanied by severe declines in numerous economic markers and widespread anxiety and uncertainty. The value of the stock market plunged 24 percent in the fall of 2008 and another 15 percent by the end of January 2009.[43] Real GDP declined at an annual rate of 2.7 percent in the third quarter of 2008, 5.4 percent in the fourth quarter of 2008, and 6.4 percent in the first quarter of 2009.[44] As Figure 1 illustrates, the TED spread, which reflects the perception of risk in the credit markets, was at its highest point in October 2008, when it reached 457 basis points.[45]

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[37] Congressional Oversight Panel, *December Oversight Report: Taking Stock : What Has the Troubled Asset Relief Program Achieved?*, at 9 (Dec. 9, 2009) (online at cop.senate.gov/documents/cop-120909-report.pdf) (hereinafter "COP December Oversight Report").

[38] Council of Economic Advisors, *Economic Report of the President*, at 27 (Feb. 2010) (online at www.gpoaccess.gov/eop/2010/2010_erp.pdf) (hereinafter "Economic Report of the President"); Alan B. Kruger, chief economist and assistant secretary for economic policy, U.S. Department of the Treasury, Keynote Address at the American Academy of Actuaries, *The Links Between the Financial Crisis and Jobs*, at 2 (July 20, 2009) (online at www.treas.gov/offices/economic-policy/AK-Actuaries-07-20-2009.pdf) (hereinafter "Links Between the Financial Crisis and Jobs").

[39] *Id.*, at 2.

[40] Economic Report of the President, *supra* note 38, at 27. The TED spread is defined as the difference between the interest rates of the 3-month London interbank offered rate (LIBOR) (the rate at which banks lend to each other in London's interbank money market) and the 3-month Treasury bill. Since short-term Treasury securities are largely seen as a risk-free investment, the difference between LIBOR and 3-month Treasury Bills should reflect the confidence of banks in one another, and by extension the perceived risk in the lending markets. *See* Federal Reserve Bank of Minneapolis, *Measuring Perceived Risk—The TED Spread* (Dec. 2008) (online at www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4120) (hereinafter "Measuring Perceived Risk—The TED Spread").

[41] Links Between the Financial Crisis and Jobs, *supra* note 38, at 2.

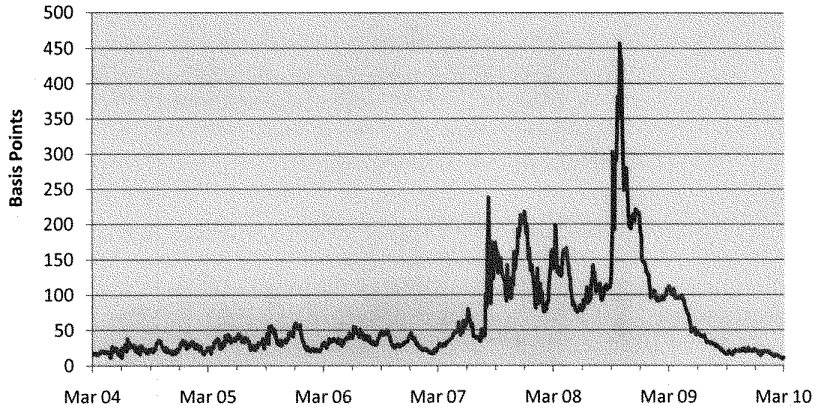
[42] "A credit crunch occurs when the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects. Credit crunches often involve a reduction in the funds that depository institutions, such as commercial banks and savings and loans, channel from savers to investors. Credit crunches affect economic activity because most small- and medium-sized businesses depend on banks when financing investment projects or current operations. Thus, unusual circumstances that force depositories to reduce business loans can restrict the activity of these firms regardless of market interest rates." *See* Council of Economic Advisors, *Economic Report of the President,* at 46 (Feb. 1992) (online at fraser.stlouisfed.org/publications/erp/issue/1584/download/5985/ERP_1992.pdf).

[43] Economic Report of the President, *supra* note 38, at 27.

[44] Economic Report of the President, *supra* note 38, at 27.

[45] As the economy began to stabilize, the TED spread narrowed. In January 2009, this spread declined to 94 basis points and further declined to reach a low of 19 basis points at December 31, 2009. By May 5, 2010, the spread had further declined to 21 basis points. For 2009, the TED spread averaged 53.8 basis points. For the period January 1, 2010 to May 5, 2010, the TED spread averaged approximately 15 basis points. *See* SNL Financial.

FIGURE 1: TED SPREAD [46]



1. Small Business Lending During the Credit Crunch: What Happened Then, and What Has Happened Since?

As discussed above in Section A, it is difficult to gather data about small business credit or to generalize across small business market participants. One source of information on trends, however, is the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices (Survey of Senior Loan Officers), which is based on quarterly data reported by the Survey of Senior Loan Officers respondents, and addresses changes in the supply of and demand for loans to businesses and households.[47]

The Survey of Senior Loan Officers data indicate whether conditions are tightening or easing, as of the last Survey of Senior Loan

[46] SNL Financial.

[47] All data in this section are derived from the chart data in the Survey of Senior Loan Officers from the quarter specified in the discussion. The percentages cited in this report from the Survey of Senior Loan Officers are all "net percentages." The Federal Reserve explains:

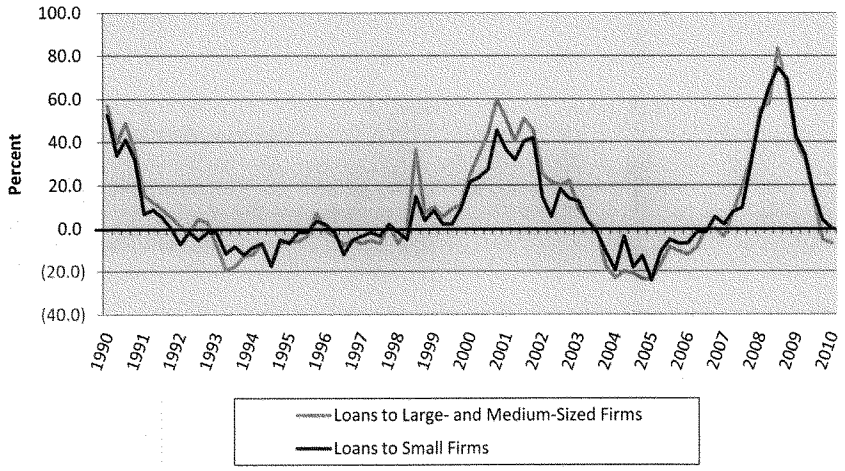
> For questions that ask about lending standards, reported net percentages equal the percentage of banks that reported tightening standards ('tightened considerably' or 'tightened somewhat') minus the percentage of banks that reported easing standards ('eased considerably' or 'eased somewhat'). For questions that ask about demand, reported net fractions equal the percentage of banks that reported stronger demand ('substantially stronger' or 'moderately stronger') minus the percentage of banks that reported weaker demand ('substantially weaker' or 'moderately weaker').

See January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 15. Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Bank Lending Practices, Chart Data* (May 3, 2010) (online at www.federalreserve.gov/boarddocs/snloansurvey/201005/chartdata.htm). The Survey of Senior Loan Officers does not provide metrics as to specific increases in markets such as interest rates or demand. Instead, it measures the percentage of Survey of Senior Loan Officers respondents that report increases, decreases, or no change from the last survey in the metric discussed. For example, the Survey of Senior Loan Officers respondents will describe whether loan demand has increased or decreased, but not by how much. (Based on responses from the current Survey of Senior Loan Officers, the United States is still in an environment in which credit is tightening, albeit more slowly than in late 2008 and early 2009). The information in the Survey of Senior Loan Officers is gathered from responses from 55 domestic banks in the fourth quarter of 2009 (56 respondents in the first quarter of 2010) and 23 U.S. branches and agencies of foreign banks. The discussion in this section is based *only* upon the domestic banks, particularly because the foreign bank information did not include lending to small businesses. The Survey of Senior Loan Officers distinguishes between large and middle market firms and small business firms. Large and middle market firms are based on annual sales of $50 million or more. Small business firms are based on annual sales of less than $50 million. For this discussion, references to large businesses also include middle market firms.

Officers, credit conditions were still tightening, albeit more slowly than they had been at the end of 2008 and the beginning of 2009. Data from various quarters of the Survey of Senior Loan Officers show a precipitous drop in lending to small businesses in the last quarter of 2008, and conditions that remained tight throughout 2009. Figure 2 shows that credit for commercial loans for large and small businesses was tightest in the fourth quarter of 2008, and tightened more slowly from its low point over the course of 2009. For loans to small businesses, in the first quarter of 2008, 51.8 percent of the Survey of Senior Loan Officers respondents reported that they had tightened credit standards, but by the fourth quarter of that year, that percentage had risen to 69.2 percent. Credit remained tight during the first part of 2009: in the first quarter of 2009, 42.3 percent of the Survey of Senior Loan Officers respondents reported that they had tightened credit standards. By the fourth quarter of 2009, however, only 3.7 percent of the Survey of Senior Loan Officers respondents reported that they had further tightened credit standards. In the first quarter of 2010, the net percentage of Survey of Senior Loan Officers respondents that reported further tightening of credit standards was zero. These data largely reflect the fact that most banks had already tightened their lending over the course of the previous quarters.[48]

[48] For the fourth quarter of 2009, none of the Survey of Senior Loan Officers respondents reported "easing of credit standards" for small business commercial lending. *See* January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 15, at 12. For commercial lending to large businesses, only 3 respondents reported credit standards "easing somewhat" and none of the respondents reported "tightened " credit standards. *Id.* One of the Survey of Senior Loan Officers respondents reported "easing of credit standards" for small business commercial lending, which was offset by one respondent that reported "tightened somewhat" of credit standards. *See* April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 19, at 12. For commercial lending to large businesses, only 6 respondents reported credit standards "easing somewhat," which was offset by two respondents that reported "tightened somewhat" of credit standards. April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 19, at 11.

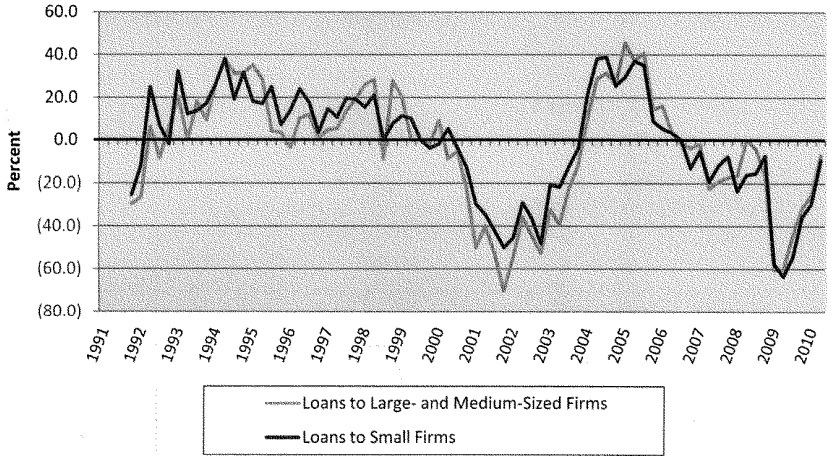
FIGURE 2: NET PERCENTAGE OF DOMESTIC BANKS REPORTING TIGHTENING STANDARDS FOR C&I LOANS (DIFFERENCE BETWEEN RESPONDENTS THAT REPORTED TIGHTENED CREDIT STANDARDS VS. EASED CREDIT STANDARDS) [49]



At the same time that banks reported tightened credit standards in 2008 and 2009, commercial lending demand by both large and small businesses weakened. As Figure 3 illustrates, commercial lending demand for both large and small businesses declined quarterly starting in the second quarter of 2008. In the first quarter of 2008, 16.1 percent of the Survey of Senior Loan Officers respondents reported that small business commercial lending demand fell, compared to a faster decline in the fourth quarter of 2008, when 57.7 percent of the Survey of Senior Loan Officers respondents reported falling loan demand. According to the Survey of Senior Loan Officers, small business commercial lending reached its lowest point in the first quarter of 2009, when 63.5 percent of the Survey of Senior Loan Officers respondents reported declining commercial loan demand. In the fourth quarter of 2009 and the first quarter of 2010, however, 29.6 percent and 9.3 percent, respectively, of the Survey of Senior Loan Officers respondents reported falling loan demand, suggesting that demand continued to be soft, although not falling as precipitously as in the first quarter of 2009—although this could mean that demand had already fallen so low that it was difficult for it to fall further.

[49] For the charts in this section that address the Survey of Senior Loan Officers, net percentage is defined as the difference between the number of the Survey of Senior Loan Officers respondents reporting tightening credit standards over easing of credit standards. The chart points for 1990 through 2010 are based on the quarterly data for the previous three months. For example, the 2010 chart point (the last available) is based on information for the first quarter ended March 31, 2010.

FIGURE 3: NET PERCENTAGE OF DOMESTIC BANKS REPORTING STRONGER DEMAND FOR C&I LOANS (DIFFERENCE BETWEEN RESPONDENTS THAT REPORTED STRONGER LOAN DEMAND VS. WEAKER DEMAND)

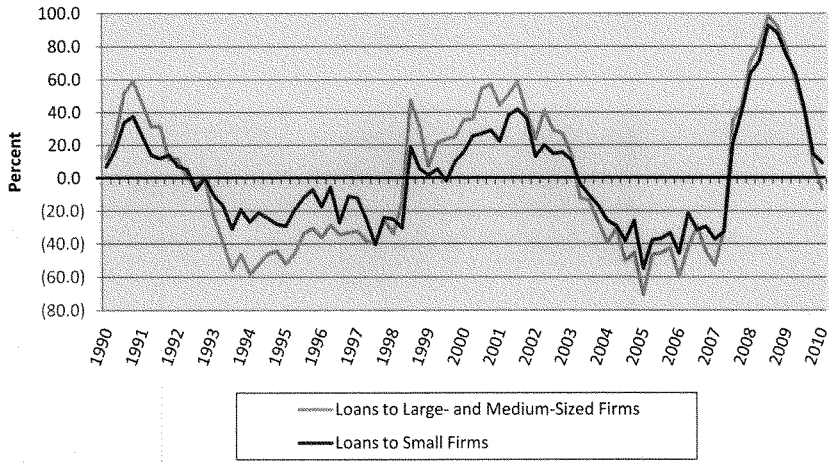


An indicator of credit cost, and therefore availability, is the "net interest rate spread." The net interest rate spread measures the difference between the average interest yield received by banks on interest-earning assets (e.g., loans, mortgage-related securities and investments) and the average interest rate the bank has to pay on deposits and borrowings (i.e., cost of funds). If the cost of funds is constant, wider spreads usually indicate that banks perceive greater risk and are charging higher interest rates, while narrower spreads indicate that banks perceive less risk. It is difficult, however, to predict loan volume from interest rate spreads, because the spreads can reflect a variety of different factors, including perceived risk, efforts to rebuild capital, and cost of funds, any of which can push loan volumes in different directions. Net interest rate spreads for loans to all businesses widened in 2008, peaked in the fourth quarter of 2008, and began to narrow in 2009 and the first quarter of 2010.[50] Figure 4 shows the percentage of banks reporting change in net interest rate spreads on a quarterly basis for large businesses and small businesses. For loans to small businesses, 63.6 percent of the Survey of Senior Loan Officers respondents reported widening spreads in the first quarter of 2008, a number that surged to 88.5 percent in the fourth quarter of 2008, and barely moderated to 75 percent in the first quarter of 2009. By the fourth quarter of 2009 and first quarter of 2010, however, only 14.8

[50] As in prior economic downturns, interest rate spreads on smaller (for this data, $1 million or below) C&I loans have increased since the beginning of the financial crisis by about a full percentage point relative to the Federal Funds rate, an increase that also applied to larger loans. This pattern is typical during a recession and reflects a tightening in loan underwriting and the imposition of a higher risk premium on loans to businesses during periods of economic distress and dislocation. Spreads overall are currently higher than during the boom and higher than during the 2001–2002 recession, and are historically high, if not particularly unusual for recessionary periods. *See* Board of Governors of the Federal Reserve System, *Survey of Terms of Business Lending* (May 5–9, 1997—Feb. 1–5, 2010) (online at www.federalreserve.gov/releases/e2/).

percent and 9.3 percent, respectively, of the Survey of Senior Loan Officers respondents reported widening net interest rate spreads.

FIGURE 4: NET PERCENTAGE OF DOMESTIC BANKS REPORTING INCREASING SPREADS OF LOAN RATES OVER BANKS' COST OF FUNDS (DIFFERENCE BETWEEN RESPONDENTS THAT REPORTED WIDER NET INTEREST RATE SPREADS VS. NARROWED NET INTEREST RATE SPREADS)



2. Other Small Business Lending Data

The drop in commercial loan demand was accompanied by lower numbers of loans and lower dollar amounts of loans outstanding. Figures 5 and 6 illustrate the dollar amount and number of loans outstanding in commercial loans at domestic commercial banks and indicate that after a surge last decade these numbers stagnated from 2007 through 2009.[51] From 2006 to 2007, there was a 99 percent increase in commercial loans of less than $100,000,[52] resulting in a 12 percent increase in the dollar amount of commercial loans outstanding and an 89.7 percent increase in the number of loans outstanding. Commercial loans of smaller amounts are generally presumed to be to small businesses, and the data therefore indicate that there was an explosion in small business lending by commercial banks during the boom.[53] From 2007 to 2009, however, the dol-

[51] The dollar amount and number of loans outstanding do not necessarily show a dramatic change when economic conditions change (unless the loans are callable). The maturities of commercial loans are, however, typically for a specific period (usually between one and five years). Accordingly, in a recessionary period, the number of loans and the dollar amount of loans outstanding would not necessarily immediately or dramatically decrease.

[52] SBA suggests that some of these microloans are credit card loans, as it attributes growth in such loans over the 2007–2008 period to marketing of business credit cards. *See* Small Business Economy Report, *supra* note 13, at 75.

[53] All lending went up during the boom, but in contrast to small businesses, larger corporations often accessed the capital markets, not banks, for credit. During the boom, the capital markets were widely accessible to larger corporations. By contrast, at present all lending has been contracting, although "[bond] issuance has picked up considerably. . ." *See* Alan B. Kruger, chief economist and assistant secretary for economic policy, U.S. Department of the Treasury, Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association (May 3, 2010) (online at treasury.gov/press/releases/tg683.htm). Cf. Securities Industry and Financial Markets Association, *Research Quarterly: 4Q and Full Year 2009*,

Continued

lar amount of outstanding commercial loans decreased by 3.7 percent, and the number of loans increased by 0.5 percent, showing the preliminary signs of decline.

FIGURE 5: C&I LOANS OUTSTANDING AT COMMERCIAL BANKS (ADJUSTED FOR INFLATION) [54]

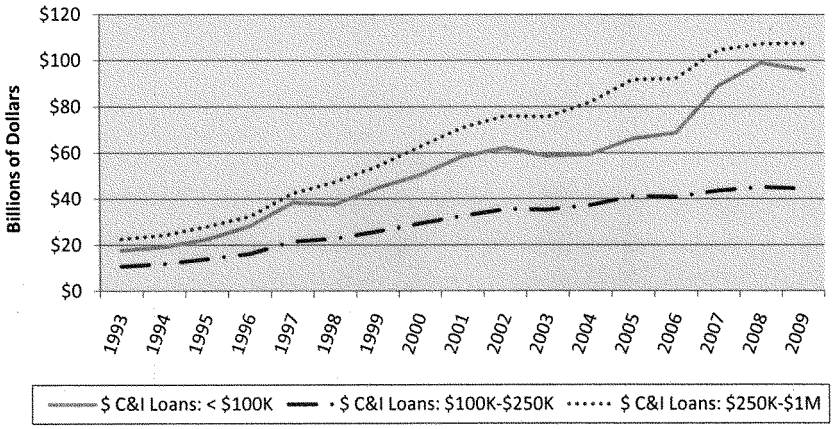
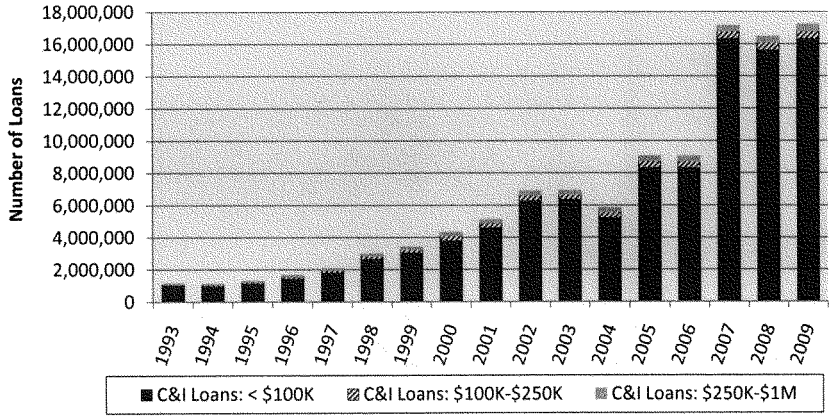


FIGURE 6: NUMBER OF C&I LOANS BY ACTUAL LOAN SIZE [55]



3. Data from Past Recessions

The prior tables and discussion show that during the credit crunch interest rate spreads surged, demand for commercial lend-

at 17 (Feb. 12, 2010) (online at www.sifma.org/uploadedFiles/Research/ResearchReports/2010/CapitalMarkets_ResearchQuarterly_20100212_SIFMA.pdf) ("Total corporate bond issuance fell 4.3 percent to $207.9 billion in the 4Q'09 from $217.3 billion in 3Q'09, but was above the $81.1 billion issued in the same year-earlier period").

[54] SNL Financial. These figures were converted into 2005 dollars using the GDP deflator. *See* Federal Reserve Bank of St. Louis, *Gross Domestic Product: Implicit Price Deflator* (online at research.stlouisfed.org/fred2/data/GDPDEF.txt) (accessed May 7, 2010).

[55] SNL Financial.

ing plummeted, and recovery has been slow. Past recessions, in 1981, 1990, and 2001, provide some points of comparison for evaluating whether the current credit constriction is in line with past experience. The relative value of past data for the current inquiry can depend in part on the source for the recession: for example, the 1981 and 2001 recessions were primarily the result of high interest rates, while the 1990 recession was primarily the result of a deflationary credit collapse.[56] The current recession began with the collapse of a credit boom and concurrent devaluations in a variety of sectors, including housing.[57] Despite these differences, prior downturns can provide a useful point of comparison.

Figure 7 tracks outstanding commercial lending, adjusted for inflation, at all domestic commercial banks across the recessions of 1981, 1990, and 2001. As the chart illustrates, the dollar amount of outstanding commercial loans for domestic banks decreased only 3.8 percent during the 1981 recession, and commercial lending did not significantly stall afterwards. The rate of increase in commercial lending after 1981, however, was sluggish compared to the increases following the recessions of 1990 and 2001. After the end of the 1990 recession, by contrast, the dollar amount of outstanding commercial loans continued to decline. In January 1994, the dollar value of outstanding commercial loans reached a low of $737 billion, representing decreases of 16.7 percent and 13.3 percent, respectively, from the beginning and end of the 1990 recession.[58] Similarly, the post-recessionary period of the early 2000s shows constriction in commercial lending like that which followed the 1991 recession. While the total amount of outstanding commercial loans decreased only five percent between March and November 2001, after the end of the 2001 recession outstanding commercial loans continued to decline. In May 2004, the dollar amount of outstanding commercial loans had fallen 24.3 percent and 20.4 per-

[56] The data included in this discussion are derived from the National Bureau of Economic Research (NBER), which measures the length of recessions. The recession of 1981 began in July 1981 and ended in November 1982 (the "1981 recession"). The recession of 1990 began in July 1990 and ended in March 1991 (the "1990 recession"). In addition, the 2001 recession began in March 2001 and ended in November 2001 (the "2001 recession"). *See* National Bureau of Economic Research, *Business Cycle Expansions and Contractions* (online at www.nber.org/cycles.html) (hereinafter "Business Cycle Expansions and Contractions") (accessed Mar. 22, 2010). The 1981 recession was the result of tight monetary policies which led to high interest rates. *See* Congressional Budget Office, *The Prospects for Economic Recovery*, at 14 (Feb. 1982) (online at www.cbo.gov/ftpdocs/51xx/doc5135/doc03b-Entire.pdf). The 1990 recession was the result of a combination of "pessimistic consumers, the debt accumulations of the 1980s, the jump in oil prices after Iraq invaded Kuwait, a credit crunch induced by overzealous banking regulators, and attempts by the Federal Reserve to lower the rate of inflation." Federal Reserve Bank of San Francisco, *Economic Review No. 2: What Caused the 1990–1991 Recession*, at 33 (1993) (online at www.frbsf.org/publications/economics/review/1993/93-2_34-48.pdf). The 2001 recession was the result of the dot.com era coming to a close and high interest rates, exacerbated by the attacks of 9/11. *See* Mary Daly and Fred Furlong, *Profile of a Recession—the U.S. and California,* Federal Reserve Bank of San Francisco Economic Letter, No. 2002–04, at 1–2 (Feb. 22, 2002) (online at www.frbsf.org/publications/economics/letter/2002/el2002-04.pdf). *See also* Michael D. Bordo and Joseph G. Haubrich, *Credit Crises, Money and Contractions: An Historical View,* National Bureau of Economic Research, Working Paper 15389, at 12–13 (Sept. 2009) (online at www.nber.org/papers/w15389.pdf).

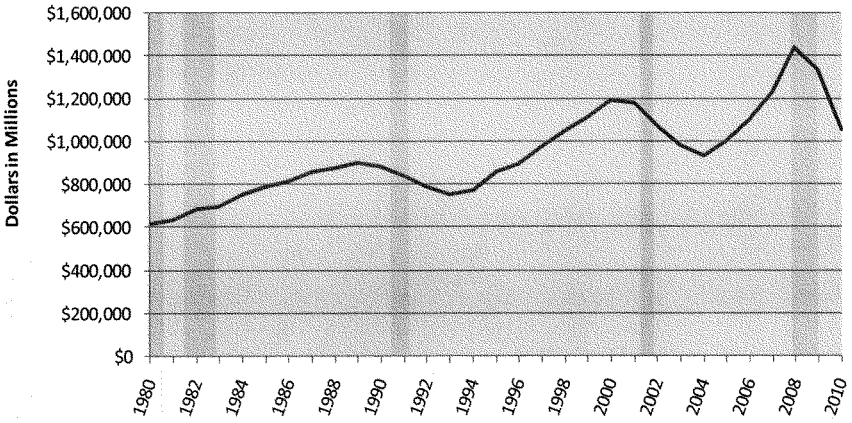
[57] Links Between the Financial Crisis and Jobs, *supra* note 38, at 3. *See also* Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, Journal of Economic Perspectives, Volume 23, Number 1, at 77–78 (online at princeton.edu/markus/research/papers/liquidity_credit_crunch.pdf).

[58] The percentage declines are calculated as follows. Total average July 1990 outstanding commercial loans were $885 billion and January 1994 average outstanding commercial loans totaled $737 billion. $885 billion less $737 billion equals $148 billion. $148 billion divided by $885 billion equals 16.7 percent. Total March 1991 outstanding commercial loans were $851 billion and January 1994 outstanding commercial loans totaled $738 billion. $851 billion less $738 billion equals $113 billion. $113 billion divided by $851 billion equals 13.3 percent.

cent, respectively, from the beginning and end of the 2001 recession.[59]

As noted above, data from these recessions, while useful, provide imperfect models upon which to gauge current conditions.[60] From the present vantage point it is also difficult to gauge whether the recovery, when it appears, will be comparable to the past data, as those analyses evaluate several years, and such evaluations for this recession lie in the future. The data show, however, that lending is very sensitive to economic cycles, and lending in and after recent past recessions has either stagnated or fallen.

FIGURE 7: OUTSTANDING C&I LOANS IN COMMERCIAL BANKS (SEASONALLY AND INFLATION-ADJUSTED)[61]



4. Lending by Participants in the Capital Purchase Program (CPP)

As Congress contemplates the Small Business Lending Fund (SBLF), it is worth questioning whether the Capital Purchase Pro-

[59] The percentage declines are calculated as follows. Total March 2001 average outstanding commercial loans were $1.2 trillion and May 2004 outstanding commercial loans totaled $908 billion. $1.2 trillion less $908 billion equals $292 billion. $292 billion divided by $1.2 trillion equals 24.3 percent. Total November 2001 outstanding commercial loans were $1.14 trillion, and May 2004 outstanding commercial loans totaled $908 billion. $1.14 trillion less $908 billion equals $232 billion. $232 billion divided by $1.14 trillion equals 20.4 percent.

[60] As another point of comparison, the Survey of Senior Loan Officers conducted during the 2001 recession, in the first quarter of 2001, stated that 34.5 percent of Survey respondents reported falling small business commercial loan demand and a faster decline in the fourth quarter of 2001, where 45.4 percent of Survey respondents reported falling loan demand. *See* Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Bank Lending Practices, Chart Data* (Feb. 1, 2010) (online at www.federalreserve.gov/boarddocs/snloansurvey/201002/chartdata.htm).

[61] The shaded areas reflect periods of recession. *See* Business Cycle Expansions and Contractions, *supra* note 56 (accessed May 7, 2010). The NBER has not yet determined whether the recession that began in December 2007 has ended nor established the date of its ending. This chart assumes that this recession ended at the end of Q2 2009, the last quarter of net decline in the GDP. *See* Bureau of Economic Analysis, *Gross Domestic Product* (online at www.bea.gov/national/txt/dpga.txt) (accessed Apr. 5, 2010). *See also* Board of Governors of the Federal Reserve System, *Assets and Liabilities of Commercial Banks in the United States* (Instrument: Commercial and industrial loans; All Commercial Banks; SA) (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H.8) (accessed May 7, 2010). The above figures for outstanding C&I loans were averaged for each year and then adjusted using the GDP deflator. The figure for 2010 reflects averaged data through April 21, 2010. The 2010 average was then adjusted using the 2009 GDP deflator mechanism.

gram (CPP), a TARP-funded capital infusion program for large and small banks, led to an increase in overall lending levels or small business lending levels.[62] The data show that lending by the largest CPP recipients, those with assets over $100 billion, and recipients of 81 percent of the funds disbursed under the CPP—declined, a decrease that is all the more stark given that lending appears to have increased at medium-sized banks, those with assets between $10 and $100 billion, although those received only 11.4 percent of CPP funds.[63]

Although it is possible to question whether lending levels might have decreased further absent the CPP, there are no data to support or challenge this assertion. In particular, two gaps in reporting and data gathering have made it nearly impossible to make a useful evaluation of the effectiveness of capital infusion programs for the purposes of increasing lending.[64] The first is Treasury's failure, at the outset of the CPP, to require tracking of funds received through the TARP. Although Treasury intended CPP recipients to increase the flow of credit to U.S. borrowers, the CPP contracts' terms failed to establish how this objective must be met, measured, or reported. Treasury's failure to condition TARP assistance on specific requirements, including reporting, as previously identified by the Panel, contributes to an incomplete picture of how recipients used TARP funds.[65]

The second is Treasury's poor data collection requirements. In October 2008 Treasury began to track the lending activity of the top 22 recipients under the CPP. Treasury did not require these institutions to break out their small business lending until April 2009.[66] As discussed in Section A, although metrics for small business lending depend on shifting definitions of firm size and loan amount, when it requested data, Treasury provided these institu-

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[62] In addition to the CPP, the Targeted Investment Program (TIP) was an additional TARP-funded capital infusion program. The only institutions that received TIP funds were Citigroup and Bank of America, each of which received $20 billion. Upon repayment of funds by these institutions, the TIP was terminated in December 2009.

[63] *See* Section E.3, *infra*, for further detail.

[64] Although SIGTARP's recent report contains, in Figure 2.12, a chart comparing small-business loans versus TARP assistance by bank size, this chart only shows correlation, and not causation. April 2010 SIGTARP Quarterly Report, *supra* note 28, at 110 ("Although CPP was meant for investments in healthy and viable banks, some CPP recipients have filed for bankruptcy protection").

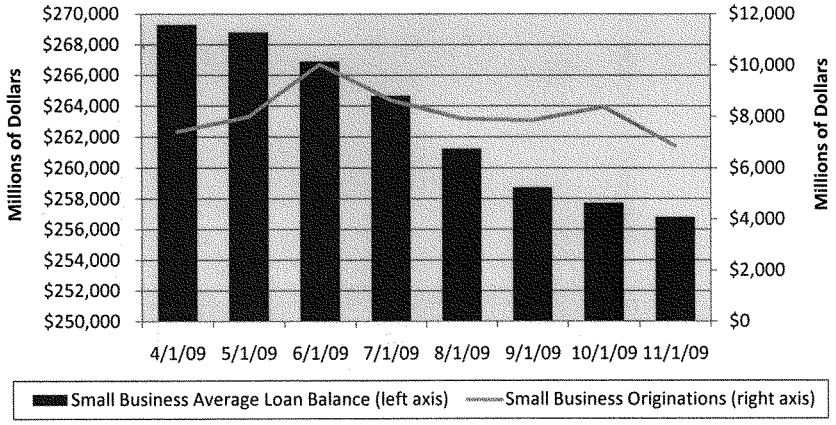
[65] When asked how institutions used the TARP funds they were given, Treasury raised the difficulty in tracking individual dollars through an institution in response—in essence, that because money is fungible, it is not useful to track particular funds. Nevertheless, as the Panel and SIGTARP have noted, Treasury could have conditioned receipt of TARP assistance upon requirements to report the usage of those funds and the overall lending activities of the institutions in question. *See* Congressional Oversight Panel, *January Oversight Report: Taking Stock: Accountability for the Troubled Asset Relief Program*, at 57 (Jan. 9, 2009) (online at cop.senate.gov/documents/cop-010909-report.pdf); COP December Oversight Report, *supra* note 37, at 108–111. *See also* Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets*, at 5 (Jan. 14, 2010) (online at cop.senate.gov/documents/cop-011410-report.pdf) (hereinafter "COP January Oversight Report"); Office of the Special Inspector General for the Troubled Asset Relief Program, *SIGTARP Survey Demonstrates that Banks Can Provide Meaningful Information on Their Use of TARP Funds* (July 20, 2009) (online at sigtarp.gov/reports/audit/2009/SIGTARP_Survey_Demonstrates_That_Banks_Can_Provide_Meaningfu%20Information_On_Their_Use_Of_TARP_Funds.pdf). Further, banking industry witnesses at the Panel's Field hearing in Phoenix stated that they would support a tracking requirement for capital infusion programs. *See* Congressional Oversight Panel, Testimony of Candace Wiest, president and chief executive officer, West Valley National Bank, *Transcript: Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing–042710–phoenix.cfm) (hereinafter "Testimony of Candace Wiest").

[66] The existing source for this information is the FDIC, which currently provides these data on an annual basis—a rough measure from which to evaluate shorter term trends.

tions with guidance which relied heavily on the respective institution's internal loan classification system. At present, however, Treasury no longer requires institutions that have repaid their TARP funding to participate in the survey. Therefore, as of January 2010, the survey no longer consists of lending data for these 22 institutions, and Figure 8 below reflects data only through November 2009, the last reporting period that included monthly data for all of these institutions.[67] To date, only 10 of these 22 institutions continue to provide lending data to Treasury.[68] As a result of the limited data provided by Treasury, it is difficult to track small business lending and overall lending for all CPP recipients.

As Figure 8 illustrates, both small business lending and the small business average loan balance decreased through November 2009 for the top 22 CPP recipients. The average small business loan balance for these institutions decreased 4.6 percent from April 2009 to November 2009. Total small business originations for these institutions decreased by 7.4 percent for this same period. These declines are, however, comparable to declines in these institutions' total lending; their total average loan balance decreased by 5.2 percent during the same period, and their total loan originations decreased by approximately 10.4 percent.[69]

FIGURE 8: SMALL BUSINESS LENDING BY TOP 22 CPP RECIPIENTS MONTHLY LENDING SURVEY [70]



The Panel believes that Treasury's currently limited data collection is at best regrettable. In addition, Treasury has changed the way in which it reports CPP data. Treasury previously published

[67] U.S. Department of the Treasury, *The Monthly Lending and Intermediation Snapshot* (Apr. 16, 2010) (online at www.financialstability.gov/impact/monthlyLendingandIntermediationSnapshot.htm) (compiling data from April 2009 to November 2009).

[68] The top 22 CPP recipients comprise the following: American Express, Bank of America, Bank of New York Mellon, BB&T, Capital One, CIT, Citigroup, Comerica, Fifth Third, Goldman Sachs, Hartford, JPMorgan Chase, KeyCorp, Marshall & Illsley, Morgan Stanley, Northern Trust, PNC, Regions, State Street, SunTrust, U.S. Bancorp, and Wells Fargo. The following 10 banks continue to report to Treasury: CIT, Citigroup, Comerica, Fifth Third, Hartford, KeyCorp, Marshall & Illsley, PNC, Regions, and SunTrust. *See Id.*

[69] *Id.*

[70] *Id.*

a survey of the top 22 CPP recipients. Treasury currently publishes the Capital Purchase Program Monthly Lending Report, which measures only three metrics in comparison to the 26 measured by the survey of the top 22 CPP recipients. Data from institutions that received CPP funding should remain in the survey so as to better enable taxpayers to determine the ways in which these institutions are participating in the market. Ultimately, to the Panel's dismay, the late inclusion of small-business lending metrics and the new, more limited data that Treasury publishes make it very difficult to track CPP recipients' lending, including small-business lending, over time.[71]

Capital infusions are a rough answer to a multifaceted problem, and clear data could have been very valuable, particularly given that there is some evidence that, rather than lending, banks are keeping cash. Looking at past recessionary periods, cash as a percentage of total assets at banks has oscillated, but not dramatically, with relatively minimal responsiveness to recessions. In 2008, however, banks began to retain cash out of line with past recessions. There are several possible sources for this phenomenon. The downturn in the economy has injected more uncertainty—and therefore more room for subjective analysis—into the process of determining the appropriate level of loan loss reserves, and banks may fear that bank examiners will impose conservative loan loss reserve requirements. Banks may also keep cash in anticipation of the passage of financial regulatory reform legislation that will likely increase capital requirements.[72] The Federal Reserve's decision in October 2008 to pay interest on excess reserves has also created an additional incentive to hold cash.[73] In addition, banks experiencing capital weakness—due to anticipated losses in the CRE market or balance sheets still plagued by troubled assets—may hold cash as a means of buttressing their capital position. It is too soon to determine whether the more ordinary oscillations of cash retention will resume again, or whether cash levels will return to pre-crisis levels. Because these questions are not particular to small business lending, and, further, may implicate policy considerations (such as monetary policy) beyond the scope of this report, this report does not attempt to deal with them in depth.

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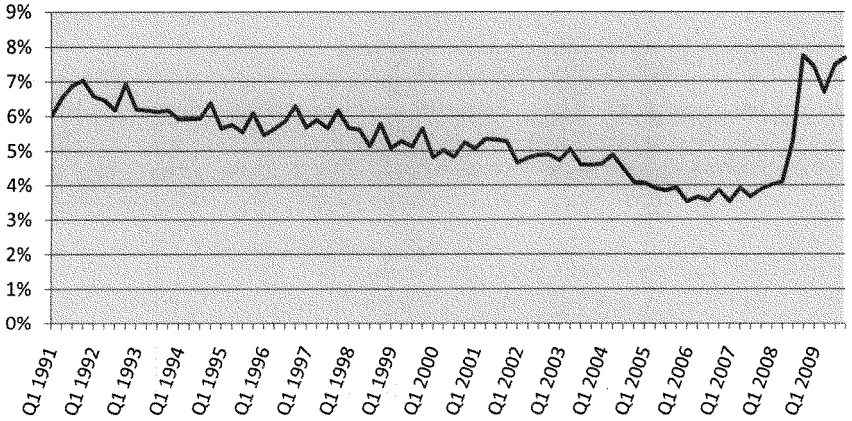
[71] Of the CPP recipients who have repaid their funds, only Bank of America breaks out its small business lending. The Panel has previously noted its frustration with similar gaps in Treasury's data. At that time, Treasury did not include small business lending in its monthly reports. Although Treasury remedied that omission, the new structure of and data included in the reports poses similar problems. *See* COP May Oversight Report, *supra* note 3, at 17–18.

[72] *See* Senate Committee on Banking, Housing, and Urban Affairs, *Summary:* Restoring American Financial Stability, at 1 (Mar. 17, 2010) (online at banking.senate.gov/public/ files/ FinancialReformSummaryAsFiled.pdf) (hereinafter "Senator Dodd Financial Regulation Reform Summary").

[73] *See* Board of Governors of the Federal Reserve System, *Interest on Required Balances and Excess Balances* (Oct. 6, 2008) (online at www.federalreserve.gov/monetarypolicy/ reqresbalances.htm) (describing the policy, and noting that setting the interest rate on such balances would give the Federal Reserve additional monetary policy tools).

FIGURE 9: CASH AS A PERCENTAGE OF TOTAL ASSETS [74]



As Congress contemplates the Small Business Lending Fund (SBLF), another program that would provide capital to banks, data on any links between capital infusions and increased lending could have substantially and usefully informed the program. After all, even if low loan volume is in fact the result of constrictions in supply, an assertion that is by no means clear, a bank might not necessarily use an unrestricted capital infusion to increase leverage. The bank may also use it to shore up capital weakness; free up funds for safer investment elsewhere; or be held as cash, among other things. Regrettably, given the lack of data, and the multiple uses that banks can have for capital infusions, it is difficult uncritically to accept the proposition that another supply-side capital infusion program will, this time, unlock credit.

D. Government Lending Initiatives and Small Business

1. Pre-Crisis

In stable credit markets, the government's effort to facilitate small business lending relies chiefly on programs run by the SBA.[75] The SBA acts as direct lender or guarantor on a principal loan portfolio of $91.9 billion.[76] Guarantees, which comprise the bulk of the SBA's outstanding loan portfolio, derive from the agency's 7(a) and 504 loan programs, and its small business investment company program (SBIC).[77] Direct loans originate from the SBA's

[74] FBR Capital Markets.

[75] Monetary, fiscal, and regulatory policies executed by other government entities also affect lending markets, including those supporting small businesses, but they are beyond the scope of this report. Multiple federal agencies provide direct loans and loan guarantees, as well, in support of targeted sectors, including the housing, education, business and development, and export markets. For a further discussion of these agencies and programs, *see* Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2011*, at 345–358 (Feb. 1, 2010) (online at www.whitehouse.gov/omb/budget/fy2011/assets/topics.pdf) (hereinafter "Analytical Perspectives: 2011 Budget").

[76] Includes unaudited data through March 31, 2010. U.S. Small Business Administration, *Table 1—Unpaid Principal Balance by Program* (online at www.sba.gov/idc/groups/public/documents/sba_homepage/serv_bud_lperf_upbreport.pdf) (accessed May 12, 2010).

[77] In fiscal 2009, guarantees on 7(a) and 504 loans accounted for 55 percent and 26 percent of the SBA's outstanding loan portfolio, respectively. *See* U.S. Small Business Administration, *Summary of Performance and Financial Information for Fiscal Year 2009*, at 18 (Feb. 22, 2010)

microloan and disaster loan programs. The expansion of SBA-guarantee programs is a key part of the government's economic recovery strategy, as discussed below.[78] This report discusses the pre-crisis programs, their administration, and their expansion in order to assess recovery efforts, present and future.

a. Guarantee Programs

i. 7(a) and 504 Loan Programs

The SBA's 7(a) and 504 programs guarantee small business loans that private lending institutions would otherwise be unlikely to extend under reasonable terms. Proceeds on 7(a) loans can be used for most general business purposes; 504 loans apply primarily to real estate purchases and improvements.[79] SBA does not evaluate borrower applications directly for either program, instead relying on participating institutions to make lending determinations and underwrite qualifying loans. Guarantees, pre-crisis, typically covered 85 percent of the value of a 7(a) loan and 40 percent of the financing for 504 projects on loans up to $1.5 million.[80] Lenders are required to provide monthly reports to SBA on the status of their SBA-guaranteed portfolio. SBA monitors lender risk—the likelihood SBA will need to purchase the guaranteed portion of defaulted business loans—through a third-party contractor. To offset program costs, SBA charges 7(a) program lenders a single up-front fee and yearly servicing fees, and it charges 504 borrowers a one-time guarantee fee and annual program fees.[81]

ii. Small Business Investment Company Program

The small business investment company program allows SBICs, which are private SBA-licensed venture capital funds, to raise capital by issuing SBA-guaranteed debentures. SBICs leverage this capital, combining private funds with those borrowed, to make debt and equity investments in qualifying small businesses. Borrowing, pre-crisis, was limited to 300 percent of an SBIC's private capital base, or $150 million per SBIC and $225 million if multiple licenses are under common control. Debentures have 10-year terms with semiannual interest payments and a balloon principal payment at

(online at www.sba.gov/idc/groups/public/documents/sba_homepage/serv_aboutsba_perf_summ.pdf) (hereinafter "SBA Performance Summary for 2009").

[78] Historically SBA-guaranteed loans account for only a sliver of the aggregate small business lending market. *See* note 32, *supra*.

[79] Financing for 504 loans is delivered through certified development companies (CDCs), nonprofit community development corporations. In a typical 504 transaction, a third-party private lender provides 50 percent of the project's financing pursuant to a first-lien mortgage, a CDC provides up to 40 percent of the financing through a debenture that is fully guaranteed by SBA and takes a junior-lien, and a borrower contributes the remaining 10 percent. U.S. Small Business Administration, Office of Financial Assistance, *Lender and Development Company Loan Programs*, SOP 50–10(5), at 238 (Aug. 1, 2008) (online at www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105.pdf) (hereinafter "Lender and Development Company Loan Programs").

[80] For 7(a) loans, pre-crisis, the SBA guaranteed 75 percent on loans in excess of $150,000 and 85 percent on those below. The maximum loan approved by the private lender could not exceed $2.0 million. For 504 loans, CDC participation was capped at $1.5 million for a single project, $2.0 million if certain public policy goals are met, and $4.0 million for manufacturing businesses. U.S. Small Business Administration, *Quick Reference to SBA Loan Program* (Oct. 1, 2008) (online at www.sba.gov/idc/groups/public/documents/wv_clarksburg/wv_sbaquickreferenceguide.pdf).

[81] Lender and Development Company Loan Programs, *supra* note 79, at 151, 158, 313–314.

final maturity.[82] Pools of debentures are securitized and sold to investors through periodic public offerings, with market-set interest rates. Portfolio management and investment decisions are made by the SBICs' fund managers, pursuant to certain portfolio restrictions.

b. Direct Lending Programs

i. Microloan Program

The SBA's microloan program offers small short-term loans to small businesses for any general operating purpose, except real estate purchases.[83] The SBA does not evaluate borrowers for creditworthiness. Borrowers submit loan applications directly to participating local intermediaries—nonprofit organizations with lending experience—that make credit decisions at the local level. To minimize risk to the SBA, intermediaries are required to contribute 15 percent of any loan from internal sources. The SBA distributes funds directly to the intermediaries, which, in turn, extend loans to borrowers.[84] Loans are capped at $35,000 and average about $13,000 per borrower. Each microloan must be repaid by the borrower within six years. The intermediaries are not required to make any payments during the first year, although interest begins to accrue immediately after the SBA disburses funds to the intermediary. The SBA determines an intermediary's repayment schedule on a case-by-case basis within a maximum 10-year period. As security, the SBA takes a first lien position in an intermediary's dedicated funds and any microloan payments receivable.[85]

ii. Disaster Loan Program

The SBA's disaster loan program offers low-interest, fixed-rate loans to homeowners, renters, and businesses in declared disaster areas. Unlike the underwriting for its other programs, the SBA evaluates disaster loan applications and directly makes credit determinations.[86] Disaster loans are available in two forms: those for

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[82] Prepayment is without penalty and must be made in whole on a semiannual payment date. U.S. Small Business Administration, *The SBIC Program: Application Process* (online at www.sba.gov/aboutsba/sbaprograms/inv/forsbicapp/INV_APPLICATION_PROCESS.html) (accessed May 6, 2010).

[83] The SBA also distributes grants to the intermediaries to assist borrowers with marketing, management, and technical assistance. Grants cannot exceed 25 percent of an intermediary's outstanding SBA loan balance. The intermediaries must also contribute at least 25 percent of any grant. U.S. Small Business Administration, *Technical Assistance Funds* (online at www.sba.gov/financialassistance/prospectivelenders/micro/taf/index.html) (accessed May 6, 2010).

[84] An intermediary cannot borrow more than $750,000 from the SBA in its first year in the program. In future years, an intermediary's obligation cannot exceed an aggregate of $3.5 million, subject to statutory limitations on the total amount of funds available per state. U.S. Small Business Administration, *Terms & Conditions for Intermediaries* (online at www.sba.gov/financialassistance/prospectivelenders/micro/terms/index.html) (accessed May 6, 2010).

[85] Dedicated funds include: (1) a microloan revolving fund, which contains proceeds from SBA loans, contributions from non-federal sources, and payments from microloan borrowers; and (2) a loan loss reserve fund maintained at a level equal to 15 percent of the outstanding balance of the notes receivable owed to an intermediary by its microloan borrowers. *Id.*

[86] Following a disaster, SBA conducts borrower outreach and support. After receipt of a loan application, staff in SBA's Loan Processing and Disbursement Center review the borrowers' eligibility, credit, and repayment ability. Approved applications are assigned to an SBA loss verifier, who verifies physical losses and estimates property damage. Next, the staff underwrites the application and reviews the applicant's credit history, repayment ability, and eligibility in greater depth. If approved, SBA issues the first disbursement of the unsecured portion of the loan—up to $14,000 for physical disaster loans. After SBA verifies lien requirements on the collateral property, it may disburse an additional secured portion of the physical disaster loan. Because no physical repairs are associated with economic injury disaster loans, SBA generally makes full disbursement for these loans once collateral and insurance requirements are met.

physical property damage, and those for economic injury.[87] Individuals may collect up to $240,000 for physical damage to their primary residence and personal effects. Businesses may collect up to $2 million for joint physical and economic injury assistance. Disaster loans are available in advance of anticipated insurance payments. Borrowers are then required to use any insurance payments to pay down their outstanding SBA obligations. The SBA adjusts interest rates on disaster loans periodically and applies separate rates depending on whether a borrower has access to third-party credit. Interest on economic injury loans is capped at four percent. For borrowers with third-party credit access, the maximum loan term is 30 years; for those without, the maximum is three years.[88] Repayment schedules are established on a case-by-case basis.

c. Credit Crunch: Why SBA Programs were Inadequate

An active secondary market for 7(a) and 504 loans allows lending institutions to transfer risk and raise capital by selling the guaranteed portion of their loans into securitized pools, which are then sold to investors.[89] In 504 loan transactions, the non-SBA-guaranteed first lien mortgages are also pooled and securitized. Lenders use capital raised in the secondary market to extend additional 7(a) and 504 loans to borrowers. In fall 2008, the secondary markets for SBA-guaranteed 7(a) loans and non-SBA-guaranteed 504 first lien mortgages froze, mirroring broader credit market conditions.[90] Monthly volume on 7(a) secondary market securities, which had averaged $328 million during fiscal 2008, dropped dramatically, averaging $100 million between October 2008 and January 2009.[91] The credit contraction filtered into the primary market for SBA loans, in part, because of the unique manner in which these loans are securitized. A small group of specialized broker-dealers buy SBA loans directly from the lending institutions that originate them, then hold these loans in their securities inventory until they have a sufficient number to assemble into securitization pools. This process requires broker-dealers to borrow funds to finance their inventory of loans pending their pooling and sale to investors. When the spread between the prime interest rate and LIBOR began to tighten—narrowing already thin investment returns on SBA-guar-

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Government Accountability Office, *Small Business Administration: Additional Steps Should Be Taken to Address Reforms to the Disaster Loan Program and Improve the Application Process for Future Disasters*, at 8 (July 29, 2009) (GAO–09–755) (online at www.gao.gov/new.items/d09755.pdf).

[87] Borrowers requesting economic injury loans from the SBA must first seek access to credit through private credit sources; those requesting loans for physical property damage only are not bound to this initial requirement. *See* U.S. Small Business Administration, *Frequently Asked Questions about Physical Disaster Business Loans* (online at www.sba.gov/services/disasterassistance/basics/FAQs/index.html) (accessed May 11, 2010).

[88] U.S. Small Business Administration, *Fact Sheet about U.S. Small Business Administration (SBA) Disaster Loans* (online at www.sba.gov/idc/groups/public/documents/sba__homepage/serv__da__disastr__loan__factsht.pdf) (accessed May 11, 2010).

[89] In 7(a) transactions, lenders generally retain the nonguaranteed portion on their balance sheets. Government Accountability Office, *Status of the Small Business Administration's Implementation of Administrative Provisions in the American Recovery and Reinvestment Act of 2009*, at 4 (Jan. 19, 2010) (GAO–10–298R) (online at www.gao.gov/new.items/d10298r.pdf).

[90] The secondary market for the SBA-guaranteed debenture portion of 504 loans remains largely intact. *See* COP May Oversight Report, *supra* note 3, at 52. *See* U.S. Small Business Administration, *Q&A for Small Business Owners* (online at www.sba.gov/idc/groups/public/documents/sba__homepage/recovery__act__faqs.pdf) (accessed May 7, 2010) (hereinafter "SBA Recovery Act FAQs").

[91] SBA Performance Summary for 2009, *supra* note 77, at 19.

anteed securities—investor demand significantly dropped.[92] This strained the capacity of broker-dealers, who experienced both liquidity and credit pressures. Broker-dealers were largely unable to raise capital by securitizing their current inventories, nor could they sell their inventories to pay off existing loans. At the same time, because the institutions that traditionally lend to broker-dealers faced the same uncertain economic climate, and in some cases an impaired financial position, as well, they tightened broker-dealers' credit access, reducing their lines of credit, or withdrawing them altogether.[93] Lending institutions, which now were unable to sell SBA loans to broker-dealers, transfer their risk, and raise capital for new loans, significantly curtailed their lending to borrowers under the SBA's programs. Concurrently, the crisis of confidence spread to the real economy, diminishing loan demand.[94] Combined, these factors led to a sizeable fall in 7(a) and 504 loan originations. From October 2008 to January 2009, monthly gross approvals for 7(a) and 504 loans dropped 45 percent from fiscal 2008 averages, from $1.5 billion to $830 million.[95]

2. Crisis Programs

Since the onset of the financial crisis, the federal government has instituted a series of programs designed to support lending and liquidity. These programs generally fall into three categories: (1) capital infusions; (2) support for secondary markets; and (3) guarantee programs.

a. Capital Infusions

Capital infusions are intended to stabilize and shore up the balance sheets of financial institutions. A more stable balance sheet theoretically allows a bank to use its excess capital in ways other than building reserves, including lending.

i. Capital Purchase Program (CPP)

Treasury's principal TARP program to provide banks with capital and stabilize the financial system has been the CPP, which based funding upon the size of the participating institution.[96] Treasury hoped that with a strengthened capital base, "financial institutions [would] have an increased capacity to lend to U.S. businesses and consumers and to support the U.S. economy."[97] CPP funding termi-

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[92] As a measure of borrowing and lending, Prime/LIBOR tracks the rate U.S. banks charge their most creditworthy customers (Prime) compared to LIBOR. While the three-month LIBOR rate generally was 300 basis points below the Prime rate, in October 2008, the spread tightened, with LIBOR exceeding the Prime rate for a time. Because SBA pools are tied to the Prime rate and most investors use a LIBOR-based source of funds, this significantly dampened demand. *See* Coastal Securities, Inc., *State of the SBA Market* (Dec. 3, 2008) (online at www.coastalsecurities.com/
GGL_Market_Info%5CState%20of%20the%20SBA%20Markets_2008_12_03.pdf) ("as would be expected, many of these investors [sat] on the sidelines waiting for this spread to return to its historical level").

[93] COP May Oversight Report, *supra* note 3, at 52–53.

[94] *See* Section E for further details. *See also* SBA Performance Summary for 2009, *supra* note 77, at 20.

[95] SBA Performance Summary for 2009, *supra note* 77, at 19.

[96] As of May 6, 2010, $65.3 billion in CPP funds is still outstanding to 637 institutions. *See* U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 6, 2010* (May 10, 2010) (online at www.financialstability.gov/docs/transaction-reports/5_10_10%20Transactions%20Report%20as%20of%205_6_10.pdf).

[97] U.S. Department of the Treasury, *Capital Purchase Program* (Nov. 3, 2009) (online at www.financialstability.gov/roadtostability/capitalpurchaseprogram.html).

nated on December 29, 2009. The program provided approximately $205 billion in capital to 707 financial institutions, including over 650 small and medium-sized financial institutions.[98]

ii. Term Auction Facility (TAF)

The Federal Reserve's Term Auction Facility (TAF) is a loan program created in December 2007 as a response to the then-frozen interbank lending market. Under the TAF, the Federal Reserve auctions 28-day or 84-day loans to banks. Depository institutions eligible to access the Federal Reserve's discount window can submit bids.[99] The Federal Reserve then ranks the bids from the highest to the lowest and awards loans, starting with the highest rate bid, until the auctioned funds are exhausted. The banks secure the TAF loans with collateral that would be eligible for discount-window loans.

The amount of funds lent to banks through the TAF each month varies greatly. In the initial months of the program, the Federal Reserve offered $20 billion for auction each month,[100] although this amount increased to $150 billion as the credit crunch worsened.[101] No termination date for TAF has been announced, but the Federal Reserve has been steadily reducing the amount of funds offered.[102]

iii. Community Development Capital Initiative (CDCI)

On October 21, 2009, the White House announced a small business lending initiative under the TARP to invest lower cost capital in Community Development Financial Institutions (CDFIs).[103] According to Treasury, the financial crisis strained the resources of many CDFIs, many of which saw decreased lending demand and decreased funding.[104]

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[98] House Committee on Financial Services and House Committee on Small Business, Written Testimony of Herbert M. Allison, Jr., assistant secretary for financial stability, U.S. Department of the Treasury, *Condition of Small Business and Commercial Real Estate Lending in Local Markets*, at 2 (Feb. 26, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/allison.pdf) (hereinafter "Herb Allison Testimony before House Financial Services and House Small Business Committees"). *See also* Section C.4, *infra*.

[99] Bids are between $5 million and 10 percent of the auctioned funds at an interest rate within Federal Reserve guidelines.

[100] Board of Governors of the Federal Reserve System, *Federal Reserve and Other Central Banks Announce Measures Designed to Address Elevated Pressures in Short-Term Funding Markets* (Dec. 12, 2007) (online at www.federalreserve.gov/monetarypolicy/20071212a.htm).

[101] Board of Governors of the Federal Reserve System, *Federal Reserve and Other Central Banks Announce Further Coordinated Actions to Expand Significantly the Capacity to Provide U.S. Dollar Liquidity* (Sept. 29, 2008) (online at www.federalreserve.gov/monetarypolicy/20080929a.htm).

[102] In the most recent auction in March 2010, the Federal Reserve auctioned $25 billion, of which only $3.4 billion was actually loaned out. Board of Governors of the Federal Reserve System, *Press Release* (Mar. 9, 2010) (online at www.federalreserve.gov/monetarypolicy/20100309a.htm) (announcing the results of the March 8, 2010 TAF Auction).

[103] The primary mission of CDFIs is to promote economic development in struggling areas, both urban and rural, that are underserved by traditional financial institutions. CDFIs are certified by Treasury's CDFI Fund, which was created in order to promote economic revitalization and community development in low-income communities. In order to maintain CDFI certification (and, therefore, to be eligible for CDCI assistance), financial institutions must document that over 60 percent of their small business lending and other economic development activities target low-income communities or underserved populations. U.S. Department of the Treasury, *Community Development Capital Initiative* (online at www.financialstability.gov/roadtostability/comdev.html) (hereinafter "Community Development Capital Initiative") (updated Mar. 26, 2010).

[104] House Committee on Financial Services, Written Testimony of Michael S. Barr, assistant secretary for financial institutions, U.S. Department of the Treasury, *Community Development Financial Institutions (CDFIs): Their Unique Role and Challenges Serving Lower-Income, Underserved, and Minority Communities*, at 2 (Mar. 9, 2010) (online at www.house.gov/apps/list/hear-

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On February 3, 2010, Treasury announced final terms for the CDCI.[105] Under the initiative, a CDFI may receive a capital infusion if its regulators determine that it is eligible for the program.[106] CDFI banks, thrifts, and credit unions will be able to receive capital at a dividend rate of two percent (compared to the five percent rate under the CPP). Given that the Administration anticipates capital investments to CDFIs to be below $100 million, Treasury expects that the participating CDFIs will likely be within EESA's *de minimis* exception[107] and will not have to issue warrants. Participants will, however, be subject to the executive compensation requirements that apply to other TARP recipients. In the program's final form, Treasury included an increase in the amount of capital available to CDFIs, equal to up to five percent of a CDFI's risk-weighted assets,[108] and an allowance for CDFIs that have already received CPP funding to convert their existing investments, so long as they do not participate in both TARP programs simultaneously. CDFI credit unions—which were not eligible to participate in the CPP—will be allowed to apply for subordinated debt for up to 3.5 percent of total assets (which is roughly equivalent to the rates offered to CDFI banks and thrifts).

According to Treasury, about 210 institutions will be eligible for capital assistance under this initiative, including 60 banks and thrifts (with a total of $21 billion in assets) and 150 credit unions (with a total of $5 billion in assets). The application to participate in the CDCI must have been received by April 30, 2010.[109] Treas-

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ing/financialsvcs_dem/barr.pdf). As Assistant Secretary Barr notes, the American Recovery and Reinvestment Act (ARRA) also provided increased support to CDFIs, allowing the CDFI Fund to award $98 million in assistance to 69 CDFIs as well as an additional $1.5 billion in New Markets Tax Credit (NMTC) authority for the 2008 and 2009 fiscal years.

[105] *See* U.S. Department of the Treasury, *Obama Administration Announces Enhancements for TARP Initiative for Community Development Financial Institutions* (Feb. 3, 2010) (online at www.financialstability.gov/latest/pr_02032010.html); U.S. Department of the Treasury, *CDCI Program FAQs* (online at www.financialstability.gov/docs/CDCI/CDCI%20FAQs.pdf) (accessed May 11, 2010).

[106] Institutions that would not otherwise be recommended for participation by their regulator can also participate under certain circumstances. In such cases, Treasury will provide dollar-for-dollar matching capital investments, for up to five percent of a CDFI's risk-weighted assets, against private capital investments. Treasury will provide matching capital investments so long as the CDFI is in a viable position after the receipt of the new private and Treasury capital. Treasury will not provide capital to a CDFI until the institution has in fact raised the private capital, and its investment will also be senior to the matching investment. Community Development Capital Initiative, *supra* note 103 (updated Mar. 26, 2010).

[107] EESA § 113(d)(3)(A). EESA requires that the government receive warrants in exchange for all TARP investments. 12 U.S.C.§ 5223(d). However, a "de minimis" provision allows Treasury to create exemptions from this requirement for small institutions. *See* 12 U.S.C. § 5223(d)(3)(A) ("The Secretary shall establish de minimis exceptions to the requirements of this subsection, based on the size of the cumulative transactions of troubled assets purchased from any one financial institution for the duration of the program, at not more than $100,000,000"). Treasury has not yet published any regulation establishing a formal de minimis exception. To date, exceptions have been considered only for CDFIs receiving less than $50 million.

[108] The amount of capital available under the CDCI as a percentage of risk-weighted assets is greater than under the CPP. Under the CPP term sheet, "[e]ach [qualifying financial institution] may issue an amount of Senior Preferred equal to not less than 1 percent of its risk-weighted assets and not more than the lesser of (i) $25 billion and (ii) 3% of its risk weighted assets." U.S. Department of the Treasury, *Term Sheet for CPP Preferred*, at 1 (online at www.financialstability.gov/docs/CPP/termsheet.pdf). Treasury anticipates that the increased risk-weighted assets percentage under the CDCI (up to five percent) will allow CDFIs to leverage their capital, multiplying the amount of lending in low-income communities.

[109] U.S. Department of the Treasury, *CDCI FAQ Regarding Application Deadline* (online at www.financialstability.gov/docs/CDCI/CDCI%20FAQ%20Regarding%20Application%20Deadline.pdf) (accessed May 11, 2010).

In conversations with Panel staff, the American Bankers Association indicated that it has been in touch with some banks seeking to convert to CDFIs in order to take advantage of this program, and that the CDFIs are generally pleased with the terms of the new program, espe-

ury has projected that the CDCI will use $780.2 million of TARP funds. Treasury has noted that CDFIs are already meeting the Administration's lending objectives because they must conduct between 60 and 80 percent of their lending in low- and moderate-income communities in order to be certified as CDFIs.[110]

b. Supporting Secondary Markets

The government has developed numerous initiatives for supporting secondary lending markets. Secondary markets allow depository institutions either to sell or securitize loans, converting potentially illiquid assets into cash and shifting assets off their balance sheets.

i. Term Asset-Backed Securities Loan Facility (TALF)

Driven by the asset-backed securities (ABS) market freeze in the fall of 2008, the Federal Reserve and Treasury announced the creation of the Term Asset-Backed Securities Loan Facility (TALF) in late November 2008. The TALF was designed to promote renewed issuance of consumer and business asset-backed securities (ABS) at more normal interest rate spreads.[111] Every month, the FRBNY made loans to investors to purchase securities backed by certain classes of securities.[112] These securities were then pledged to the FRBNY as collateral.[113]

As of February 26, 2010, the TALF has supported the secondary market for 480,000 SBA-guaranteed loans to small businesses, 2.6 million auto loans, 876,000 student loans, over 100 million corporate and consumer credit card accounts, and 100,000 loans to larger businesses.[114] Since the TALF's inception, rate spreads for ABS have declined significantly (by as much as 75 percent on average), and some argue that the TALF has revitalized the

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cially because they feel they were left out of the previous TARP capital infusion initiatives. ABA conversations with Panel staff (Mar. 22, 2010).

[110] Treasury conversations with Panel staff (Feb. 2, 2010).

[111] Board of Governors of the Federal Reserve System, *Press Release* (Nov. 25, 2008) (online at www.federalreserve.gov/newsevents/press/monetary/20081125a.htm); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions* (Apr. 1, 2010) (online at www.newyorkfed.org/markets/talf_faq.html) (hereinafter "TALF: Frequently Asked Questions").

[112] Eligible classes of ABS include auto loans, student loans, credit card loans, equipment loans, floorplan loans, insurance premium finance loans, small business loans fully guaranteed as to principal and interest by the SBA, receivables related to residential mortgage servicing advances (servicing advance receivables) or commercial mortgage loans. During 2009, the program was expanded to allow investors to finance both existing and newly issued commercial mortgage-backed securities (CMBS).

[113] TALF: Frequently Asked Questions, *supra* note 111. The FRBNY is authorized to lend up to $200 billion in 3- or 5-year nonrecourse loans under this program, while Treasury agreed to commit as much as $20 billion of TARP funds as a backstop to defray the losses realized by the FRBNY if loan defaults occur. U.S. Department of the Treasury, *Consumer & Business Lending Initiative* (July 17, 2009) (online at www.financialstability.gov/roadtostability/lendinginitiative.html). As of May 5, 2010, Treasury had loaned $104 million to TALF. *See* Federal Reserve Bank of New York, *Factors Affecting Reserve Balances* (H.4.1) (May 6, 2010) (online at www.federalreserve.gov/releases/h41/Current/). For Treasury's backstop to be fully depleted and for FRBNY to incur any loan losses subsequently, however, posted collateral would need to decline in value by over one-third. *See* COP December Oversight Report, *supra* note 37, at 50.

[114] House Committee on Financial Services and House Committee on Small Business, Written Testimony of Elizabeth A. Duke, governor, Board of Governors of the Federal Reserve System, *Condition of Small Business and Commercial Real Estate Lending in Local Markets*, at 7 (Feb. 26, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/duke.pdf) (hereinafter "Elizabeth Duke Testimony before House Financial Services and House Small Business Committees"). *See also* TALF: Frequently Asked Questions, *supra* note 111.

securitization markets overall.[115] In a recent report, however, GAO noted that while market conditions for some TALF-eligible asset classes have seen some improvements, other asset classes, such as commercial mortgage-backed securities (CMBS),[116] remain weak, and their securitization markets are still fragile.[117] The TALF ceased making loans collateralized by newly issued and legacy ABS on March 31, 2010; loans collateralized by newly issued CMBS will end on June 30, 2010, unless the Federal Reserve Board extends the facility.[118]

ii. Public-Private Investment Program (PPIP)

Treasury announced the Public-Private Investment Program (PPIP) on March 23, 2009. PPIP is designed to allow banks and other financial institutions to shore up their capital by removing troubled assets from their balance sheets.[119] The PPIP creates public-private investment funds (PPIFs) financed by private investors, whose capital contributions are matched dollar-for-dollar by Treasury using TARP funds. The investment funds may also obtain debt financing from Treasury equal to the full value of the fund's capital investments. As of March 31, 2010, Treasury has committed approximately $30 billion to eight funds; approximately 88 percent of the PPIP portfolio holdings are non-agency residential mortgage-backed securities (RMBS),[120] and 12 percent are CMBS.[121]

Treasury has made very little information available about the PPIP. It is difficult to determine whether small and medium-sized banks have participated in this program by selling assets to the PPIFs, but it is likely that they have not.[122]

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[115] *See, e.g.*, Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 2; Elizabeth Duke Testimony before House Financial Services and House Small Business Committees, *supra* note 114, at 8.

[116] CMBSs are asset-backed bonds based on a group, or pool, of commercial real-estate permanent mortgages.

[117] Government Accountability Office, *Troubled Asset Relief Program: Treasury Needs to Strengthen its Decision-Making Process on the Term Asset-Backed Securities Loan Facility*, at 36–37 (Feb. 2010) (GAO–10–25) (online at www.gao.gov/new.items/d1025.pdf).

[118] Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions—Changes from February 17 FAQs* (Apr. 1, 2010) (online at www.ny.frb.org/markets/talf/faq_100401_blackline.pdf).

[119] U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Program, Program Update—Quarter Ended December 31, 2009* (Jan. 29, 2010) (online at www.financialstability.gov/docs/External%20Report%20_%2012_09%20FINAL.pdf). Although the PPIP, when announced, included both a legacy loans program and a legacy securities program, the legacy loan program has been postponed. U.S. Department of the Treasury, *Press Release* (Jul. 8, 2009) (online at www.financialstability.gov/latest/tg_07082009.html); Federal Deposit Insurance Corporation, *Press Release* (Jun. 3, 2009) (online at www.fdic.gov/news/news/press/2009/pr09084.html).

[120] RMBSs are asset-backed bonds based on a group, or pool, of residential real estate permanent mortgages.

[121] U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Program, Program Update—Quarter Ended March 31, 2010* (Apr. 20, 2010) (online at www.financialstability.gov/docs/External%20Report%20_%2003_10%20Final.pdf) (hereinafter "PPIP Program Update—Quarter Ended March 31, 2010").

[122] Treasury does not track PPIP purchases by institution size. However, some answers can be surmised. Larger banks are significantly more likely than small and medium-sized banks to hold secondary market securities on their balance sheets, limiting the exposure of smaller banks, in general, to these legacy assets. To date, as PPIP purchases have been only RMBS and CMBS, it is unlikely that smaller banks have participated in the program. *See* Independent Community Bankers of America (ICBA) conversations with Panel staff (Mar. 25, 2010); Rajeev Bhaskar, Yadav Gopalan, and Kevin L. Kliesen, *Commercial Real Estate: A Drag for Some Banks but Maybe Not for U.S. Economy,* The Regional Economist (Jan. 2010) (online at research.stlouisfed.org/publications/regional/10/01/commercial-real-estate.pdf). *See also* COP February Oversight Report, *supra* note 2, at 130.

iii. SBA 7(a) and 504 Securities Purchase Programs

In addition to the TALF, Treasury has allocated $15 billion of EESA funds for a program to make direct purchases of securities backed by the government-guaranteed portion of SBA 7(a) loans and the non-government-guaranteed first lien mortgage loans affiliated with the SBA's 504 loan program. As discussed above, prior to the fall of 2008, there was a healthy secondary market for the government-guaranteed portion of SBA 7(a) loans. In the fall of 2008, however, the secondary market for SBA 7(a) loans froze altogether.[123] Unable to shed the associated risk from their books, and free up capital to make new loans, commercial lenders significantly curtailed their SBA lending and other lending activities.[124] Treasury announced its SBA 7(a) initiative in March 2009 to help restart small business credit markets and provide an additional source of liquidity designed to foster new lending.[125]

Treasury has made $5.3 billion available for this direct purchase program. Despite stating that 7(a) and 504 purchases would begin by May 2009,[126] Treasury did not implement the program until March 19, 2010 (with purchases totaling $57.9 million of SBA 7(a) securities in trades that settled or are scheduled to settle on March 24 and May 28, respectively).[127] Treasury indicated that it started

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[123] *See* Section C.1, *supra,* for further discussion of the freezing of the credit markets in the fall of 2008.

[124] U.S. Department of the Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Oct. 19, 2009) (online at www.financialstability.gov/roadtostability/unlocking Credit for SmallBusinesses.html) (hereinafter "Fact Sheet: Unlocking Credit for Small Businesses"). Lenders sell their SBA loans into the secondary loan markets to provide an alternative funding source in addition to deposits and other funding sources, such as lines of credit and debt issuance proceeds. Lenders can thereby raise funds for additional lending, manage their liquidity needs, earn fees by servicing the sold loans, and avoid tying up capital. Although lenders' exposure to SBA-guaranteed loans is substantially reduced by participation in the SBA program, an inability to sell SBA loans to broker-dealers prevents the redeployment of generated capital to extend additional loans. Government Accountability Office, *Size of the SBA 7(a) Secondary Markets is Driven by Benefits Provided,* at 8 (May 1999) (GAO–99–64) (online at www.gao.gov/archive/1999/gg99064.pdf).

[125] As originally described, Treasury's 7(a) securities purchases will be guided by its financial agent, EARNEST Partners, an investment manager with SBA-guaranteed loan experience. U.S. Department of the Treasury, *Financial Agency Agreement for Asset Management Services for SBA Related Loans and Securities* (Mar. 16, 2009) (online at www.financialstability.gov/docs/ContractsAgreements/TARP%20FAA%20SBA%20Asset%20Manager%20__%20Final%20to%20be%20posted.pdf). While Treasury may purchase securities directly from "pool assemblers" and banks, it can accept or reject offers, depending on its evaluation (as assisted by the work of its investment manager) of the bids in the context of the current and historical market rates for SBA and other securities. Treasury has stated that it will purchase the securities at prices that will provide banks with liquidity for small business loans and protect the taxpayers' interest. Treasury conversations with Panel staff (Mar. 2, 2010); U.S. Department of the Treasury, *Unlocking Credit for Small Businesses: FAQ on Implementation* (Mar. 17, 2009) (online at www.financialstability.gov/docs/FAQ-Small-Business.pdf) (hereinafter "Unlocking Credit for Small Businesses: FAQ on Implementation").

[126] Government Accountability Office, *Troubled Asset Relief Program: One Year Later, Actions are Needed to Address Remaining Transparency, and Accountability Challenges,* at 79–80 (Oct. 8, 2009) (GAO–10–16) (online at www.gao.gov/new.items/d1016.pdf); Unlocking Credit for Small Businesses: FAQ on Implementation, *supra* note 125. Treasury had previously indicated that it would stand ready to purchase new securities backed by the guaranteed portions of 7(a) loans packaged between March and December 2009, providing "assurances to community banks and other lenders that they can sell the new 7(a) loans they make, providing them with cash they can use to extend even more credit." Fact Sheet: Unlocking Credit for Small Businesses, *supra* note 124. Treasury did not take these actions, however, due to the delay in commencing this program.

[127] U.S. Department of the Treasury, *Troubled Asset Relief Program: Transactions Report for Period Ended April 16, 2010,* at 29 (online at www.financialstability.gov/docs/transaction-reports/4-20-10%20Transactions%20Report%20as%20of%204-16-10.pdf). These transactions are backed by 90 small business loans across 30 states. Treasury conversations with Panel staff (Mar. 31, 2010).

to make purchases recently in light of the conclusion of the TALF and the uncertainty surrounding the extension of certain American Recovery and Reinvestment Act (ARRA) provisions related to small businesses (and in particular, the government's 90 percent guarantee of SBA-backed loans).[128] Treasury believes that the direct purchase program will allow it to have a program ready if the small business lending market dips because of the TALF's conclusion. As this program is still in its early stages, its eventual size remains unclear, but Treasury notes that it is launching this program with a "buy-and-hold" strategy and with the intent to provide liquidity in, but not dominate, the market. At present, Treasury states that it does not intend to target a certain number of trades, but will continue to make purchases going forward and intends to purchase different types of securities. Treasury is still in the process of formulating specific metrics to evaluate its effectiveness, but notes that it continues to monitor closely the health of the secondary market and has regular conversations with its financial agent regarding current market conditions.[129] Treasury has to date not made any purchases of 504 first-lien mortgage securities under this program and has no present plans to make such purchases.[130]

This program raises a variety of issues, including whether there is a need to purchase these securities (the market may be restarting on its own)[131] and whether the program will affect access to credit for small businesses in a meaningful manner, because only a small fraction of small business loans—approximately three to four percent—are guaranteed through the SBA's 7(a) program.[132] In addition, while 40–45 percent of 7(a) loans have been securitized historically, very few non-SBA small business loans are securitized (due to a lack of documentation and data on their performance),[133] limiting the effectiveness of a secondary-market-driven program. Accordingly, the Panel concluded in its May 2009 oversight report that any program targeted at restarting the secondary market for securities backed by SBA loans, no matter how well designed or successful, could only have a limited impact in addressing the overall credit concerns of America's small businesses.[134] Treasury acknowledges that SBA loans are a comparatively small piece of small business financing and that its SBA purchase program is not the most important component of the government's package of assistance to small businesses. Treasury believes it is nonetheless

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[128] Treasury conversations with Panel staff (Mar. 31, 2010). *See* Section D.2(c)(ii), *supra* (discussing the 90 percent guarantee).

[129] Treasury conversations with Panel staff (Mar. 2, 2010).

[130] Treasury conversations with Panel staff (Apr. 29, 2010).

[131] *See, e.g.*, Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98.

[132] *See* Section B.2, *infra*.

[133] *See* Congressional Oversight Panel, *May Oversight Report: Reviving Lending to Small Businesses and Families and the Impact of the TALF*, at 50–58 (May 7, 2009) (online at cop.senate.gov/reports/library/report-050709-cop.cfm) (hereinafter "COP May Oversight Report") (citing Devon Pohlman, Federal Reserve Bank of Minneapolis, *With Support, Securitization Could Boost Community Development Industry* (Nov. 2004) (online at www.minneapolisfed.org/publications__papers/pub__display.cfm?id=2416)). *See also* Ron J. Feldman, Federal Reserve Bank of Minneapolis, *An Update on the Securitization of Small Business Loans* (Sept. 1997) (online at www.minneapolisfed.org/publications__papers/pub__display.cfm?id=3632) (stating that "the heterogeneity of small business loans has made it difficult for a firm to act as a conduit to the securitization market for small business lenders"); Kenneth Temkin and Roger C. Kormendi, U.S. Small Business Administration, *An Exploration of a Secondary Market for Small Business Loans*, at 6 (Apr. 2003) (online at www.sba.gov/advo/research/rs227__tot.pdf).

[134] COP May Oversight Report, *supra* note 133, at 19, 57–58.

useful to provide a flexible backstop for the secondary market for SBA loans.[135]

iv. Fannie Mae and Freddie Mac

Fannie Mae (Fannie) and Freddie Mac (Freddie) are government-sponsored enterprises (GSEs) that were chartered by Congress with a mission to provide liquidity, stability, and, affordability to the U.S. housing and mortgage markets. Fannie and Freddie operate in the U.S. secondary mortgage market by purchasing and securitizing mortgages, rather than making direct mortgage loans.[136]

The features of the GSEs' government charters (e.g., a line of credit with Treasury, public mission requirements, limited competition, lower capital requirements) created a perception of a government guarantee, and resulted in Fannie and Freddie becoming significantly overleveraged and undercapitalized. In 2008, Fannie and Freddie reported combined losses in excess of $108 billion.[137] The Federal Housing Finance Agency (FHFA) placed Fannie and Freddie into conservatorship on September 6, 2008, and they continue to function as government-backed enterprises.[138]

Fannie's and Freddie's securitization and guarantee functions have long played a dominant role in housing finance, but this role has increased as a result of the recent lack of private capital in the mortgage origination market.[139] In early February 2010, Fannie announced plans to increase substantially its "purchases of delinquent loans from single-family [mortgage-backed securities] trusts," while Freddie announced plans to purchase "substantially all" loans that are 120 or more days delinquent.[140] By purchasing and

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[135] Treasury conversations with Panel staff (Mar. 31, 2010).

[136] Congress established Fannie in 1938 to create a secondary market for FHA-insured loans, but its charter was amended in 1954 so that it could focus on the secondary market more generally. In 1970, Congress established Freddie as a new government-chartered entity to provide an additional source of liquidity for mortgage loans. *See* Analytical Perspectives: 2011 Budget, *supra* note 75, at 349.

[137] Federally regulated banks must hold four percent capital against their mortgages, but Fannie and Freddie were required to hold only 2.5 percent capital against their on-balance sheet mortgage portfolio, and only 0.45 percent against mortgages they guaranteed. *See* House Committee on Financial Services, Written Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *Housing Finance-What Should the New System Be Able to Do?: Part I-Government and Stakeholder Perspectives,* at 8–11 (Mar. 23, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/testimony_–_geithner.pdf) (hereinafter "House Financial Services Testimony of Timothy Geithner") (discussing the role of the GSEs, their collapse, and placement into conservatorship).

[138] In connection with the GSEs being placed into conservatorship, Treasury agreed to provide financial support to the GSEs through the establishment of Preferred Stock Purchase Agreements. In December 2009, Treasury decided to replace the $200 billion cap on Treasury's funding commitment to each GSE with a formulaic cap that increases above $200 billion by the amount of any losses and decreases by any gains (but not below $200 billion), which will become permanent at the end of three years. *See* Analytical Perspectives: 2011 Budget, *supra* note 75, at 350.

[139] In 2009, Fannie and Freddie "provided approximately 72 percent of all the liquidity to the single-family mortgage market and approximately 80 percent of the liquidity to the multifamily market," purchasing or guaranteeing $823.6 billion and $548 billion, respectively, in mortgage loans and mortgage-related securities. Freddie Mac, *Supporting the Nation's Housing Recovery* (online at www.freddiemac.com/corporate/company_profile/FM_housing_crisis.html) (accessed May 7, 2010); Fannie Mae, *Mission Performance Report,* at 3 (Mar. 2010) (online at www.fanniemae.com/media/pdf/2010/mission-performance-report.pdf); House Financial Services Testimony of Timothy Geithner, *supra* note 137, at 11 (noting that the GSEs financed or guaranteed "just under 40 percent" of new single-family mortgage originations in 2006; the increased role in 2009 is a result of the "near complete absence of private capital in the mortgage origination market").

[140] Fannie Mae, *Fannie Mae to Purchase Delinquent Loans from Single-Family MBS Trusts* (Feb. 10, 2010) (online at www.fanniemae.com/newsreleases/2010/

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securitizing mortgage loans, Fannie and Freddie shore up the balance sheets of financial institutions, theoretically helping banks redeploy capital and extend new credit to households and businesses.

c. Guarantee Programs[141]

The third category of government crisis programs involves guarantees.[142] Unlike direct capital infusions, guarantees do not require the immediate outlay of cash (and if the guarantees expire without having been triggered, cash may never be needed). Their main purposes are to reduce the risk associated with potential payment defaults and to encourage lenders and investors to risk their money in distressed and uncertain markets. By ensuring that the government will at least partially absorb losses, guaranteeing liabilities or backstopping losses on assets can help establish financial stability and calm the financial markets. During the financial crisis, the federal government dramatically expanded its role as a guarantor.

i. Temporary Liquidity Guarantee Program (TLGP)

The FDIC created the Temporary Liquidity Guarantee Program (TLGP) in October 2008 in order to provide liquidity in the interbank lending market and restore confidence in banks and other financial institutions. The program has two aspects: (1) the Debt Guarantee Program (DGP), which guarantees newly issued senior unsecured debt of insured depository institutions and most U.S. bank holding companies; and (2) the Transaction Account Guarantee Program (TAG), which guarantees certain noninterest-bearing transaction accounts at insured depository institutions.[143] Under the DGP, upon the uncured failure of a participating institution to make a scheduled payment of principal or interest, the

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4938.jhtml?p=Media&s=News+Releases); Freddie Mac, *Freddie Mac to Purchase Substantial Number of Seriously Delinquent Loans From PC Securities* (Feb. 10, 2010) (online at www.freddiemac.com/news/archives/mbs/2010/20100210_pc_securities.html). As discussed above, mortgage-backed securities are asset-backed bonds based on a group, or pool, of residential or commercial permanent mortgages.

[141] The guarantee programs discussed in this section are not TARP initiatives, but rather come from a variety of non-Treasury government actors. *See, e.g.,* Federal Deposit Insurance Corporation, *Temporary Liquidity Guarantee Program* (online at www.fdic.gov/regulations/resources/tlgp/index.html) (accessed May 7, 2010); The White House, *FAQs for Citizens* (online at www.recovery.gov/FAQ/Pages/ForCitizens.aspx) (accessed May 7, 2010).

[142] While the Panel's discussion of guarantees focuses on several guarantee programs, the Panel notes that various forms of guarantee programs were used by the federal government during the financial crisis. For example, under the Asset Guarantee Program (AGP), Treasury, the FDIC, and the Federal Reserve guaranteed, until the program was ended in December 2009, approximately $250.4 billion of Citigroup's assets. The guarantee, originally for $301 billion, followed a continued deterioration of Citigroup's financial status after it received CPP funds. In addition, through the Temporary Guarantee Program for Money Market Funds (TGPMMF), Treasury reassured anxious investors by guaranteeing that money market funds would not fall below $1.00 per share. *See* COP January Oversight Report, *supra* note 65, at 49.

[143] Final Rule: Temporary Liquidity Guarantee Program, 12 CFR 370, 73 Fed. Reg. 72244 (Nov. 26, 2008) (online at www.fdic.gov/news/board/08BODtlgp.pdf). In the fall of 2008, the FDIC issued a six-month extension of the TAG until June 30, 2010. Insured depository institutions participating in the extended TAG are subject to higher fees. All insured depository institutions participating were able to opt out of the extension. All eligible institutions were automatically enrolled in the DGP, but had until December 5, 2008 to opt out if they did not want to participate. "Eligible institutions" are FDIC-insured depository institutions, U.S. bank holding companies, U.S. financial holding companies, U.S. savings and loan holding companies, and affiliates of insured depository institutions. The FDIC-insured branches of foreign banks were not included. 12 CFR §370.2(a)(1).

FDIC pays the unpaid amount and then makes the scheduled payments of principal and interest through maturity.[144]

Approximately 6,500 financial institutions, mostly smaller institutions, chose to opt out of the DGP, largely because smaller banks do not typically issue debt, so the program was functionally irrelevant to them.[145] As March 31, 2010, 32 insured depository institutions with $10 billion or less in assets had a total of $1.6 billion in debt outstanding under the DGP, as compared to $305.4 billion in total outstanding debt for all issuers.[146] The DGP therefore appears to have had little impact on smaller banks. While the TAG applied to all depository institutions and likely encouraged some depositors to keep their noninterest-bearing transaction accounts in banks, its particular impact on smaller banks is difficult to determine.

ii. Increased Government Guarantee on SBA 7(a) Loans

Finally, as part of its Small Business and Community Lending Initiative, the Administration has encouraged lending institutions to participate in SBA programs. The ARRA includes a provision that reduces the risk to private lenders by temporarily increasing the government guarantee on loans issued through the SBA's 7(a) loan program to as much as 90 percent.[147] According to SBA, this

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[144] 12 CFR §370.3(a). The program did not guarantee debt of less than 30 days' maturity or debt maturing after June 30, 2012 (as debt maturing after June 30, 2012 was considered long-term non-guaranteed debt). While the DGP closed to new debt issuances on October 31, 2009, the FDIC will continue to guarantee debt issued prior to that date until the earlier of its maturity or June 30, 2012. The DGP was originally set to expire on June 30, 2009, but the FDIC extended it to October 31, 2009. The FDIC also established a six-month emergency guarantee facility to be made available to insured institutions and other participants in the DGP, but it is only available to institutions that cannot issue debt without the guarantee, and carries significantly higher fees. *See* Federal Deposit Insurance Corporation, *Extension of Temporary Liquidity Guarantee Program* (Mar. 18, 2009) (online at www.fdic.gov/news/news/financial/2009/fil09014.html); Federal Deposit Insurance Corporation, *Expiration of the Issuance Period for the Debt Guarantee Program, Establishment of Emergency Guarantee Facility* (online at www.fdic.gov/news/board/NoticeSept9no6.pdf) (accessed May 7, 2010).

[145] *See, e.g.,* Federal Deposit Insurance Corporation, *List of Entities Opting Out of the Debt Guarantee Program* (Dec. 8, 2009) (online at www.fdic.gov/regulations/resources/TLGP/optout.html).

[146] Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Apr. 16, 2010) (online at www.fdic.gov/regulations/resources/tlgp/total_issuance03-10.html).

[147] *See* SBA Recovery Act FAQs, *supra* note 90. Prior to this increase, the guarantees were for up to 85 percent for loans at or below $150,000, and up to 75 percent for larger loans. *See* note 80, *supra.*

ARRA also includes other provisions targeted at small businesses, such as a provision authorizing the SBA to make low-interest loans to systemically important secondary broker-dealers who pool SBA loans to sell into the secondary market; a provision temporarily waiving up-front fees that the SBA charges on 7(a) loans that increase the cost of credit for small businesses; and a provision temporarily eliminating certain fees typically charged on 504 loans. The fee waivers were made retroactive to the enactment of the ARRA on February 17, 2009. The legislation also cut taxes for small businesses, permitting them to write off more of their expenses and to earn an instant refund on their taxes by "carrying back" their losses five years instead of two.

Under ARRA, the SBA received $730 million, which included $375 million to increase the SBA guarantee on 7(a) loans to 90 percent and to waive borrower fees on most 7(a) and 504 loans. Those funds expired on November 23, 2009, and an additional $125 million appropriation was provided in December 2009, as well as authority to continue both programs through February 2010. These funds expired in late February 2010. On March 2, 2010, President Obama signed legislation authorizing an additional $60 million for the program and extending until March 28, 2010 ARRA's fee relief and enhanced guarantee provisions. On March 26, 2010, President Obama authorized an additional $40 million and signed another extension of the special ARRA provisions through April 30, 2010. On April 15, 2010, the President authorized an additional $80 million and signed a fourth extension through May 31, 2010. U.S. Small Business Administration, *SBA Recovery Lending Extended Through May* (Apr. 16, 2010) (online at www.sba.gov/idc/groups/public/documents/sba-homepage/news-release-10-15.pdf).

enhancement (combined with other ARRA small business enhancements) has reduced operating costs for small business owners and brought lenders back to SBA loan programs.[148]

3. Other Programs

Many state and local entities have programs to support small business lending within their geographic boundaries. These programs generally mirror, on a smaller scale, tools employed by SBA, including both direct lending and loan guarantees.[149] State and local programs serve a similar policy goal, as well—to facilitate credit for borrowers who cannot otherwise obtain credit from private lending sources. If, moving forward, increased loan demand exposes a "structural shortfall in supply," as some market participants suggest, state and local programs may provide an effective complement to Treasury's strategy.[150] Treasury has indicated its openness to tap the existing infrastructure and expertise of state and local entities in this regard.[151] For a discussion of state programs created or expanded to address the contraction in small business lending, *see* Annex II.

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[148] U.S. Small Business Administration, *Extension of SBA Recovery Lending Programs Will Support $1.8 Billion in Small Business Lending* (Mar. 4, 2010) (online at www.sba.gov/idc/groups/public/documents/sba_homepage/news_release_10_06.pdf) ("The increased guarantee and reduced fees on SBA loans helped put almost $22 billion into the hands of small business owners and brought more than 1,100 lenders back to SBA loan programs. As a result, average weekly loan approvals by SBA have climbed by 87 percent compared to the weekly average before passage of the Recovery Act"); House Committee on Financial Services and House Committee on Small Business, Written Testimony of Karen G. Mills, administrator, U.S. Small Business Administration, *Condition of Small Business and Commercial Real Estate Lending in Local Markets,* at 1 (Feb. 26, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/mills.pdf).

In addition to continuing to call for a permanent increase in the maximum loan sizes for the SBA's 7(a) and 504 programs, the Administration has also recently announced two new small business lending legislative proposals: a refinancing program for small business owner-occupied commercial real estate and an expanded working capital loan program. The CRE refinancing initiative would temporarily expand the SBA's existing 504/CDC program to support refinancing for small business owner-occupied CRE loans that are maturing in the next few years. The working capital loan program would temporarily raise the cap on SBA Express loans from $350,000 to $1 million in order to allow expanded access to working capital. U.S. Small Business Administration, *Fact Sheet: Administration Announces New Small Business Commercial Real Estate and Working Capital Programs,* at 2–3 (Feb. 5, 2010) (online at www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf).

Furthermore, President Obama recently signed an executive order promulgating the Administration's National Export Initiative, which is designed to increase access to trade financing for businesses, with a new $2 billion per year effort to increase support for small- and medium-sized businesses. The White House, *President Obama Details Administration Efforts to Support Two Million New Jobs by Promoting New Exports* (Mar. 11, 2010) (online at www.whitehouse.gov/the-press-office/president-obama-details-administration-efforts-support-two-million-new-jobs-promoti).

[149] Senate Committee on Small Business and Entrepreneurship, *What Works for Small Businesses* (2008 Edition).

[150] Senate Banking, Housing, and Urban Affairs, Subcommittee on Economic Policy, Written Testimony of Raj Date, chairman and executive director, Cambridge Winter Center for Financial Institutions Policy, *Restoring Credit to Main Street: Proposals to Fix Small Business Borrowing and Lending Problems,* at 1 (Mar. 2, 2010) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6f18ee9b-ee97_49db_86b4_07d8983198ab) (hereinafter "Testimony of Raj Date before the Senate Banking Committee"). *See* Federal Reserve Bank of Atlanta, *Small Business Survey* (Apr. 2010) (hereinafter "Federal Reserve Bank of Atlanta Small Business Survey").

[151] Treasury conversations with Panel staff (Apr. 14, 2010).

E. Examining the Continued Contraction in Lending

1. What's Going Wrong? Supply, Demand, and Regulation Arguments

Low lending levels can be difficult to analyze, as numerous factors—bank strength or weakness, number of creditworthy borrowers, soft demand for goods and services, and deleveraging, among other things—can all contribute in varying ways to lending levels. Further, the relative importance of these factors in the overall mix can shift over time, as demand and supply shift and interact.

a. Demand-based Arguments

i. Need for Credit: Sales

For many industries, demand for credit is a reflection of sales. A sale can necessitate credit to cover increased expenses during the period after the sale has been made but before payment has been received. For example, a manufacturing company would need to buy materials and produce goods to fill an order before payment for the order has been received. A company may need to hire additional staff to meet demand and may need to pay the new employees' salaries for several pay periods before the new employees begin to generate new revenue. This dynamic, of course, also applies in the contrary situation: low demand for a business's goods or services is likely, in turn, to decrease that business's demand for credit.

Some element of the current low lending levels is likely attributable to low demand for sales. According to a survey by the NFIB, access to credit is not the primary concern of small businesses at this time. Only eight percent of those surveyed identified access to credit as their most pressing concern, although, of course, these respondents may nonetheless have sought credit during this period.[152] The primary concerns, according to the survey, were lack of sales (50 percent) and uncertainty about the economy (22 percent).[153] The Federal Reserve Bank of Atlanta (FRBA) has also recently completed a survey of small businesses, seeking information about their borrowing experiences since the start of the recession.[154] Approximately 25 percent of FRBA small firm respondents that had not applied for credit in the last three months cited as one reason, among other listed options, that sales/revenue did not warrant it.[155] Such concerns, common in the midst of any recession, will necessarily depress demand for credit.

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[152] Small Business Credit in a Deep Recession, *supra* note 18, at 1.

[153] Small Business Credit in a Deep Recession, *supra* note 18, at 1. The survey did not ask whether access to credit was a concern at all; it asked only whether access to credit was a business's "primary" concern. It is therefore possible that more than eight percent of respondents were concerned about credit but had other, more pressing concerns that they identified as "primary."

[154] Federal Reserve Bank of Atlanta Small Business Survey, *supra* note 150. The survey collected responses from 267 firms in the real estate, construction, retail, manufacturing, service, and other industries in the Federal Reserve Bank Sixth district. The majority of firms had fewer than 250 employees, and annual revenues of less than $5 million. Approximately one third of participating firms had less than $1 million in annual revenues. The survey did not have start-up respondents.

[155] Respondents were able to "check all that apply." Other reasons cited were: credit terms offered by lenders will be unfavorable, sufficient cash on hand, existing line of credit meets needs, do not think lenders will approve request, will not need credit, and other. Of these, the

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Information provided by the banks themselves reflects similar conditions. The Federal Reserve's Survey of Senior Loan Officers from the last quarter of 2009 reported that, overall, demand for commercial and industrial loans was flat or down in that quarter,[156] and that a majority of survey respondents at domestic banks that saw decreased demand attributed it to a decreased need for inventory financing and accounts receivable financing,[157] both of which suggest low sales volumes. The most recent report, covering the first quarter of 2010, showed demand to be flat overall.[158] In addition to the above factors, in the first quarter of 2010, a majority of respondents also attributed flat demand to decreased customer investment in plant or equipment and an increase in customer internally generated funds.[159] Furthermore, recessions are typically accompanied by broad deleveraging,[160] which suggests that a decrease in loan demand is to be expected.

ii. Desire for Credit: Creditworthiness and the "Discouraged Borrower"

In his testimony before the Panel last month, FDIC San Francisco Regional Director Stan Ivie noted that "our community banks [that have sufficient capital] clearly want to lend, but the demand is not there from the creditworthy borrowers. It seems like the healthy borrowers who could borrow are not interested in borrowing at this time."[161] In this light, low demand can also be attributable to several different borrower characteristics. Borrowers may be healthy and uninterested in credit, unhealthy and interested in credit but unable to meet requirements, or, finally, may be the so-called "discouraged" borrowers: would-be borrowers who do

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preponderance of the responses were concentrated in the following categories (in descending order): sufficient cash on hand, sales/revenue, existing line of credit meets needs and will not need credit. The next most common category was "do not think lenders will approve request," discussed further below, followed by "credit terms unfavorable," and "other."

[156] January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 15, at 11, 23.

[157] January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 15, at 11, 26 (67 percent of respondents stated that "customer inventory financing needs decreased" was "somewhat important" to weaker loan demand, and 10 percent stated that it was "very important"; 81 percent stated that "customer accounts receivable financing needs decreased" was "somewhat important"; and 10 percent said it was "very important"; 57 percent said that the factor of "customer investment in plant or equipment decreased" was "somewhat important," and 38 percent said it was "very important"; and 52 percent said that the factor of "customer internally generated funds increased" was "somewhat important," and 10 percent said it was "very important").

[158] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 11, 23 (showing that 64 percent of banks report that demand for C&I loans from large and mid-size firms was "about the same" since the last quarter, and 68 percent report that demand for C&I loans from small firms was also "about the same" since the last quarter).

[159] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 11, 26.

[160] McKinsey & Co., *Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences*, at 13 (Jan. 2010) (online at www.mckinsey.com/mgi/reports/freepass_pdfs/debt_and_deleveraging/debt_and_deleveraging_full_report.pdf) (noting that "empirically . . . deleveraging has followed nearly every major financial crisis in the past half-century").

[161] Congressional Oversight Panel, Testimony of Stan Ivie, San Francisco regional director, Federal Deposit Insurance Corporation, *Transcript: Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-042710-phoenix.cfm) (hereinafter "Testimony of Stan Ivie"). Mr. Ivie also noted, however, that "many banks have financial difficulties right now with their credit quality and they need to reserve their capital for losses and future losses which results in less capital and liquidity to lend . . . to borrowers." *Id.* In the FRBA study, those firms that had not applied for credit in the three months before the survey cited, in order (high to low), sufficient cash on hand, sales/revenue, existing line of credit meets needs, will not need credit, do not think lenders will approve request, credit terms unfavorable, and other as their reasons for not applying. *See* note 154, *supra*.

not seek credit because they believe (rightly or wrongly) that they would not be approved if they applied. According to the NFIB survey, eight percent of respondents fit into the category of discouraged borrowers: five percent of respondents sought no credit because of fear of rejection. Of those who did seek credit, 35 percent sought less than they wanted because they did not believe they would be approved. Approximately 15 percent of respondents across various industries in the FRBA survey who did not apply for credit cited a belief that they would not be approved as one reason for failing to seek it.[162] It is not clear how many of those who were denied credit might have obtained financing in a better economy, or how many "discouraged borrowers" may have actually been extended credit had they sought it.[163] It is also unclear how many of these would-be borrowers were creditworthy and therefore actually eligible for financing: put another way, their concerns may have been well-founded. A small business may therefore state that it is interested in receiving credit, but if that business does not apply for financing, it does not create measurable demand for loans.

Finally, in addition to those businesses that are not seeking loans (either because they do not need them or do not believe they will receive them), there are businesses that have sought credit, but have been in some fashion disappointed in their efforts. To the extent that a would-be borrower is an attractive applicant but cannot obtain financing, that suggests there is a problem with capital supply. To the extent, however, that the would-be borrower is not an attractive credit risk, that may support an argument regarding a lack of demand. Although only a small percentage of those surveyed by the NFIB cited access to credit as their largest business concern, this figure does not indicate how many of those particular respondents may have sought and been denied credit. According to the NFIB survey, 55 percent of respondents sought credit in 2009.[164] Of those, 60 percent were not able to meet all of their credit needs, and 23 percent were unable to meet any of their credit needs.[165] In the FRBA survey, only about one third of respondents reported that they had sought credit in the past three months. Of those who sought credit, 39 percent were denied, and another 20 percent received less than they had requested. Thirty-six percent received the full amount requested. In this environment,

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[162] The survey permitted respondents to mark "all that apply." Potential borrowers may also be unaware that some banks are still looking to make loans. At the Panel's hearing in Phoenix, the president of a small local bank expressed concerns about notifying potential borrowers that her bank was in a position to lend: "We don't have the distribution center necessarily to get out there. We don't have large advertising budgets . . . So I think that's part of the issue, as well, is just getting the word out there that we are looking." Testimony of Candace Wiest, *supra* note 65.

[163] The FRBA survey also found that a small number—13 out of 267 respondents—stated that they had not applied for credit in the last three months because they believed that the terms on which the credit would be offered would be unfavorable, while 25 out of 267 respondents did not apply for credit because they feared they would be rejected. The survey permitted respondents to "check all that apply," and therefore there may be overlap between these and the other available choices. Federal Reserve Bank of Atlanta Small Business Survey, *supra* note 150, at 48.

[164] Small Business Credit in a Deep Recession, *supra* note 18, at 1.

[165] In comparison, a survey of small and mid-sized businesses by the National Small Business Association (NSBA) found that 70 percent of respondents were able to obtain "adequate" financing in 2008 and that 67 percent of respondents in the 2007 survey said the same. National Small Business Association, *2008 Survey of Small and Mid-Sized Business* (2008) (online at www.nsba.biz/docs/2008bizsurvey.pdf).

therefore, seeking credit may not necessarily meet with all or even partial success.

iii. Borrower Condition

In addition to soft demand for goods and services, borrowers themselves may not be in a position to borrow. Discussions of credit demand typically focus on demand by creditworthy loan applicants. But many small businesses, even those that have weathered the recession, have nonetheless been battered by it. Generally, banks require small businesses to show revenues that have increased quarter after quarter before they are willing to extend credit. Some businesses have had their credit damaged, but even a business owner with perfect credit may have a weak balance sheet showing sales that are at best flat but are more likely to be trending downward.[166]

Additionally, there may be other pressures on small businesses that depress demand. Some small businesses may use real estate—either the owner's residence, the business premises, or some other property—as collateral for commercial credit. Severely depressed real estate prices across the country have impacted the quality of businesses' balance sheets and have decimated businesses' ability to provide sufficient collateral to obtain the credit they need.[167] Furthermore, to the extent a mortgage is underwater, a business owner may lose additional flexibility inasmuch as he or she may not be able to sell the property to pay off a loan or relocate, or may not be able to sell one piece of property to buy another. Finally, demand for credit may also be affected by tax or regulatory concerns, although each individual business may be affected differently. When decreased cash flow results from tax increases, it could decrease the ability of firms to borrow, because they have less cash available for servicing a debt.[168]

As stated above, however, the elements of low lending levels may shift over time. Although demand has, overall, been down in the last year, there are indications that many business owners have at least started thinking about borrowing again. According to the American Bankers Association (ABA), some of its members have reported an increase in inquiries from small business owners about the availability and terms of loans.[169] These inquiries have not

[166] It is, furthermore, impossible to determine how many businesses were never established because of the recession. For example, many start-up businesses have traditionally used home equity loans to fund the first few years of their existence. This market, however, has almost entirely dried up since the start of the crisis. *See* Section B.2, *supra*.

[167] Some small businesses may argue that a business today with flat, or even slightly depressed, sales is a very sturdy business since only the most stable enterprises were able to pass through 2009 and remain standing. Banks argue, however, that they are not venture capitalists: they do not invest in businesses but make loans and so want there to be sufficient sales and collateral to ensure the loan is repaid. *See* Philadelphia Business Journal, *Business Lending Tougher* (July 11, 2008) (online at www.bizjournals.com/philadelphia/stories/2008/07/14/story2.html) (quoting William Dunkelburg, Professor of Economics at Temple University and Chairman of Liberty Bell Bank: "banks are not venture capitalists. If there's no collateral or business history, they are supposed to be judicious and make low-risk loans").

[168] Small businesses can also face disproportional regulatory compliance costs. *See* Small Business Economy Report, *supra* note 13, at 38–39 ("small businesses face disproportionately higher costs per employee than their larger counterparts in complying with federal regulations").

[169] ABA conversations with Panel staff (Mar. 22, 2010); Senate Committee on Banking, Housing and Urban Affairs, Written Testimony of Arthur C. Johnson, chairman and chief executive officer, United Bank of Michigan, on Behalf of the American Bankers Association, *Restoring Credit to Main Street: Proposals to Fix Small Business Borrowing and Lending Problems*, at 5 (Mar. 2, 2010) (online at banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=745bbf42-ab72-45de-90d2-17ab8af2aaeb&Witness_ID=9308a897-6f34-402b-a772

yielded an increase in demand for actual loans,[170] and the latest Senior Loan Officer Survey showed inquiries to be flat in the most recent quarter,[171] but the National Small Business Association (NSBA) and the NFIB have both stated that they expect their members to see increased sales this year and in 2011.[172] One expert has testified that:

> [o]ver the coming quarters . . . the binding constraint on small business lending will shift from a deficit of demand, to a deficit of supply. As the real economy begins to recover, we should expect demonstrably credit-worthy small business owners to begin to demand credit in greater amounts. As that demand materializes, however, it is quite possible that it will go unmet by the financial system. Indeed, it seems likely that the threat of a shortfall of credit supply will be more pronounced in small business than anywhere else in the credit markets.[173]

Many respondents to the FRBA survey also stated that they would seek credit in the near future to fund business expansion. Mr. Ivie has similarly testified before the Panel that the lack of demand from qualified borrowers is "a confidence issue and once we see the economy start to recover and employment start to recover, then I think the businesses will be more willing to borrow."[174] If demand increases, and small firms are unable to obtain needed credit to keep pace with an improving economy, it could impair the ability of these companies to contribute to our nation's overall recovery. Should businesses see sales improve in late 2010 or 2011, strong credit markets will be essential for this uptick in sales to translate into improvement in the economy overall, and the next question must be whether, under current conditions, there would be sufficient supply to meet a potential increase in demand.

b. Supply-side Arguments: Lenders

If there is an increase in demand, it is not clear that the banks are ready to meet it. Like the small business owners who responded to the NFIB survey, many of the banks that responded to the Survey of Senior Loan Officers cited uncertainty about the economy as a key concern. Overall, the banks that responded to the Federal Reserve survey did not tighten credit in the quarter ended March 31, 2010, although the majority of these banks had already undergone significant tightening of their credit standards in the first two quarters of 2009, most of which has not yet been unwound.[175] Of the respondents who stated that their credit standards had tightened in the first quarter of 2010, 62 percent said that "less favorable or more uncertain economic outlook" was "somewhat important," and another 19 percent said that it was "very impor-

-e512c6240a24) (noting that demand for small business loans has fallen "dramatically" since the start of the recession).

[170] ABA conversations with Panel staff (Mar. 22, 2010).

[171] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 11, 28.

[172] NSBA conversations with Panel staff (Mar. 24, 2010); NFIB conversations with Panel staff (Mar. 22, 2010).

[173] Testimony of Raj Date before the Senate Banking Committee, *supra* note 150, at 3.

[174] Testimony of Stan Ivie, *supra* note 161.

[175] Elizabeth Duke Testimony before House Financial Services and House Small Business Committees, *supra* note 114.

tant."[176] Additionally, 87 percent said that "reduced tolerance for risk" was at least "somewhat important."[177] In contrast, decreased liquidity in secondary markets for these loans, defaults by borrowers in public debt markets, deterioration in their bank's current or expected capital position, and deterioration in their bank's current or expected liquidity position were not cited as particularly important factors.[178]

There is also the problem of the health of the banks themselves. In a stable economy, banks will extend credit and seek a risk-adjusted rate of return.[179] But in the current environment, many banks have suffered from increased loan defaults and, as a result, have insufficient capital to make additional loans.[180] Raising capital, however, has been difficult in the last year, even for healthy banks, given the scarcity of capital and the uncertainty that has clouded any predictions about the entire sector. These uncertainties include interest rate risk, unrealized losses, and the prospect of tighter capital requirements, among other things.[181] Not only does such uncertainty make raising capital difficult, it also may lead banks to conserve capital instead of making loans. The difficulty in raising capital is underscored by the sector's instability, highlighted in a recent statement by FDIC Chairman Sheila Bair, who recently said she believed that "we'll go above the 2009 level [of 140 bank failures], but that bank failures will peak this year. The institutions by asset size might be a little smaller, but there will be more of them."[182]

At present, there are more than 700 banks on the FDIC's "watch list." The commercial real estate sector also poses a problem for banks and particularly for community banks, whose portfolios hold a much larger share of such loans than large banks.[183] The sec-

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[176] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 11, 17.

[177] January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 15, at 11, 17 (50 percent said "somewhat important" and 37 percent said "very important"). These numbers reflect a less optimistic outlook than those from the Senior Loan Officer Opinion Survey for the last quarter of 2009. According to that survey, of the banks that tightened lending standards, only nine percent cited "less favorable or more uncertain economic outlook" as a very important factor, and 27 percent cited "reduced tolerance for risk" as a very important factor.

[178] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 11, 17. (56 percent of respondents said that decreased liquidity in secondary markets was "not important," 87 percent said increased defaults were not important, 91 percent said deterioration in their bank's current position was "not important," and 75 percent said deterioration in their bank's current or expected capital position was "not important").

[179] *See* Section B, *supra* (describing the growth in credit over the early part of the last decade).

[180] Elizabeth Duke Testimony before House Financial Services and House Small Business Committees, *supra* note 114, at 3 (noting that "for most commercial banks, the quality of existing loan portfolios continues to deteriorate even as levels of delinquent and nonperforming loans remain on the rise. Throughout 2009, loan quality deteriorated significantly for both large and small banks, and the latest data from the fourth quarter indicate continuing elevated loss rates across all loan categories").

[181] *See* Section F.3(a), *infra.*

[182] Janet Morrissey, *FDIC's Sheila Bair on Bank Failures and Too-Big-To-Fail*, Time (Apr. 9, 2010) (online at www.time.com/time/business/article/0,8599,1978560,00.html) (quoting Chairman Bair). This level is still lower than peak failures in 1988 and 1989, but is nonetheless much higher than the period from 1989 to the present, or than the decades preceding the late 1980's. *See* Federal Deposit Insurance Corporation, *Failures and Assistance Transactions* (online at www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30) (accessed May 11, 2010) (compiling statistics from 1934 to 2008).

[183] *See* Federal Deposit Insurance Corporation, *The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects* (Jan. 2005) (online at www.fdic.gov/bank/analytical/banking/2005jan/article1.html) (noting that "[a]lthough community banks control less than 14 percent of banking-sector assets, they fund almost 29 percent of the industry's commercial real estate lending"). Also, for a general discussion, *see* the Panel's February 2010 report. COP February Oversight Report, *supra* note 2, at 19–26.

ondary market for these loans has been severely affected, and impaired commercial tenancy rates show no sign of improving in the near term.[184] Finally, to the extent that 2010 continues to see high bank failure rates, the pool of existing smaller banks that are the most likely to engage in so-called relationship lending—in which the bank considers the loan applicant holistically, drawing on an ongoing relationship with the business and its owner—will likely shrink, leaving fewer local banks available.[185] Unless conditions in the smaller banking sector improve substantially, smaller banks may not have the capacity to meet future increased demand.[186]

There are signs that the availability of capital is improving, however. At the Panel's recent hearing in Phoenix, Mr. Ivie testified that "As a result of that, we are starting to see capital come in to some of our institutions. We've had several of our institutions recently have success in accessing the capital markets and raising capital."[187] Any improvement in the availability of capital should help provide banks with a broader range of options.

c. Additional Supply-based Arguments

Despite overall bank weakness, there are, nonetheless, banks that state that they are able, willing, and eager to increase lending but that the current regulatory climate makes this extremely difficult. There have been anecdotal reports that bank examiners have become more conservative and have required increasing levels of capital in the last year. Federal Reserve Board Governor Elizabeth Duke testified in February that:

> [s]ome banks may be overly conservative in their small business lending because of concerns that they will be subject to criticism from their examiners. While prudence is warranted in all bank lending, especially in an uncertain economic environment, some potentially profitable loans to creditworthy small businesses may have been lost because of these concerns, particularly on the part of small banks. Indeed, there may be instances in which individual examiners have criticized small business loans in an overly reflexive fashion.[188]

To allay fears within the industry that bank examination standards might be discouraging lending to creditworthy borrowers by requiring potentially excessive capital levels, federal banking regu-

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[184] *See, e.g.*, Congressional Oversight Panel, Written Testimony of Jon D. Greenlee, associate director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System, *Atlanta Field Hearing on Commercial Real Estate*, at 5–6 (Jan. 27, 2010) (online at cop.senate.gov/documents/testimony-012710-greenlee.pdf).

[185] *See* Section E.3, *infra* (discussing lending technologies). *See also* Testimony of Stan Ivie, *supra* note 161 (discussing relationship lending and the threats to the community banks best positioned to conduct this type of lending).

[186] While larger banks presumably would be able to absorb some of an increase in demand, they have been generally pulling back from the small business lending sector, making the degree to which they might move into the sector unclear. *See* Section E.3, *infra*.

[187] Testimony of Stan Ivie, *supra* note 161. A recent release from the law firm Wachtell, Lipton, Rosen & Katz reflects similar conditions: "[t]he first four months of 2010 have seen strong equity market interest in financial institutions carried forward from 2009" and that"[t]he numerous announced and priced deals of the last several weeks have been more concentrated in community and regional banks." Wachtell, Lipton, Rosen, & Katz, LLP, *Financial Institutions Developments, Recent Transactions Show Continued Strong Capital Market Interest in a Diversity of Financial Institutions* (May 6, 2010).

[188] Elizabeth Duke Testimony before House Financial Services and House Small Business Committees, *supra* note 114, at 5.

latory agencies and the Conference of State Bank Supervisors issued an *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 5, 2010.[189] The statement stresses that financial institutions that engage in prudent small business lending and base their decisions on the creditworthiness of individual borrowers will not be subject to supervisory criticism. This statement builds upon principles in existing guidance, including the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* and the *Policy Statement on Prudent Commercial Real Estate Loan Workouts,* issued in November 2008 and October 2009, respectively. According to Assistant Secretary of the Treasury for Financial Stability Herbert M. Allison, Jr., this new guidance "should yield greater consistency among the agencies and help banks provide prudent small business lending."[190] Banking industry groups, however, maintain that, while the statement is appreciated, it has done little to change the behavior of individual examiners.[191]

While it is impossible to determine whether examiners are adhering to stated guidelines or whether they are taking a more conservative approach—bank examinations are confidential and are conducted on a case-by-case basis—banks may perceive a difference in the way examinations are handled because of certain provisions within the accounting rules. For example, if a loan is restructured because of borrower distress (i.e., "troubled-debt restructure"), that loan cannot be pooled for the purposes of setting loan loss reserve levels.[192] Instead, loan reserves must be set aside to offset the specific risk that the restructured loan presents. Because banks may now have a larger percentage of restructured loans on their books, and because these loans may remain on the books for a longer period, banks may be required to keep high loan loss reserves to offset the specific risks presented by these loans. Moreover, bank examiners may face a larger number of situations that require the use of the individual examiner's judgment because the current economic outlook, and often the value of a given asset, is less predictable than in better economic times, and that judgment may conflict with the bank's. At the Panel's most recent hearing in Phoenix, Mr. Ivie testified to the reasons that the perception exists that the bank examiners have imposed overly rigorous standards on banks making small business loans.[193] First he noted that "[e]xaminers will not criticize financial institutions for making good loans or entering into prudently structured workout arrangements." The reason, he stated, that banks may disagree with the examiners' stance on refinanced loans is that, in cases where a borrower's condition has deteriorated to the point that it is making interest payments out of the proceeds of the loan itself, the examiners are unwilling

[189] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Conference of State Bank Supervisors, *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* (Feb. 5, 2010) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20100205.pdf).

[190] Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 4.

[191] ICBA conversations with Panel staff (Mar. 25, 2010).

[192] *See* Accounting Standard Codification (ASC) 310–10–35, *Receivables—Scope and Scope Exceptions*.

[193] Phoenix Field Hearing on Small Business Lending, *supra* note 29, at 9–11.

to consider this to be a performing loan. The combination of these factors may have led banking groups to see examiners' behavior as increasingly conservative and restrictive.

Without taking a position on the current regulatory atmosphere, the Panel notes that the balance between sufficient regulation and over-regulation is a fine one. In an overly permissive regulatory environment, banks may tend to make riskier loans, exacerbating the economy's precarious position. In an overly restrictive regulatory environment, however, banks may become too conservative, and there will be insufficient credit available to help pull the economy out of the recession.

The ABA has also indicated that the lump-sum prepayment of $45 billion, or 3.25 years' worth of insurance premiums, that the FDIC required of its member banks in the fourth quarter of 2009 has depleted capital levels at institutions that could have otherwise used that money for lending.[194] The FDIC, however, has rejected this assertion. Chairman Bair has testified that "[p]repayment would not materially impair the capital or earnings of insured institutions" and that "the FDIC believes that most of the prepaid assessment would be drawn from available cash and excess reserves, which should not significantly affect depository institutions' current lending activities."[195] Chairman Bair supported this assertion by noting that FDIC-insured institutions are more liquid than they were a year ago and that they currently hold 22 percent more in liquid balances than they did last year. Given the current lending environment, there are banks that have high capital, and for these institutions, these fees may not have had much effect. Banks that are capital-constrained, however, may have been more affected by these frontloaded fees, and might then be less able to provide loans than banks with healthier capital levels. Ultimately, because examinations are confidential, it is difficult to assess banks' capacity to lend, especially since banks have been required to draw on capital to increase loan loss reserves as a buffer against potential increased defaults as borrowers continue to stumble in the recovering economy.

To the extent that well-capitalized banks are not lending—either because of tighter standards or because of uncertainty about the economy—it seems that, beginning with the start of the crisis, these banks have kept capital in very low-risk, low return invest-

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[194] American Bankers' Association, Letter to Robert Feldman, executive secretary, Federal Deposit Insurance Corporation (Oct. 28, 2009) (online at www.fdic.gov/regulations/laws/federal/2009/09c109AD49.PDF). The FDIC explained this action in a press release, stating that:

> Prepayment of assessments will allow the industry to strengthen the cash position of the Deposit Insurance Fund (DIF) immediately, while allowing the capital impact of deposit insurance assessments to be felt gradually over time as the industry improves its own financial position. The banking industry has substantial liquidity to prepay assessments. As of June 30, FDIC-insured institutions held more than $1.3 trillion in liquid balances, or 22 percent more than they did a year ago. Prepaying assessments will put the industry's liquid balances to good use in conserving capital and helping to maintain the capacity of banks to lend while they rebuild the DIF. FDIC analysis indicates that this arrangement is much less likely to impair bank lending than a one-time special assessment.

Federal Deposit Insurance Corporation, *Banks Tapped to Bolster FDIC Resources, FDIC Board Approves Proposed Rule to Seek Prepayment of Assessments* (Sept. 29, 2009) (online at www.fdic.gov/news/news/press/2009/pr09178.html).

[195] *See* Senate Committee on Banking, Housing and Urban Affairs, Written Testimony of Sheila C. Bair, chairman, Federal Deposit Insurance Corporation, *Examining the State of the Banking Industry* (Oct. 14, 2009) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore__id=6277ecd6-1d5c-4d07-a1ff–5c4b72201577).

ments such as U.S. Treasury bonds, with the Federal Reserve, which now pays limited interest on such funds,[196] or in similar investments. Banks' holdings in Treasuries, for example, have spiked since the start of the current recession.[197] While still only a small percent of the overall sector—just one percent—this increase indicates a strong trend toward safe investments at the expense of profit. Assuming a normal business cycle, however, such safe but low-earning assets may not be sufficient to satisfy bank shareholders, and as bank executives feel pressure to increase earnings again, banks may develop some appetite, although likely still limited, for investments that provide greater reward even if it means taking on a certain amount of additional risk.

Ultimately, low lending levels have many contributing factors, among them the instability of some of the banks that lend and low sales demand, which often results in low demand for credit. These dynamics are, however, always in flux. If sales improve and—as anticipated by some FRBA respondents—credit demand increases, it is not clear that smaller banks, which are still under enormous stress, are prepared to handle that demand.

2. Is There any Evidence that any Government Program is Helping?

Three of the operational TARP programs could have a direct or indirect effect on small business lending: the capital injection programs, the TALF, and the PPIP.

Capital injection programs, the primary example of which is the CPP, can have an indirect effect on small business lending. It is possible that the capital injection programs succeeded at maintaining a certain level of small business lending that would otherwise have fallen even more sharply, though any such impact would be very difficult to measure since Treasury did not require all TARP recipients to report on their lending levels or use of TARP funds. Even with the additional capital, however, and as discussed in Section C above, there was a decline in small business lending among the 22 largest CPP recipients. Indeed, the Panel has previously noted that Treasury did not require recipients to increase, or even maintain, lending levels to small businesses or consumers under the CPP.[198] While the agreement signed by CPP participants included a recital that "the Company agrees to expand the flow of credit to U.S. consumers and businesses on competitive terms to promote the sustained growth and vitality of the U.S. economy," this language is merely precatory.[199]

The TALF is one of the few TARP programs that could have had a direct effect on small business lending.[200] As discussed in Section

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[196] Board of Governors of the Federal Reserve System, Press Release (Oct. 6, 2008) (online at www.federalreserve.gov/monetarypolicy/20081006a.htm) (announcing plan to pay limited interest on depository institutions' required and excess reserve balances).

[197] Federal Reserve Bank of St. Louis, *Economic Research: Series: USGSEC, U.S. Government Securities at All Commercial Banks* (online at research.stlouisfed.org/fred2/series/USGSEC?cid=99) (accessed May 11, 2010).

[198] *See generally* COP May Oversight Report, *supra* note 3, at 17.

[199] U.S. Department of the Treasury, *Securities Purchase Agreement [CPP]: Standard Terms,* at 7 (online at www.financialstability.gov/docs/CPP/spa.pdf) (hereinafter "Securities Purchase Agreement [CPP]: Standard Terms") (accessed May 11, 2010).

[200] In addition to small business loans, small businesses that use credit cards for borrowing might have benefited from TALF to the same extent as other credit card borrowers. $26 billion

D.2, above, small business loans were one of the categories of eligible collateral under the program. The program has settled loans collateralized by $2.15 billion in small business loan ABS.[201] Treasury has told Panel staff that, like the other TALF sectors, the TALF had an "announcement effect" in opening up the SBA-loan secondary markets at a time that they were severely constricted.[202] That said, however, as the Panel discussed in its May 2009 report, securitization programs generally have little effect on small business lending. Generally, the only small business loans that are securitized are those that are SBA-backed, and they constitute a fraction of the small business lending market.[203]

The PPIP might also be having an indirect effect on credit availability to small businesses. By removing risky assets from bank balance sheets, it should theoretically free up capital that could be used for new lending. The program has likely not been used, however, by small and community banks.[204] And to the extent that it is used, its relatively small footprint would not be able to provide a significant effect on the small business lending market. Finally, as the PPIFs have only recently begun to purchase assets, any effects from the program have yet to be seen.

Ultimately, it is not clear that any of the TARP programs in place to date has had a noticeable effect on small business lending. As discussed above, many of the operational TARP programs are irrelevant to small banks. These programs were designed for general applicability, rather than specifically for small banks or smaller businesses, and had modest effects on small business lending, if any.[205]

3. Lender Size and Lending Technologies

Small business lenders can generally be divided into four categories: smaller banks (those with under $10 billion in assets), mid-sized banks (those with $10 billion to $100 billion in assets), the largest banks (those with over $100 billion in assets), and non-bank lending institutions. The supply of small business loans has declined since 2008, with all types of lenders reducing lending since the crisis.[206] The FDIC has attributed the decline in total lending across all sizes of institutions to "[t]ighter underwriting standards, deleveraging by institutions seeking to improve their capital ratios, and slack loan demand. . . ."[207] Within these general declines in

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in loans backed by credit card receivables were settled in TALF. Data provided by Federal Reserve Bank of New York.

[201] Data provided by Federal Reserve Bank of New York.

[202] Treasury conversations with Panel staff (Apr. 1, 2010). *See also* Section D.1(c), *supra*.

[203] *See generally* COP May Oversight Report, *supra* note 3, at 50–51. *See also* Section D.2(b)(iii) discussing the limited role of securitization of small business loans, *supra*.

[204] ICBA conversations with Panel staff (Mar. 25, 2010). Treasury does not track which banks sell assets into the program. In fact, the PPIP Legacy Loans Program, which would have purchased whole loans from banks and would probably have seen greater participation from small and medium banks, has been shelved indefinitely. *See* COP December Oversight Report, *supra* note 37, at 24, 179.

[205] Treasury officials maintain that all of Treasury's programs, including the potential new small business lending fund, are intended to act in tandem, and that no one program is solely responsible for addressing small business lending. Treasury conversations with Panel staff (Apr. 14, 2010).

[206] This discussion of declining lending levels by bank size and the effect of lending technologies does not address contributing factors such as decreased demand, which is discussed in Section E.1, *supra*.

[207] Phoenix Field Hearing on Small Business Lending, *supra* note 29, at 3–4.

lending levels, however, there has also been a series of market shifts. Some lenders have exited the market. In addition, the different methods of making lending decisions by bank lenders of varying sizes and types can be more favorable than others to small businesses, and can change in importance over time. Based on multiple factors, it appears that market share may be shifting back toward smaller banks, which may result in new pressures for small businesses.

a. Size and Type of Lender: Shifts in Market Share

i. Lender Size and Market Share

All sizes of banks provide loans to small businesses, with roughly half the total dollar volume coming from smaller banks. Smaller banks, those with assets less than $10 billion, provided 46.7 percent of the dollar value of all small business loans in 2009. The largest banks, those with more than $100 billion in assets, provided 34 percent of small business loans that year. As shown in Figure 10, these numbers have changed over the past decade. In 1999, the biggest banks provided only 14.9 percent of small business loans, while banks with under $10 billion in assets provided 56.9 percent. Similarly, in 2002, 52.8 percent of small-denomination commercial loans were made by banks with less than $10 billion in assets.[208] From 2006 to 2008, however, the largest banks' share of small business lending jumped considerably—from 26.6 percent of the market in 2006 to 37.4 percent in 2008. The small business lending market share of the smallest banks—those with less than $1 billion in assets—has been falling fairly steadily over the past decade.[209] The relatively equal share of the market between smaller banks, on the one hand, and medium and larger banks, on the other, does not capture the unequal distribution of banks' exposure to small business lending. Even though smaller banks provide roughly half of the total dollar volume of all small business lending, small business lending makes up a significantly larger portion of their lending portfolios than it does for larger banks. As shown in Figure 11, in 2009 C&I loans of under $1 million made up 9.3 percent of the portfolios of the smallest banks, and 6.7 percent of the portfolios of banks with between $1 and $10 billion in assets. By contrast, it made up 4.4 percent for banks with between $10 and $100 billion in assets and only 2.5 percent of banks with assets over $100 billion.

[208] SNL Financial.
[209] SNL Financial. All figures based on dollar volume of loans.

FIGURE 10: SOURCES OF SMALL BUSINESS LENDING—OUTSTANDING C&I LOANS (OF LESS THAN $1 MILLION) AT COMMERCIAL BANKS OF VARYING SIZES (SIZE BY ASSETS) [210]

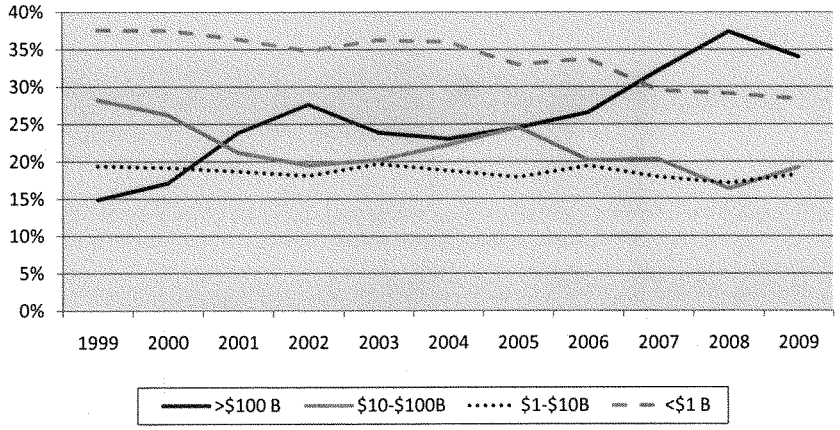
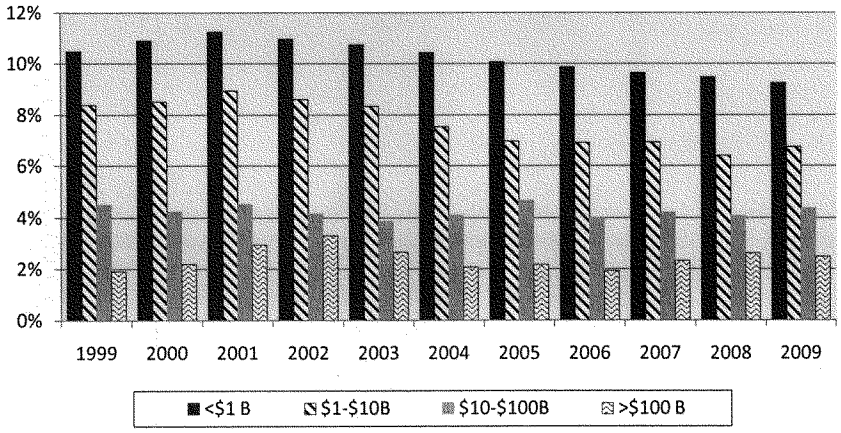


FIGURE 11: PERCENTAGE OF BANK LENDING GOING TO SMALL BUSINESSES—C&I LOANS UNDER $1 MILLION AS A PERCENTAGE OF ALL LOANS AT COMMERCIAL BANKS, BY BANK SIZE [211]



ii. Shifts in Market Share after the Credit Crisis

The shift of market share from smaller banks to larger banks reversed during and after the crisis. From 2008 to 2009, the largest banks' small business loan portfolios fell by 9.03 percent. This decline is higher than the 4.1 percent decline in such banks' entire lending portfolios. During this time period the smallest banks'

[210] Federal Deposit Insurance Corporation, *Statistics on Banking* (Instrument: Loans and Leases—Small Business Loans) (online at www2.fdic.gov/sdi/main4.asp) (accessed May 5, 2010).
[211] SNL Financial.

small business lending portfolios fell by 2.67 percent, while their entire lending portfolios fell 0.2 percent. Banks with assets between $1 billion and $100 billion grew their small business portfolios as well as their entire lending portfolios during this time.[212] Similarly, since the start of the crisis, large banks have cut back on all lending to an even greater degree than have smaller banks.[213] One study found that small business customers of larger banks (those with more than $100 billion in assets) have been less likely than customers of smaller banks to receive the credit they wanted.[214]

At the same time that larger banks pulled back, non-bank lending sources left the market. Prior to the credit crunch, institutions such as CIT Group, GE Capital, and Allied Capital became major players in this field. CIT was the largest originator of SBA 7(a) loans for nine consecutive years.[215] CIT was also a major lender to the retail industry, particularly in the factoring sector.[216] The bankruptcies of CIT and Allied Capital's Ciena Capital portfolio lender, as well as the constriction in securitization markets, have negatively impacted small business lending.[217] Many small business owners were also hurt by major small business credit card issuer Advanta's late May 2009 announcement that it was closing all of its credit card lines effective June 1, 2009.[218]

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[212] Banks with assets between $1 and $10 billion grew their small business loan portfolio by 6.6 percent; banks with assets between $10 and $100 billion grew them by 17.4 percent, after they fell 12.4 percent the prior year. SNL Financial.

[213] Phoenix Field Hearing on Small Business Lending, *supra* note 29, at 4 ("Institutions with total assets greater than $100 billion as of December 31st reported an aggregate net decline in total loans and leases of $116.8 billion in the quarter, or over 90 percent of the total industry decline. On a merger-adjusted basis, at community banks that filed reports as of December 31st, total loan and lease balances decreased $4.3 billion during the quarter. A majority of institutions (53.2 percent) reported declines in their total loan balances during the quarter"); Elizabeth Duke Testimony before House Financial Services and House Small Business Committees, *supra* note 114, at 2. *See* Section E.1(c), *supra* (discussing in detail credit conditions over time).

[214] Small Business Credit in a Deep Recession, *supra* note 18, at 8.

[215] National Small Business Association, *CIT Bankruptcy: What it Means for Small Business* (Nov. 4, 2009) (online at www.nsba.biz/content/printer.2638.shtml).

[216] Letter from Tracy Mullin, president and chief executive officer, National Retail Federation, to Timothy Geithner, secretary, U.S. Department of the Treasury, *NRF Letter To Treasury Secretary About CIT* (July 14, 2009) (online at www.nrf.com/modules.php?name=Pages&sp_id=1092) ("CIT is one of the very few lenders who act as a 'factor' for the thousands of small and middle-sized vendors who supply U.S. retailers with much of the merchandise sold in their stores. . . . [A] factor provides the short-term financing that allows a vendor to produce goods once an order from a retailer has been received"). Through factoring, a small business will sell a receivable stream to a lender. CIT was the largest provider of factoring services to small businesses. Professor Gregory Udell conversations with Panel staff (Apr. 5, 2010).

[217] CIT Group exited bankruptcy in December 2009. CIT Group, *CIT Shares Commence Trading on New York Stock Exchange* (Dec. 10, 2009) (online at www.businesswire.com/portal/site/cit/index.jsp?ndmViewId=news_view&newsId=20091210005961&newsLang=en). It has reentered the small business lending market with a commitment for $500 million in new loans and the issuance of TALF-eligible equipment lease ABSs. CIT Group, *CIT Gives Boost to Small Businesses—Commits $500 Million in New Loans and Waives Packaging Fee* (Dec. 14, 2009) (online at www.businesswire.com/portal/site/cit/index.jsp?ndmViewId=news_view&newsId=20091214005577&newsLang=en); CIT Group, *CIT Closes $667 Million TALF-Eligible Equipment Lease Securitization* (Mar. 11, 2010) (online at www.businesswire.com/portal/site/cit/index.jsp?ndmViewId=news_view&newsId=20100311006452&newsLang=en). On April 27, 2010, CIT made its first post-bankruptcy earnings announcement, with better than expected earnings of $97.3 million or 49 cents per share. During the earnings call, CEO John Thain said that small business lending "applications were up 70% in terms of dollar volume." CIT Group, *Q1 2010 CIT Group Earnings Conference Call*, at 2 (Apr. 27, 2010) (at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDI5NTV8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1).

[218] Advanta Corp., *Form 8–K* (May 22, 2009) (online at www.sec.gov/Archives/edgar/data/96638/000115752309004084/a5970987.txt).

b. Lending Technologies and Lender Size

Although the FDIC cited institutional deleveraging, decreased demand, and tighter underwriting standards for the overall drop in lending, this would not explain shifts in market share from larger to smaller banks.[219] An explanation for both the increase and subsequent decrease in large banks' presence in the small business lending market may lie in the different uses of "lending technologies" among large and small banks over the course of the last decade. Both large and small banks' small business lending can be divided into four categories of "lending technologies"—relationship lending, asset-based lending, credit scoring, and financial statement lending.[220] The last three categories can together be considered "transaction based" lending, as they are all based on "hard" data about the borrower or collateral. Credit scoring is done almost entirely by large banks, and relationship lending almost entirely by small banks.[221] The other two are performed by large and small banks alike.[222]

Credit scoring is an adaptation of a method long used in consumer lending, developing statistical techniques to put a number on a small business's credit risk. Credit scoring uses "information from the financial statements of the business, [with] heavy weighting . . put on the financial condition and history of the principal owner, given that the creditworthiness of the firm and the owner are closely related for most small businesses."[223] Credit scoring is primarily used for loans of under $250,000.[224] It grew in importance for small business loans in the early part of the last decade, and one early study found that credit scoring increased the likelihood that a large bank would make a small business loan in a low- or moderate-income area. A more impersonal form of lending, it was less labor-intensive, less costly, and less dependent on collateral. It may have reduced spreads for small business loans and increased credit availability,[225] and may be responsible for some portion of larger banks' growing market share over the course of the decade.

With the post-crisis reduction of lending by larger banks, the dominance of credit scoring has reversed with a shift back towards relationship lending. Unlike credit scoring and other transaction-based lending, relationship lending is based on what are called "soft" data.[226] Relationship lending involves a small bank manager or loan officer who is part of the same community as the small business owner; through this long-term relationship, the bank de-

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[219] *See* Phoenix Field Hearing on Small Business Lending, *supra* note 29, at 3–4.

[220] Asset-based lending is done based on the availability of collateral. Financial statement lending is based on the strength of the business's balance sheet and income statements.

[221] *See* Testimony of Stan Ivie, *supra* note 161.

[222] Of course, much lending is a combination of two or more of these lending technologies. Gregory F. Udell, *How Will a Credit Crunch Affect Small Business Finance?,* Federal Reserve Bank of San Francisco Economic Letter, Number 2009–09 (Mar. 6, 2009) (online at www.frbsf.org/publications/economics/letter/2009/el2009-09.pdf).

[223] Allen N. Berger and Gregory F. Udell, *Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure,* Economic Journal, at 8 (2002) (online at www.federalreserve.gov/PUBS/feds/2001/200136/200136pap.pdf) (hereinafter "The Importance of Bank Organisational Structure").

[224] *Id.,* at 8.

[225] W. Scott Frame, Michael Padhi, and Lynn Woosley, *The Effect of Credit Scoring on Small Business Lending in Low- and Moderate-Income Areas,* at 1, 3–4 (Apr. 2001) (online at www.frbatlanta.org/filelegacydocs/wp0106.pdf).

[226] The Importance of Bank Organisational Structure, *supra* note 223, at 3.

velops "soft" information—knowledge and comfort level with the borrower's financial stability, business potential, and lending risk.[227] Smaller banks' physical presence in communities and their knowledge of the local economy, culture, and population make them a natural source for such small business lending.[228]

Small businesses that obtain credit through relationship lending at local banks are less reliant on the three hard data categories. The manager of a small bank who has grown up with a small business owner might be more willing to overlook a slow six-month period, knowing, for example, that the business owner was dealing with a difficult family situation at the time. This informal process could pose a problem, however, for borrowers who are shut out of the small bank lending market by their local bank's capital constraints. If these borrowers must then turn to small banks in other communities or to larger banks, they might need to rely more heavily on hard data. This could be problematic for some small businesses that relied on relationship lending, as they could lack audited financial statements or assets that could serve as collateral.[229] If one of these businesses lost its relationship lender because of weak capital at the bank or the bank's failure or consolidation, it would probably take some time for that business to assemble the documentation or collateral needed to obtain new credit.[230]

These shifts in and shocks to the small business lending landscape mean that portions of the market share of small business lending are shifting back to smaller banks. This could, however, lead to greater instability for small businesses. Because of large banks' size, they are able to make large volumes of small business loans even though these loans remain a small part of their portfolio. By contrast, small banks make a similar amount of small business loans, but those loans constitute a larger portion of their lending portfolios, so pressures on the small business lending markets affect those small banks to a greater degree. Small banks tend to have greater concentrations of commercial real estate assets, and are therefore in greater danger of a potential commercial real estate crunch. In fact, smaller banks with the highest exposure to commercial real estate provide approximately 40 percent of all small business loans.[231] A higher market share of small business

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[227] "[T]he lender bases its decisions in substantial part on proprietary information about the firm and its owner through a variety of contacts over time. This information is obtained in part through the provision of loans and deposits and other financial products. Additional information may also be gathered through contact with other members of the local community, such as suppliers and customers, who may give specific information about the firm and owner or general information about the business environment in which they operate. Importantly, the information gathered over time has significant value beyond the firm's financial statements, collateral, and credit score, helping the relationship lender deal with informational opacity problems. . . ." The Importance of Bank Organisational Structure, *supra* note 223, at 9.

[228] Testimony of Raj Date before the Senate Banking Committee, *supra* note 150, at 5.

[229] Gregory F. Udell, *How Will a Credit Crunch Affect Small Business Finance?,* Federal Reserve Bank of San Francisco Economic Letter, Number 2009–09 (Mar. 6, 2009) (online at www.frbsf.org/publications/economics/letter/2009/el2009-09.html).

[230] *See* Elizabeth Duke Testimony before House Financial Services and House Small Business Committees, *supra* note 114, at 4–5 ("Established banking relationships are particularly important to small businesses, who generally do not have access to the broader capital markets and for whom credit extension is often based on private information acquired through repeated interactions over time. When existing lending relationships are broken, time may be required for other banks to establish and build such relationships, allowing lending to resume").

[231] COP February Oversight Report, *supra* note 2, at 42; Dennis P. Lockhart, president and chief executive officer, Federal Reserve Bank of Atlanta, Remarks at the Urban Land Institute's Emerging Trends in Real Estate Conference, *Economic Recovery, Small Businesses, and the*

lending for these banks could portend a tight market for small business credit until banks are able to resolve their commercial real estate portfolios.

Large banks' reducing lending to small business pushes more of the small business lending market onto smaller banks, at the same time that many of these smaller banks are struggling to resolve their commercial real estate portfolios. The end result of shifting smaller business lending back to smaller banks is difficult to predict, and whether the shift is stable remains to be seen. Given that Treasury intends to focus on smaller banks ($10 billion or less) in order to spur small business lending, the role and market share of smaller banks takes on substantial importance.

F. New Initiative for Small Business Lending

In his State of the Union address on January 27, 2010, President Barack Obama announced the creation of a new fund to support lending to small businesses.[232] Less than one week later, on February 2 and 3, 2010, the Administration announced two separate programs with the shared goal of fueling small business lending: the CDCI and the SBLF. The CDCI, a $780 million program that is discussed in more detail above, will use TARP funds to target lending in underserved and minority communities.[233] In contrast, the proposed SBLF would be established through new legislation, which would transfer $30 billion in repaid TARP funds to a non-TARP program.[234] The SBLF would then inject capital into small and medium banks and use incentives to encourage them to increase their lending. To exempt the SBLF from current congressional budget process requirements ("paygo rules"), the Administration had originally designated the $30 billion expenditure as an "emergency requirement," and had also proposed a reduction in the ceiling on TARP purchase authority.[235] In a more recent draft, the

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Challenge of Commercial Real Estate (Nov. 10, 2009) (online at www.frbatlanta.org/news/speeches/lockhart_111009.cfm).

[232] President Obama first announced his plan for the program during a speech in Landover, Maryland on October 21, 2009. The White House, *Remarks by the President on Small Business Initiatives* (Oct. 21, 2009) (online at www.whitehouse.gov/the-press-office/remarks-president-small-business-initiatives-landover-md).

[233] *See* Section D.2, *supra* (for an extended discussion of the CDCI).

[234] The White House, *Small Business Lending Fund—Fact Sheet* (Feb. 2, 2010) (online at www.whitehouse.gov/sites/default/files/FACT-SHEET-Small-Business-Lending-Fund.pdf) (hereinafter "Small Business Lending Fund Fact Sheet"). On May 7, the Administration provided Congress with revised proposed legislation for the program, and the discussion of the SBLF in this report is based upon that proposal. It modifies the original proposal in some respects, and includes a provision that replaces the paygo provisions with a statement that the "Administration will work with the Congress to determine the most appropriate means of offsetting the cost of the program." Draft legislation provided to the Panel by Treasury (May 7, 2010).

[235] Prior version of draft legislation provided to the Panel by Treasury (Apr. 13, 2010). According to the Administration, "paygo" is a statutory rule that would require the government to "pay for new tax or entitlement legislation" such that "[c]reating a new non-emergency tax cut or entitlement expansion would require offsetting revenue increases or spending reductions." The White House, *Message from the President to Congress Regarding PAYGO Legislation* (June 9, 2009) (online at www.whitehouse.gov/the_press_office/Message-from-the-President-to-Congress-regarding-PAYGO-legislation/). Section 4(g) provides an exemption for "emergency requirements." Statutory Pay-As-You-Go Act of 2010, Pub. L. 111–139 (Feb. 12, 2010) (online at www.gpo.gov/fdsys/pkg/PLAW-111publ139/pdf/PLAW-111publ139.pdf) ("If a provision is designated as an emergency requirement under this Act, CBO or OMB, as applicable, shall not include the budgetary effects of such a provision in its estimate of the budgetary effects of that PAYGO legislation").

Administration has left open the most appropriate means of offsetting the cost of the program.[236]

1. Program Details

Banks would be eligible for the SBLF only if they hold less than $10 billion in assets. To receive the funds, a bank would first need to receive approval from its regulator. The program would divide eligible institutions into two categories: banks with less than $1 billion in assets (small banks) and banks with between $1 billion and $10 billion in assets (medium banks). Small banks would be eligible for investments of Tier 1 capital of up to five percent of their risk-weighted assets, while the cap for medium banks would be set at three percent. Receiving banks could then leverage these funds to the extent permitted by their regulators.[237]

The core of the SBLF program is an incentive for banks to increase lending. Participating institutions would pay a dividend of five percent, which could drop as low as one percent if the bank "demonstrates increased small business lending relative to a baseline set in 2009" and rise to seven percent if the bank's lending rate decreases or plateaus after two years.[238] The SBLF currently defines "small business lending" as any loan made by a bank with less than $10 billion in assets that falls into one of four categories: (1) commercial and industrial loans, (2) owner-occupied, non-farm, non-residential real estate loans, (3) loans to farmers and loans that finance agricultural production, and (4) loans secured by farmland.[239] For every 2.5 percent incremental increase in loans made by small and medium banks, the dividend would be reduced by one percent. The enumerated loans would be monitored for a two-year period, starting on the date of the investment. Based on the lending rate at the end of that two-year period, the dividend rate would be "locked-in" and "the bank would benefit from this attractive rate for the following three years." By contrast, if the bank's lending rate decreased or stayed the same over those two years, the dividend rate would rise to seven percent. At the end of this five-year period, the dividend rate would increase to nine percent, which would provide an incentive for banks to repay the funds.[240] Banks that had previously received CPP or CDCI funds would have an additional incentive to participate: they could convert the terms of their CPP or CDCI funds to the more favorable terms of the SBLF.[241]

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[236] Draft legislation provided to the Panel by Treasury (May 7, 2010).

[237] Small Business Lending Fund Fact Sheet, *supra* note 234. In most cases, the capital provided would be Tier 1. Treasury conversations with Panel Staff (Apr. 29, 2010).

[238] According to the draft legislation, the reduced dividend would apply only to an amount of the investment that a bank uses to increase lending. Draft legislation provided to the Panel by Treasury (May 7, 2010) ("The reduction in the dividend or interest rate payable to Treasury by any eligible institution shall be limited such that the rate reduction shall not apply to an amount of the investment made by Treasury that is greater than the increase in lending realized under this program").

[239] Because it does not impose a cap on the size of loans, this definition would permit loans in excess of $1 million to be categorized as "small business lending." Draft legislation provided to the Panel by Treasury (May 7, 2010). Treasury maintains that while imperfect, the definition will serve as an appropriate proxy for small business lending—Treasury asserts that the overwhelming majority of loans made by small and medium banks go to small businesses. Treasury conversations with Panel staff (Apr. 14, 2010).

[240] Small Business Lending Fund Fact Sheet, *supra* note 234.

[241] Under the CPP program, institutions are required to pay a dividend of five percent for the first five years and nine percent thereafter. Although the initial dividend under the CPP is identical to the initial dividend under the SBLF, the CPP dividend is fixed and is not eligible for

Unlike the CPP, the SBLF includes mild penalties for banks that take the money and do not use it to lend. As explained above, the program balances a dividend decrease with a dividend increase: if a bank does not increase or decreases its lending by the end of the two-year period, the dividend increases to seven percent. The SBLF is also distinct from the CPP in that it requires applicant banks to submit a "small business lending plan" describing how they plan to address the needs of small businesses.[242] However, the SBLF does not require banks to report on how they use the funds beyond reports to the FDIC. Using an incentive strategy to encourage banks to lend distinguishes the SBLF from the CPP, which included no lending incentive.

2. The Rationale for Locating the SBLF Outside of the TARP

a. The TARP "Stigma"

Treasury maintains that it is necessary to situate the SBLF outside of the TARP in order to avoid the TARP "stigma." In December 2009 testimony before the Panel, Treasury Secretary Timothy Geithner stated that banks are reluctant to accept TARP funds because they fear that they will be "stigmatized" and subject to restrictions that "might make it harder for them to run their businesses." He added that banks view TARP funds as a "sign of weakness, not strength"[243] and that "[w]e had 600 small banks withdraw their applications from TARP because they were scared about the stigma and the conditions that would come."[244] Similarly, Assistant Secretary Allison has testified that "while Treasury has the existing authority and funding today to create a small business lending facility under TARP, we are convinced that if we did so, the number of small and medium-sized banks willing to participate would decline dramatically" as a result of the "belief that a 'stigma' is associated with the TARP program."[245]

The perception of a TARP stigma is widespread. One small business group said that bank customers view the acceptance of TARP funds as a sign that a bank is on the verge of failure.[246] In testimony before the Senate Banking Committee, Arthur C. Johnson, chairman of the American Bankers Association, stated that:

> using TARP money to fund [a small business lending program] raises the *very real possibility that the TARP stigma will discourage banks from participating.* This is because hundreds of banks that had never made a subprime loan or had anything to do with Wall Street took TARP capital

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subsequent reduction. There is presently some debate as to the implications of the refinance provision. *See* House Committee on Financial Services, Written Testimony of Linus Wilson, professor of finance, University of Louisiana at Lafayette (May 11, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/wilson_testimony_5.11.10.pdf) (stating that the conversion provision could be used by financial institutions to cancel their warrants).

[242] Draft legislation provided to the Panel by Treasury (May 7, 2010).

[243] Congressional Oversight Panel, *Transcript: COP Hearing with Treasury Secretary Timothy Geithner* (Dec. 10, 2009) (online at cop.senate.gov/hearings/library/hearing-121009-geithner.cfm).

[244] House Committee on the Budget, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *Treasury Department Fiscal Year 2011 Budget* (Feb. 24, 2010) (online at www.cq.com/display.do?dockey=/cqonline/prod/data/docs/html/transcripts/congressional/111/congressionaltranscripts111-000003297661.html@committees&metapub=CQ-CONGTRANSCRIPTS&searchIndex=0&seqNum=2).

[245] Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 5.

[246] NFIB conversations with Panel staff (Mar. 18, 2010).

> with their regulator's encouragement—even though they did not need it—so they could bolster their lending and financial position. Then within weeks, they were demonized and subject to after-the-fact restrictions.[247]

Similarly, industry sources maintain that the public sees the word "TARP" as equivalent to "bailout" and that a program designed to alleviate the toxic asset problem became toxic for banks.[248] Data on the CPP are consistent with the notion of a developing TARP stigma: despite widespread participation at the outset of the program, participation dwindled over time, despite the lack of substantial improvement in the banking sector.[249] Assistant Secretary Allison testified that small banks have faced pressure from competitors that use the "'TARP recipient' label in negative advertising."[250] The public's negative perception of the TARP may also have resulted from the sense that it was used as a bailout of weak banks, even though the government initially declared that the funds would be used to support healthy institutions.[251] As the Panel noted in its January report, "TARP was supposedly given to healthy banks but in many instances this was not the case."[252]

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[247] Senate Banking, Housing, and Urban Affairs, Subcommittee on Economic Policy, Written Testimony of Arthur C. Johnson, chairman, American Bankers Association, *Restoring Credit to Main Street: Proposals to Fix Small Business Borrowing and Lending Problems,* at 8 (Mar. 2, 2010) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9ca4a5af-0b8f-4e8d-a2ca–95d846c1f3f2) (hereinafter "Testimony of Arthur Johnson before the Senate Banking Committee") (emphasis in original). Treasury confirmed that in recent months banks have consistently been reluctant to participate in the TARP due to a fear of after-the-fact restrictions and a perception that TARP funds carry a stigma. Treasury conversations with Panel staff (Apr. 7, 2010).

[248] ABA conversations with Panel staff (Mar. 22, 2010); Greater Phoenix Economic Council Delegation conversations with Panel staff (Apr. 13, 2010) (for information about the Greater Phoenix Economic Council, *see* www.gpec.org/).

[249] For example, only six institutions received CPP funds in October 2009—two months from the end of the program in December 2009—but 65 institutions received funds in March 2009. U.S. Department of the Treasury, *Troubled Asset Relief Program: Transactions Report for Period Ending April 9, 2010,* at 9–10, 13 (Apr. 13, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-13-10%20Transactions%20Report%20as%20of%204-9-10.pdf). One witness at the Panel's Field Hearing in Phoenix noted that at the outset taking TARP funds was viewed as a sign of health and stability but that over time taking the funds was viewed more negatively. *See also* Congressional Oversight Panel, Testimony of James Lundy, president and chief executive officer, Alliance Bank of Arizona, *Transcript: Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-042710-phoenix.cfm).

[250] Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 6. For example, in Texas, Worthington National Bank received $5 million in new deposits in one month after it erected anti-TARP billboards, such as "Just say no to bailout banks. Bank responsibly," "Did your bank take a bailout? We didn't," and "Don't feed the Big Banks." The bank's CEO said, "I guess people are voting with their checkbooks because people have had a tremendous response to this campaign." He initiated the campaign because he was "vehemently opposed" to accepting TARP funds and wanted to distinguish his bank from competitors that participated in the TARP. "How can we be leaders in our community and in our industry and to our children when we're taking handouts?" he asked. Worthington National Bank, *No TARP For Us* (accessed Mar. 30, 2010) (citing Fox Business, *Why One Bank Said No to TARP* (online at video.foxbusiness.com/v/3884664/why-one-bank-said-no-to-tarp)).

[251] U.S. Department of the Treasury, *Statement by Secretary Henry M. Paulson, Jr. on Actions to Protect the U.S. Economy* (Oct. 14, 2008) (online at www.financialstability.gov/latest/hp1205.html) ("Our goal is to see a wide array of healthy institutions sell preferred shares to the Treasury, and raise additional private capital, so that they can make more loans to businesses and consumers across the nation"). *See* COP December Oversight Report, *supra* note 37, at 31 ("In addition to costing taxpayers, the recent bank failures call into question Treasury's assertion that CPP funds were only available to 'healthy' or 'viable' banks"); Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress,* at 53 (Jan. 30, 2010) (online at sigtarp.gov/reports/congress/2010/January2010_Quarterly_Report_to_Congress.pdf) ("Although CPP was meant for investments in healthy and viable banks, some CPP recipients have filed for bankruptcy protection").

[252] COP January Oversight Report, *supra* note 65, at 41 n.192.

In addition, industry sources maintain that restrictions that were applied after banks accepted TARP funds have made banks hesitant to participate in the TARP, as they have no guarantee that the restrictions in place at the time they accept government funds will remain constant.[253] For support, industry sources point to the passage of ARRA four months after the TARP was established. When banks first received funds under the TARP in October 2008, the only compensation restrictions were those set forth in EESA.[254] After the ARRA amended EESA's executive compensation provisions, Treasury issued regulations creating more stringent compensation restrictions.[255] The regulations established a Special Master[256] and gave him wide latitude to oversee compensation policies at institutions that had received "exceptional financial assistance."[257] As a result, TARP recipients are currently subject to different compensation restrictions from those that existed at the outset of the program.[258]

TARP recipients have also been excluded from a benefit provided by the Worker, Homeownership, and Business Assistance Act of 2009.[259] Enacted on November 6, 2009, the Act permitted taxpayers with net operating losses in 2008 and 2009 to apply those losses to tax payments made in five preceding tax years, a provision known as the "net operating loss carryback" (NOL carryback).[260] Before this law was enacted, the NOL carryback applied only to two preceding tax years. The Act stated explicitly that the benefit would not apply to TARP recipients.[261] Bank industry

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[253] Congressional Oversight Panel, *August Oversight Report: The Continued Risk of Troubled Assets,* at 46 (Aug. 11, 2009) (online at cop.senate.gov/documents/cop-081109-report.pdf) ("As with all TARP programs, there is a risk that banks and investors may be wary of the program because fears that participation will subject them to statutory restrictions, including those that they cannot anticipate. Government involvement has been viewed by many institutions as subject to unpredictable change"); ICBA conversations with Panel staff (Mar. 25, 2010); Testimony of Arthur Johnson before the Senate Banking Committee, *supra* note 247, at 8 ("We would urge Congress to distinguish any new proposal it considers from TARP in order to avoid creating a program that permits after-the-fact restrictions").

[254] 12 U.S.C. § 5221.

[255] ARRA was signed into law by President Obama on February 17, 2009. It authorized Treasury to issue standards governing executive compensation. On June 15, 2009, Treasury issued regulations governing executive compensation. 31 CFR § 30.

[256] Kenneth Feinberg was appointed as the Special Master on June 10, 2009. The White House, *Press Briefing by Press Secretary Robert Gibbs and Secretary of Commerce Gary Locke* (June 10, 2009) (online at www.whitehouse.gov/the-press-office/briefing-secretary-commerce-gary-locke-and-press-secretary-robert-gibbs-6-10-09).

[257] *See* 31 CFR § 30.1.

[258] There is some debate about the importance of executive compensation restrictions. Assistant Secretary Allison stated that executive compensation was a concern in testimony before the House Financial Services Committee and the House Small Business Committee. *See* Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 5 ("Smaller institutions, in particular, have struggled with the executive compensation restrictions that are the same for all institutions, regardless of size. . . . This creates a situation where, for example, a small community bank may not be permitted to make severance payments to a bank teller or secretary due to the 'golden parachute' prohibition that applies to senior executives and the next five highest-paid employees. Banks with few employees wind up disproportionately affected"). Some industry sources, however, have stated that executive compensation is not an issue for small banks. ABA conversations with Panel staff (Mar. 23, 2010).

[259] Pub. L. 111–92 (Nov. 6, 2009).

[260] 26 U.S.C. § 172.

[261] 26 U.S.C. § 56 note. TARP recipients are excluded even if they have already repaid the TARP funds. Internal Revenue Service, *Questions and Answers for The Worker, Homeownership, and Business Assistance Act of 2009—Section 13 5-year Net Operating Loss (NOL) Carryback* (Feb. 24, 2010) (online at www.irs.gov/newsroom/article/0,,id=217370,00.html) ("Q2: Who cannot make an extended carryback election under WHBAA? A: Taxpayers that received certain benefits (whether or not they were repaid) under the Emergency Economic Stabilization Act of 2008

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sources have stated that when banks accepted TARP funds, they had no reason to anticipate that their status as TARP recipients would cause them to be denied access to subsequent benefits afforded to their non-TARP competitors.[262]

b. Will the SBLF Avoid the TARP "Stigma"?

It is not clear that creating a new program outside of the TARP will be sufficient to insulate it from the TARP-era stigma associated with financial institutions that accept government money and persuade banks to participate. At a Panel hearing, one bank president implied that banks may be hesitant to accept government funds in the future because they are likely to be more cautious about the possibility that the public will react negatively.[263] Treasury officials state that members of Congress have expressed concern that any linkage between the new program and the TARP would discourage participation, even if the sole connection is the transfer of funds from one program to the other.[264]

Treasury officials have suggested that the new program might be able to insulate itself from some of these stigma concerns if it were able to secure immediate participation from an anchor group of banks.[265] However, bank participation in the SBLF is likely to hinge upon the form and scope of restrictions imposed on recipients of SBLF funds.[266] To the extent that banks have become frustrated by TARP restrictions, such as limits on executive compensation and increased regulatory oversight,[267] their willingness to accept SBLF funds will be contingent upon the new program's ability to distance itself from the TARP. The Administration appears to be responsive to this concern, as Assistant Secretary Allison affirmed that "participating banks would not be subject to TARP conditions."[268] In addition, the draft contains assurances that the SBLF is "separate and distinct" from the TARP and that if there is a subsequent "change in law that modifies the terms of the investment or program in a materially adverse respect," then a bank may repay the investment "without impediment," provided that its regulators agree.[269] The assurances have, however, limited substance. Establishing the SBLF as "separate and distinct" from the TARP will

(TARP recipients) or any taxpayer that was a member of the TARP recipient's affiliated group during 2008 or 2009 may not make a WHBAA election").

[262] Industry sources conversations with Panel staff (Mar. 25, 2010); Treasury conversations with Panel staff (Apr. 7, 2010) (stating that the exclusion from the net operating loss provision made the stigma worse because it made institutions so fearful of retroactive restrictions that they were reluctant to participate).

[263] *See* Congressional Oversight Panel, Testimony of Peter Prickett, president and chief executive officer, First National Bank—Fox Valley, *Transcript: COP Field Hearing on Small Business Lending in Milwaukee,* at 56 (Apr. 29, 2009) (online at cop.senate.gov/documents/transcript-042909-milwaukee.pdf) (hereinafter "Transcript: COP Field Hearing on Small Business Lending in Milwaukee") ("[M]aybe we . . . did not think enough about the public perception of the whole [TARP] program").

[264] Treasury conversations with Panel staff (Apr. 7, 2010).

[265] Treasury conversations with Panel staff (Apr. 7, 2010).

[266] *See* Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 5 ("Previous TARP programs may have seen reduced participation as a result of several factors, including certain statutory restrictions").

[267] Transcript: COP Field Hearing on Small Business Lending in Milwaukee, *supra* note 263, at 56 ("I can tell you about every other week, I get another letter from some office I have never heard of with all kinds of questions about what we are doing with the money and this and that").

[268] Herb Allison Testimony before House Financial Services and House Small Business Committees, *supra* note 98, at 5.

[269] Draft legislation provided to the Panel by Treasury (May 7, 2010).

have little effect if in the current economic and political environment, banks are subject to a stigma for accepting government money no matter the name of the program. Moreover, the assurance that banks may repay their TARP funds if the government imposes after-the-fact restrictions not only fails to distinguish the SBLF from the CPP—after all, CPP recipients also could repay with the approval of the appropriate regulator—but also provides little solace for banks in light of the NOL carryback. As discussed above, banks that received TARP funds were denied the NOL benefit even if they had already repaid their TARP money. The assurance cannot prevent a similar situation from occurring with the SBLF.

In spite of Treasury officials' intention to ensure that the new program is distinct from the TARP, the SBLF is identical to the TARP in one key respect: the government provides public money to private banks. From the taxpayer's point of view—and from the banking industry's point of view—this core similarity may make the SBLF look uncomfortably similar to the TARP. In testimony before the Panel, one bank president suggested that a new program that uses TARP funds—even one that is established free of some of the restrictions that have plagued TARP participation—may be met with skepticism.[270] Consequently, the fact that the new program has a different name may not be enough to insulate it from the TARP stigma. And if the new program fails to address the concerns of banks, they may decline to participate in the SBLF.[271]

On the other hand, although any new program must be one in which banks will participate, if it excessively limits Treasury's flexibility, Treasury may be unable to cure flaws in the program, possibly harming taxpayers. Any new program must balance the need to ensure adequate regulatory stability so as to maintain interest in participation against the need to preserve programmatic flexibility. Any new program should also require participating institutions to gather data so that Treasury and the taxpayers can evaluate whether it is, in fact, accomplishing its goals.

3. Issues with the SBLF: Will the SBLF Increase Lending to Small Businesses?

a. Structural Problems of the SBLF

Whether the SBLF will spur lending is contingent upon three factors: an accurate diagnosis of the factors currently inhibiting small business lending, a viable strategy for spurring lending, and program mechanics that will implement that strategy effectively. First, the potential effectiveness of the SBLF depends upon an accurate diagnosis of contraction in small business lending. The SBLF assumes that the contraction in lending stems at least in part from reduced supply as opposed to reduced demand. The SBLF will be less relevant if declining business sales play a larger

[270] *See* Testimony of Candace Wiest, *supra* note 65.

[271] Without taking a position on the merits of these concerns, the Panel notes that businesses, including banks, always face regulatory uncertainty—the uncertainty of TARP restrictions is therefore arguably a difference of degree, not kind.

role in lending contraction than banks' rejections of loan applications.[272]

Second, even if the SBLF is based on an accurate diagnosis of the problems in small business lending, it employs a model that may exhibit some of the same weaknesses as the CPP. Like the CPP, the SBLF injects capital into banks, assuming that an improved capital position will increase lending—despite the lack of evidence that the CPP did so. The SBLF is, admittedly, not identical to the CPP and may spur more lending than the CPP because it provides an incentive to increase lending: even after two years, at seven percent, the capital provided is still relatively cheap. Nonetheless, participating institutions may decide to keep the government's money, rather than use it to increase lending. As discussed above, there are many pressures on banks' balance sheets, and banks that face capital constraints are less likely to lend.[273] Moreover, the SBLF includes a mild penalty for banks that fail to increase lending. Treasury maintains that if banks do not use the money to lend, the taxpayer will either suffer no cost or may profit on the program.[274] According to Treasury, the universal dividend increase at five years provides a strong incentive to repay the investment, regardless of whether the bank increases its lending.[275] Nonetheless, the distinctions between the SBLF and the CPP have the potential to be mild.

Finally, even if the problem is primarily credit supply, and even if capital injections are capable of alleviating the problem, the SBLF must still be designed in such a way as to increase lending. The SBLF offers a lending incentive: dividend reductions are offered as a reward to banks that increase their lending, while dividend increases reinforce the point. Unlike some aspects of prior TARP programs, the SBLF is primarily designed around an incentive structure. Treasury appears to be betting that an incentive-based program will spur lending to small business on a scale and scope that prior TARP programs did not.

Whether the program is likely to be effective—aside from the question of whether it is necessary or useful—hinges on several questions. First, is the incentive—a ratio of 2.5:1 of lending increases to dividend decreases, and a dividend increase for banks whose lending decreases or stagnates—sufficient to generate a change in bank behavior? Industry sources maintain that a 2.5:1 ratio is likely to be insufficient in the current environment to inspire a meaningful increase in banks' lending practices.[276] Other trade organizations echoed the concern that the program is too weak to have the desired effect, as concerns about heightened enforcement of existing regulations and uncertainty about the stringency of future regulation are likely to outweigh the effect of the incentive.[277] For example, industry sources point to the fact that among other things, Congress is considering legislation that would

[272] *See* Section E.1 (discussing whether the problem results more from limited supply or limited demand). To the extent that the problem is one of demand, a supply-side solution is unlikely to have a significant effect.

[273] FDIC conversations with Panel staff (Apr. 30, 2010).

[274] Treasury conversations with Panel staff (Apr. 7, 2010).

[275] Treasury conversations with Panel staff (Apr. 7, 2010).

[276] ABA conversations with Panel staff (Mar. 22, 2010).

[277] NSBA conversations with Panel staff (Mar. 22, 2010).

restructure the regulation of the financial sector,[278] as well as legislation that would impose a new tax on financial institutions.[279] Banks may find it difficult to incorporate a lending incentive into their short-term plans when they are faced with the possibility of more stringent regulation.[280] Of course, it is difficult to ascertain the extent to which these factors contribute to low lending levels. As discussed in more detail above, other factors—such as a bank's capital position, anticipated CRE losses, and interest rate risk—may also inhibit lending.[281]

Second, the incentive must be sufficient to overcome other barriers to lending. As the Administration has stated, it lacks the authority "directly" to alter the capital reserve requirements imposed on banks by independent banking regulators.[282] In addition, from the banks' standpoint, interest rate risk,[283] unrealized losses, continuing problems with residential and commercial mortgages, the prospect of tighter capital requirements, and the proposed implementation of mark-to-market accounting that would force the acknowledgment of losses are all major concerns that are likely discouraging banks from lending.[284] In particular, some banks may face future challenges as a result of holding troubled real estate as-

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[278] *See, e.g.*, Senator Dodd Financial Regulation Reform Summary, *supra* note 72. *See also* American Bankers Association, *Issues of Interest: Regulatory Restructuring* (May 4, 2010) (online at www.aba.com/Press+Room/071609RegulatoryRestructuring.htm) (hereinafter "Issues of Interest: Regulatory Restructuring").

[279] Senate Committee on Finance, Written Testimony of James Chessen, chief economist, American Bankers Association, *The President's Proposed Fee on Financial Institutions Regarding TARP: Part 2,* at 5–10, (May 4, 2010) (online at finance.senate.gov/imo/media/doc/050410JC1.pdf).

[280] ABA conversations with Panel staff (Mar. 22, 2010). *See also* Issues of Interest: Regulatory Restructuring, *supra* note 278.

[281] *See* Section E, *supra*.

[282] The White House, *Remarks by the President and the Vice President at Town Hall Meeting in Tampa, Florida* (Jan. 28, 2010) (online at www.whitehouse.gov/the-press-office/remarks-president-and-vice-president-town-hall-meeting-tampa-florida) (hereinafter "Remarks by the President and the Vice President at Tampa Town Hall Meeting") (stating that the Administration cannot "directly" adjust capital requirements imposed by bank regulators).

[283] Industry sources stated that many banks are concerned about interest rate risk and are reluctant to lock themselves into long-term loans at a time of historic interest rate lows. Regulators have also expressed concerns about the impact of interest rate risk on lending to small businesses. *See* Sheila C. Bair, chairman, Federal Deposit Insurance Corporation, Remarks at the FDIC's Symposium on Interest Rate Risk Management (Jan. 29, 2010) (online at www.fdic.gov/news/conferences/irr_final.pdf) ("Rapid changes in rates are especially worrisome because of the adverse impact it can have on bank lending and earning"). *See also* ABA conversations with Panel staff (Mar. 22, 2010). However, testimony during the Panel's field hearing suggested that some banks believe that they can manage interest rate risk. *See* Congressional Oversight Panel, Testimony of Lynne Herndon, Phoenix city president, BBVA Compass Bank, *Transcript: Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-042710-phoenix.cfm) (hereinafter "Testimony of Lynne Herndon").

[284] Interest rate risk is a concern not only for current lending, but for the future stability of the banking system. Current historically low interest rates do not make new lending particularly profitable on a risk-adjusted basis. Since it is likely that interest rates will rise in the near future, banks have few incentives to make new, fixed-rate loans at the current low rates. Because their cost of capital is so low, banks lose little by holding cash and Treasuries. This issue was highlighted in a recent statement by the Federal Financial Institutions Examination Council (FFIEC), which warned banks to be aware of, and manage, interest rate risk. Federal Financial Institutions Examination Council, *Financial Regulators Issue Interest Rate Risk Advisory* (Jan. 7, 2010) (online at www.ffiec.gov/press/pr010710.htm). The possible implementation of mark-to-market accounting, which would force banks to acknowledge losses on loans and other assets that are currently being booked at substantially more than market value, may also be discouraging banks from lending. *See* Financial Accounting Standards Board, *Accounting for Financial Instruments Summary of Decisions Reached to Date As of March 31, 2010* (Mar. 31, 2010) (online at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156422130). Finally, stricter bank capital requirements may also be imposed as part of the Basel II Accords. *See* Federal Deposit Insurance Corporation, *Implementation of New Basel Capital Accord in the U.S.* (online at www.fdic.gov/regulations/laws/publiccomments/basel/index.html) (accessed Apr. 14, 2010).

sets on their books.[285] If banks are forced to report losses on these assets in the coming months and years, even banks that currently appear to be well-capitalized may be forced to raise additional capital. Banks that face capital constraints are less likely to lend.[286]

The SBLF does not address these issues, nor any of the issues affecting small business credit demand. For this reason, if regulatory and market uncertainty outweighs the positive effects of the incentive, the SBLF is not likely to have a significant effect. In response to this concern, Treasury has stressed that the SBLF is not a standalone program but is rather part of a package of programs designed to strengthen small businesses in the wake of the financial crisis, including the various SBA programs.[287]

Finally, the SBLF assumes that small banks are a pure conduit for lending to smaller businesses. The definition of small business lending in the draft legislation is broad, includes farm lending of various kinds, and is not keyed, in any way, to the size of the business or farm receiving the loan. At one level, this is understandable: as discussed above, it is difficult to craft a definition of "small business" that captures a consistent market.[288] But at another level, this choice relies upon the assumption that when a smaller bank makes a loan, the recipient of that loan is more likely than not to be a small business. It remains possible that a smaller bank, inconsistent with the purpose of the legislation, could use these funds to make loans to larger entities.

b. Other Issues Associated with the SBLF

An additional risk is that the SBLF may reward banks that would have increased their lending even in the absence of government support. The SBLF's incentive structure is calculated in reference to 2009 lending levels, which were low by historical standards. If a bank increases its lending—not as a result of receiving the SBLF funds but simply to return to a more normal lending level commensurate with its long-term business model—then it will receive a reduced cost of funds. The low lending levels in 2009 also make it unlikely that the penalty provision will have much teeth: because the program uses a low baseline, and many banks may be able to increase their lending levels within two years of receiving SBLF funds. In effect, a bank may receive a government reward and avoid a penalty simply for acting in its normal course of business. In response to this concern, Treasury stated that while it is accurate that some small banks may receive an undeserved reward from participating in the program, Treasury believes that this minimal cost is worthwhile in light of the potential benefit for small businesses.[289]

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[285] Testimony of Lynne Herndon, *supra* note 283 ("But I do think that there are many banks in Phoenix that are strong that do want to loan money but are struggling to sort of get around the whole issue of the capital constraints, dealing with a lot of the issues that we've been talking about today, either the existing risk in the portfolio or the pending risks that might be coming from reappraisal due to real estate"); COP February Oversight Report, *supra* note 2, at 2 ("The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy").

[286] FDIC conversations with Panel staff (Apr. 30, 2010).

[287] *See* Section D.1, *supra*.

[288] *See* Section B.1, *supra*.

[289] Treasury conversations with Panel staff (Apr. 7, 2010).

Even if the SBLF's incentive is sufficiently strong, the program may produce one key unintended consequence. A capital infusion program that provides financial institutions with cheap capital and a penalty for banks that do not increase lending runs the risk of creating moral hazard by encouraging banks to make loans to borrowers who are not creditworthy. Although, in the legislation, the carrot—an up to four percent decrease—is arguably stronger than the stick—a two percent increase—the stick nonetheless increases the incentive. The stronger the incentive, the greater the likelihood that the program will spur some amount of imprudent lending activity. As evidenced by recent events, imprudent lending activity may in turn inflate a small lending and commercial loan bubble,[290] a result of using an increasing supply of money for transactions of diminishing credit quality. Treasury maintains that this concern is minimal as the SBLF was designed to minimize the chances that banks will use the capital to make risky bets. The program does not shift risk away from the banks that receive the capital: any institution that receives funds under the SBLF is obligated to repay that money to Treasury and therefore will lose money if it makes a bad loan. A bank is also obligated to pay Treasury an annual dividend of one to seven percent, depending on the bank's lending activity. The dividend and repayment requirements are likely to decrease the chances that banks squander the capital on imprudent lending.[291]

Further, it is unlikely that the obligation to repay Treasury will impose significant stress on a bank: the SBLF limits the amount that a bank may receive up to five percent of risk-weighted assets, and it requires the Secretary to consult with a bank's regulator prior to making the capital investment.[292] Even in the unlikely event that a bank uses all of the SBLF capital to make loans that eventually default, its balance sheet should not be severely affected. Treasury stated that when it designed the program, it worked closely with banking regulators to ensure that the SBLF would not threaten the safety and soundness of banking institutions.[293] On the other hand, Treasury should remain focused on this issue since some participating banks may experience losses on real estate loans and other stresses on their balance sheets; for such institutions, the obligation to repay Treasury may present a challenge.

For the SBLF to be effective by its terms, it must avoid both a weak incentive structure that does not spur lending and an overly robust incentive structure that generates a high rate of undesirable lending. To avoid a return to the imprudent lending practices of recent years, it is vital that institutions employ prudent due diligence standards and that regulators enforce these standards. The result of such standards is that some borrowers will not receive credit, but in the interest of avoiding a return to the lending bubble of the mid–2000s, this is a cost that the system should be prepared to bear. As Secretary Geithner has stated, "we can't go back to the

[290] The potential bubble also could have disproportionate impact across sectors and geographical areas, concentrating consequences if the bubble were to burst.

[291] Treasury conversations with Panel staff (Apr. 7, 2010).

[292] Medium banks are eligible to receive a maximum of three percent of risk-weighted assets. Draft legislation provided to the Panel by Treasury (May 7, 2010).

[293] Treasury conversations with Panel staff (Apr. 7, 2010).

situation we had over the last 10 years" in which "incentives for risk taking . . . overwhelmed all the basic checks and balances in the system."[294]

c. Alternatives to the SBLF

Supply-side solutions for small business lending may be ineffectual if the problem is demand. Nonetheless, some small businesses assert that because sales are beginning to improve,[295] the government should institute a program to ensure that small businesses have adequate access to credit.[296] Some small business owners and members of Congress have called for direct lending to small businesses, but the Administration has justified its approach—investing capital in banks rather than lending directly to small businesses—as a means of generating more loan volume. In a town hall meeting in Florida, President Obama said that a direct lending program would require a "massive bureaucracy" and would "take too long" to set up.[297] Treasury also has stated that it does not believe that the federal government should decide which businesses receive loans and which do not.[298]

Others have proposed a hybrid approach in which the government would contract with private banks to administer a lending program for small businesses. The program would be funded by the government. The administrative costs would be minimal, and banks would have an incentive to participate because they would receive fees for loans they facilitate. One potential problem with such a program is that the government—and not the banks—would bear the risks associated with the loans, which might result in banks using government money to make imprudent loans. Accordingly, any such program would need to require banks to retain some portion of the risk.

Treasury maintains that capital infusions are preferable to either the direct lending or hybrid models because they would permit a bank to leverage Treasury investments and would therefore have a broader stimulative effect on small business lending.[299] Secretary Geithner, Management and Budget Director Peter Orszag, and Chair of the Council of Economic Advisers Christina Romer have stated that the SBLF's impact could be amplified "because the cap-

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[294] Charlie Rose, *An Hour with Timothy Geithner, U.S. Treasury Secretary* (May 6, 2009) (online at www.charlierose.com/view/interview/10278).

[295] U.S. Census Bureau, *Advance Monthly Sales for Retail and Food Services* (Apr. 14, 2010) (online at www.census.gov/retail/marts/www/marts_current.html); Federal Reserve Bank of Atlanta Small Business Survey, *supra* note 150, at 40.

[296] Congressional Oversight Panel, Testimony of Cindy Anderson, chief executive officer, Great Biz Plans, *Transcript: Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-042710-phoenix.cfm). ("I don't know that the do nothing else option is a viable option"); Congressional Oversight Panel, Testimony of Mary Darling, chief executive officer, Darling Environmental and Surveying, Inc., *Transcript: Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-042710-phoenix.cfm) ("To do nothing would be terrible").

[297] Remarks by the President and the Vice President at Tampa Town Hall Meeting, *supra* note 282. Although there are a large number of SBA-affiliated banks, there are a relatively small number of SBA offices. According to Treasury, a direct lending program would fail to take advantage of the expertise of the SBA-affiliated banks, while requiring a massive effort to increase the number of SBA offices. Treasury conversations with Panel staff (Apr. 7, 2010).

[298] Treasury conversations with Panel staff (Apr. 1, 2010).

[299] Treasury conversations with Panel staff (Apr. 14, 2010).

ital could be leveraged several times into new loans."[300] For example, assuming that banks are permitted to leverage capital at a 10:1 ratio, the provision of $10 in SBLF funds would permit a bank to loan $100 to small businesses. Accordingly, unless a bank retained more than 90 percent of the funds it received under the SBLF, a capital-based program could produce more lending than the alternatives. Of course, there is no evidence that the capital injected under the CPP produced this leveraging effect, making it difficult to evaluate this theory.

Another alternative would be to permit banks to use government-provided capital to fund state lending consortia, such as those that exist in New York and South Carolina.[301] The New York Business Development Corporation (NYBDC), for example, uses funding from member banks to make loans to small businesses, "many of which do not meet the requirements for traditional financing."[302] Because of the single-purpose nature of consortium lending, this approach may be effective for deploying capital directly into new small business loans, rather than using it to shore up a bank's balance sheet. A consortium could also leverage contributed capital several times over.[303]

This option would be most effective if it included an incentive that encourages banks to provide funds to consortia. For example, just as the SBLF's lending incentive primarily rewards banks based on the loans they make, a consortium-oriented approach could employ an incentive that rewards banks for contributions they make to a consortium.[304] Because lending consortia already exist in states like New York and South Carolina, using those existing consortia to increase small business lending could require a limited investment in administrative costs and would take advantage of existing institutional expertise, although building programs from scratch in other states might take a substantial amount of time.[305] Treasury has stated that it is open to the idea of promoting programs at the state level, and it is working with states

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[300] House Committee on Appropriations, Joint Written Testimony of Timothy F. Geithner, Peter R. Orszag, and Christina D. Romer (Mar. 16, 2010) (online at treasury.gov/press/releases/tg589.htm).

[301] New York Business Development Corporation, *About Us* (online at www.nybdc.com/aboutus.html) (hereinafter "NYBDS: About Us") (accessed May 6, 2010). *See also* Business Development Corporation of South Carolina, *Welcome* (online at www.businessdevelopment.org/index.php) (accessed May 6, 2010). *See* Section D.3, *infra.* State lending consortia function primarily to: (1) allow participant banks to share risk and realize profits on loans they were unlikely to offer otherwise; (2) facilitate lending expertise that a participant bank may lack; and (3) ease credit access for local small businesses.

[302] NYBDS: About Us, *supra* note 301 (accessed May 6, 2010).

[303] Many of the existing consortia operate, at least in part, as certified CDFI or CDC lenders, leading to overlap with other Treasury recovery programs. *See also* U.S. Department of the Treasury, *Certified Community Development Financial Institutions—By Organization Type* (online at www.cdfifund.gov/docs/certification/cdfi/CDFIbyOrgType.pdf) (accessed May 6, 2010). While the similar purpose could have the benefit of making the programs run more fluid and enhancing their effectiveness, it may also strain existing resources.

[304] There are a variety of alternative options for funding state lending programs. For example, the government could create special purpose vehicles that would match private funds with government funds, using a model that is similar to programs like the PPIP. In this model, the combined private and government capital would go to the special purpose vehicle, which would then use the capital to finance state consortia. Because the government would not be providing all of the money, it would not bear all of the risk. Lending consortia could leverage the public-private funds as permitted by capital requirements. If the matching program used a public-private match ratio of 1:1 and regulatory capital ratios are set at 10:1, then every dollar of government investment could result in $20 in lending.

[305] *See* Testimony of Lynne Herndon, *supra* note 283.

to identify lending targets.[306] The Panel takes no position on whether any of the programs described above, including the SBLF, should be implemented.

G. Conclusion

There are significant challenges in designing programs to make credit available to small businesses. The wide variety among small businesses makes it difficult to collect data, target individual trends, and effectively stimulate small business lending. Because small businesses are so heterogeneous, it is easier and arguably more efficient for Treasury and other government actors to use regulated entities like banks as conduits to small businesses. The banks are easily identifiable, and, compared to the information that the government is likely to have on the assets and overall position of a small business, the government has greater familiarity with the bank. Indeed, most of the approaches that Treasury and other government actors have taken in attempting to spur small business lending rely on such intermediaries: capital infusions, guarantees, and secondary market support all depend upon an intermediary, generally a bank, to help manage aid to the small business. In this model, the bank or other intermediary uses its infrastructure to evaluate the borrower, underwrite, and later administer the loan. For its part, the government uses its relative familiarity with the bank and the banking industry to provide a backstop, such as a guarantee or other assistance, while it relies on the bank for the practical problems of lending.

That said, however, while for practical purposes it may be useful to use a regulated intermediary, this makes the intermediary the lynchpin in a government program, a role for which it is not a perfect match, because the bank's incentives and challenges are not identical to the government's. Whether the form of government's involvement is effective, furthermore, depends on the assets the bank holds. Guarantees and secondary market support, for example, are useful only if the intermediary holds assets that can be securitized or guaranteed.

Treasury has stated that it believes that providing cheap capital to the smaller banks—with an incentive to increase lending, and as part of a larger package of programs including SBA programs—will unlock the credit that CPP did not. It is true that the SBLF, unlike the CPP, provides incentives for banks to lend, which may result in a different outcome. In many ways, however, the SBLF substantially resembles the CPP: it is a bank-focused capital infusion program that is being contemplated despite little, if any, evidence that

[306] Treasury conversations with Panel staff (Apr. 14, 2010). On May 7, 2010, the Administration proposed a second small business initiative to Congress. Entitled the State Small Business Credit Initiative, the program would provide federal funding to states that create or have specific programs to support small business lending. In order to receive federal funds, these state-based programs would need to provide financial institutions with "portfolio insurance" for business loans. The insurance would cover only loans of less than $5 million that were made to business borrowers of fewer than 500 employees, and any loan covered by the program would need to place a "meaningful amount of [a financial institution's] own capital resources at risk in the loan." The program would also provide federal funding to states that create, or have existing, credit support programs—including collateral support programs, loan participation programs, and credit guarantee programs—so long as the state can demonstrate that every $1 of state funding produces at least $1 of new private credit. Draft legislation provided to the Panel by Treasury (May 7, 2010).

such programs increase lending. Had Treasury gathered more consistent data, including ongoing data from the top 22 CPP recipients, it might have been possible to have a complete basis of comparison for lending by these institutions since EESA was enacted. In the absence of that data—data showing what recipients did with the CPP funds or any effort to track lending in a way that can be meaningfully evaluated—the Panel is skeptical that Treasury has the grounds on which to make such an assumption. After all, the largest CPP recipients did not lend more: quite the contrary. Further, the SBLF imposes only a mild penalty on banks that take the funds but fail to increase lending, and there is nothing in the SBLF to create accountability or linkages between the receipt of funds and loans, something that even some small banks have said that they would welcome.

Treasury's prior attempts to spur small business lending by providing capital infusions to smaller banks through the TARP have foundered in part because smaller banks have resisted taking TARP funds. Accordingly, the SBLF, as presently envisioned, is outside the TARP. It uses capital infusions to intermediaries and creates an incentive structure that rewards banks for higher loan levels to small businesses. Whether it is likely to be productive depends, however, not only on whether banks take the funds but also on whether it, as another capital infusion program, accurately targets the source of the contraction. Even if the problem is primarily credit supply, capital infusions increase lending only if the bank does not use them to fill in holes in its capital structure or to hold as a hedge against anticipated future losses. Furthermore, the SBLF has been proposed in the face of questions as to whether the lending constriction is, in fact, a problem of supply—whereas if low lending results from low demand, then it is difficult to see how yet another bank-focused approach is likely to have an effect. Without taking any position on whether Treasury should adopt any particular lending program, including the SBLF, other approaches that are less dependent on healthy bank balance sheets, such as state-level consortia, or programs in which banks take first losses and first profits with a public backstop, might more likely achieve Treasury's stated objectives. Treasury's ability to influence the market and its reserve of funds are not unlimited. Treasury should evaluate carefully the need for a new program as well as its likely effectiveness and prudence, given that an ill-conceived program may tie up funds that could be used to better effect elsewhere.

The Panel recommends that Treasury and the relevant federal regulators:

- Establish a rigorous data collection system or survey that examines small business finance in the aftermath of the credit crunch and going forward: the Federal Reserve Bank of Atlanta has commenced a demand-side survey, for example, that could potentially be expanded to other Federal Reserve banks. Such a survey should include demand- and supply-side data and include data from banks of different sizes (both TARP recipients and non-TARP recipients), because the lack of timely and consistent data has significantly hampered efforts to approach and address the crisis;
- Require, as part of any future capital infusion program, reporting obligations that would make it easier to evaluate whether the

support provided by the program actually has the capacity to achieve the hoped-for results;

- As part of its consideration of small business lending, evaluate whether a capital infusion program is likely to have the effect of increasing lending, and is therefore worth pursuing;
- Consider specifying minimum standards for underwriting SBLF loans in order to be sure that the incentives embedded in any program do not spur imprudent lending; and
- If the SBLF is to be pursued, evaluate whether the SBLF can be implemented quickly enough to make any difference at all, particularly given that announcements followed by inaction may negatively affect the market.

ANNEX I: PENDING LEGISLATION RELATED TO SMALL BUSINESS LENDING

Senate:

Small Business Job Creation Act of 2010, introduced March 10, 2010 (S. 3103)

- *Sponsor:* Olympia Snowe (R–ME)
- *Status:* Referred to the Committee on Finance (March 10, 2010)
- *Summary:* (1) Increases the 7(a) loan guarantee to 90 percent until January 2011 and the maximum loan amount;[307] (2) Increases the maximum loan amounts of 504 loans;[308] (3) Increases the loan limit on microloans from $35,000 to $50,000, and increases the maximum loan limit of loans made to microloan intermediaries from $3.5 million to $5 million;[309] (4) Regulates the sale of 7(a) loans in secondary markets; and (5) Establishes low interest financing under Local Development Business Loan Program.

Boosting Entrepreneurship and New Jobs Act, introduced January 28, 2010 (S. 2967)

- *Sponsor*: Benjamin Cardin (D–MD)
- *Status*: Referred to the Committee on Finance (January 28, 2010)
- *Summary*: (1) Directs the SBA and Treasury to establish a joint, direct loan program for small businesses, funded with $30 billion made available under the Emergency Economic Stabilization Act of 2008; (2) Increases the percent guarantee and maximum loan amount of 7(a) loans and increases the maximum loan amount of microloans; and (3) Increases the maximum loan amounts of 504 loans.

Small Business Lending Enhancement Act of 2009, introduced December 21, 2009 (S. 2919)

- *Sponsor*: Mark Udall (D–CO); *Original Co-Sponsors*: Charles Schumer (D–NY), Joseph Lieberman (I–CT), Olympia Snowe (R–ME), Barbara Boxer (D–CA), Susan Collins (R–ME), Kirsten Gillibrand (D–NY)
- *Status*: Referred to the Committee on Banking, Housing, and Urban Affairs (December 17, 2009)

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[307] The SBA's 7(a) Loan Program, named after the section of the Small Business Act that authorizes it, is the agency's primary loan guarantee program. Under the program, a bank or similar financial institution will extend a loan to a qualifying business and the SBA will guarantee repayment of a certain percentage of the loan amount, as specified in the Act. U.S. Small Business Administration, *7(a) Loan Program* (online at www.sba.gov/financialassistance/borrowers/guaranteed/7alp/index.html) (accessed May 6, 2010).

[308] The CDC/504 Loan Program is another loan guarantee program that provides long-term, fixed-rate financing to small business, through intermediary Certified Development Companies, for certain fixed assets (e.g., land, structures, machinery, and equipment). U.S. Small Business Administration, *504 Loan Program* (online at www.sba.gov/financialassistance/borrowers/guaranteed/CDC504lp/index.html) (accessed May 6, 2010).

[309] The Microloan Program authorizes the SBA to make funds available to certain nonprofit, community-based organizations for the purpose of providing microloans to small businesses. These loans may be used for working capital or for purchasing "inventory, supplies, furniture, fixtures, machinery, and/or equipment." U.S. Small Business Administration, *Micro-Loan Program* (online at www.sba.gov/financialassistance/borrowers/guaranteed/mlp/index.html) (accessed May 6, 2010).

• *Summary*: Under the Federal Credit Union Act, (1) Increases the total permissible amount of member business loans by an insured credit union to a limit of 25 percent of the credit union's total assets; and (2) Increases, from $50,000 to $250,000, the maximum total extension of credit before a member loan is considered a member business loan.

Small Business Job Creation and Access to Capital Act of 2009, introduced December 10, 2009 (S. 2869)

• *Sponsor*: Mary Landrieu (D–LA); *Original Co-Sponsor:* Olympia Snowe (R–ME)
• *Status*: Committee on Small Business and Entrepreneurship. Ordered to be reported with an amendment favorably (December 17, 2009)
• *Summary*: (1) Increases the loan limit on 7(a) loans; (2) Increases the loan limit on 504 loans; (3) Increases the loan limit on microloans from $35,000 to $50,000, and increases the maximum loan size of loans made to microloan intermediaries from $3.5 million to $5 million; (4) Authorizes the use of 504 loans to refinance short-term commercial real estate debt into long-term, fixed rate loans; (5) Extends, through December 31, 2010, the authorization to provide 90 percent guarantees on 7(a) loans and fee elimination for borrowers on 7(a) and 504 loans, as originally set out in the American Recovery and Reinvestment Act of 2009 (ARRA); and (6) Directs the SBA to create a website where small businesses can identify lenders in their communities.

CREATE Growth and Jobs Act, introduced December 9, 2009 (S. 2855)

• *Sponsor*: Robert Menendez (D–NJ)
• *Status*: Referred to the Committee on Banking, Housing, and Urban Affairs (December 9, 2009)
• *Summary*: (1) Authorizes direct SBA loans up to $1.5 million for operations, acquisition, or expansion to businesses that are creditworthy but cannot obtain credit elsewhere; (2) Specifies maximum loan terms and overall size of the program; and (3) Makes use of TARP funds for implementation.

Small Business Intermediary Lending Pilot Program Act of 2009, introduced November 17, 2009 (S. 2780)

• *Sponsor*: Carl Levin (D–MI)
• *Status*: Referred to the Committee on Small Business and Entrepreneurship (November 17, 2009)
• *Summary*: Authorizes direct SBA 20-year loans of up to $3 million at one percent interest to a maximum of 20 non-profit, intermediary lenders, which then shall lend this money out in increments of up to $200,000 to eligible small businesses.

The Small Business Access to Capital Act, introduced October 21, 2009 (S. 1832)

• *Sponsor*: Mary Landrieu (D–LA); *Original Co-Sponsors*: John Kerry (D–MA), Jeanne Shaheen (D–NH), Robert Casey, Jr. (D–PA), Benjamin Cardin (D–MD), Tom Harkin (D–IA)

• *Status*: Referred to the Committee on Small Business and Entrepreneurship (October 21, 2009)
• *Summary*: (1) Increases maximum loan amounts under 7(a), Microloan, and 504 programs; (2) Allows borrowers to refinance previous business debt under the Local Development Business Loan Program; (3) Applies single-business investment limits to New Market Venture Capital companies; and (4) The increase in 7(a) loan amounts and the refinancing power created by this Act will expire October 1, 2010.

Bank on Our Communities Act, introduced October 21, 2009 (S. 1822)

• *Sponsor*: Jeff Merkley (D–OR); *Original Co-Sponsor*: Barbara Boxer (D–CA)
• *Status*: Referred to the Committee on Banking, Housing, and Urban Affairs (October 21, 2009)
• *Summary*: (1) Amends the Emergency Economic Stabilization Act of 2008 to require the Secretary of the Treasury to take into account the needs and viability of small financial institutions when carrying out his duties under the Act; (2) Establishes, within Treasury, the Community Credit Renewal Fund to provide up to $15 billion in assistance to community banking institutions; and (3) Establishes lending incentives to encourage community banks to extend commercial and industrial loans and penalties if certain benchmarks are not met.

IMPACT Act of 2009, introduced August 6, 2009 (S. 1617)

• *Sponsor*: Sherrod Brown (D–OH); *Original Co-Sponsors*: Evan Bayh (D–IN), Kirsten Gillibrand (D–NY), Jeff Merkley (D–OR), Debbie Stabenow (D–MI)
• *Status*: Referred to the Committee on Energy and Natural Resources, subcommittee on Energy (August 6, 2009); Hearings held (December 8, 2009)
• *Summary*: Directs the Department of Commerce to provide state grants to establish revolving loan funds that would lend to small and medium-sized manufacturers for the purpose of producing clean energy technology and energy efficient products or reducing emissions from manufacturing facilities.

The Next Step for Main Street Credit Availability Act, introduced August 6, 2009 (S. 1615)

• *Sponsor*: Olympia Snowe (R–ME)
• *Status*: Referred to the Committee on Small Business and Entrepreneurship (August 6, 2009)
• *Summary*: Increases maximum loan amounts under 7(a), Microloan, and 504 programs.

House of Representatives:

To permit the use of previously appropriated funds to extend the Small Business Loan Guarantee Program, introduced March 25, 2010 (H.R. 4938)

• *Sponsor*: José Serrano (D–NY–16)
• *Status*: Became Public Law No. 111–150 (March 26, 2010)

• *Summary*: (1) Provides additional funding of $40 million for an existing SBA program, established under ARRA, that reduces or eliminates fees related to small business lending and loan guarantees; and (2) Extends, to April 30, 2010, SBA authority to guarantee loans under this program.

Main Street Survival Act, introduced December 16, 2009 (H.R. 4340)

• *Sponsor*: Artur Davis (D–AL–7)
• *Status*: Referred to the House Committee on Financial Services (December 16, 2009)
• *Summary*: Requires Treasury to create a three-year Main Street Revolving Loan Fund Program to provide temporary loans to businesses with less than 1,000 full-time employees. Loans from this program may only be used to fund operations and are limited to $1 million with a nine-month term.

Small Business Job Creation and Access to Capital Act of 2009, introduced December 14, 2009 (H.R. 4302)

• *Sponsor*: Neil Abercrombie (D–HI–1); *Original Co-Sponsor*: Nita Lowey (D–NY–20)
• *Status*: Referred to the House Committee on Small Business (December 14, 2009)
• *Summary*: (1) Increases maximum loan amounts under 7(a), Microloan, and 504 programs; (2) Extends SBA authority to reduce loan fees for 7(a) and 504 loans through 2010; (3) Applies single-business investment limits to New Market Venture Capital companies; (4) Requires the SBA to broaden the scope of small business standards to include other measures; and (5) Allows borrowers to refinance previous business debt under the local development business loan program, subject to certain restrictions (if the debt was (i) incurred within 2 years prior to SBA application, (ii) commercial, (iii) not guaranteed by federal agency, (iv) used to acquire fixed assets, (v) collateralized by the fixed asset, and (vi) a loan which the borrower has been current on for at least one year).

Small Business Emergency Capital Assistance Act of 2009, introduced December 11, 2009 (H.R. 4295)

• *Sponsor*: Joe Courtney (D–CT–2)
• *Status*: Referred to the House Committee on Small Business (December 11, 2009)
• *Summary*: Requires the SBA to establish a program to extend direct loans (maximum of $1.5 million with 25-year repayment program) to small businesses that are economically healthy, have good credit, and are unable to obtain loans with reasonable terms from a non-federal source.

To Establish SBA Direct Lending Program, introduced December 10, 2009 (H.R. 4265)

• *Sponsor*: John Yarmuth (D–KY–3)
• *Status*: Referred to the Committee on Small Business, Financial Services (December 10, 2009)
• *Summary*: (1) Requires the SBA to establish a program to extend direct loans (maximum of $500,000 or 10 percent of annual

business revenue, whichever is less) to small businesses; and (2) Uses TARP funds to implement the program.

American Workers, State, and Business Relief Act, introduced December 7, 2009 (H.R. 4213)

- *Sponsor*: Charles Rangel (D–NY–15)
- *Status*: Passed House (December 9, 2009); Passed Senate (March 10, 2010)
- *Summary*: (1) Provides additional funding of $560 million for an existing SBA program, established under the American Recovery and Reinvestment Act of 2009, that reduces or eliminates fees related to small business lending and loan guarantees; and (2) Extends, to December 30, 2010, SBA authority to reduce or eliminate fees and guarantee loans under this program.

Small Business Financing and Investment Act of 2009, introduced October 20, 2009 (H.R. 3854)

- *Sponsor*: Kurt Schrader (D–OR–5); *Original Co-Sponsors*: Nydia Velázquez (D–NY–12), Deborah Halvorson (D–IL–11), Ann Kirkpatrick (D–AZ–1)
- *Status*: Passed House (October 29, 2009); Referred to Senate committee: Received in the Senate and Read twice and referred to the Senate Committee on Small Business and Entrepreneurship (November 2, 2009)
- *Summary*: (1) Creates two new programs: (i) the Small Business Early Stage Investment program, which assists early stage businesses in capital intensive industries by providing grant funding that will match funds from investment companies, and (ii) the Small Business Health Information Technology Financing program, which will increase access to capital, through equity investing and affordable credit, for small businesses seeking to purchase health information technology; (2) Increases the maximum loan size of 7(a) loans and simplifies the process for lenders; (3) Increases the SBA guarantee on 7(a) loans to 90 percent; (4) Removes fees on 7(a) and 504 loans; (5) Changes the American Recovery Capital (ARC) Loan Program[310] to reduce documentation, expand eligibility, and increase the maximum loan amount from $35,000 to $50,000; (6) Establishes the Capital Backstop Program that would allow the SBA to lend directly to certain small businesses;[311] and (7) Directs the SBA to expand the New Markets Venture Capital and Renewable Energy Capital Investment programs.

Small Business Microlending Expansion Act of 2009, introduced October 7, 2009 (H.R. 3737)

- *Sponsor*: Brad Ellsworth (D–IN–8)

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[310] The ARC loan program was created under ARRA to provide fully guaranteed loans to small businesses for the purpose of making payments toward principal and interest on existing debts. U.S. Small Business Administration, *SBA ARC Loan Program* (online at www.sba.gov/recovery/arcloanprogram/index.html) (accessed May 6, 2010).

[311] This program allows small businesses to submit loan applications directly to the SBA. If the SBA finds that the small business is eligible for a loan under 7(a) standards, the application will be forwarded to preferred lenders. If no preferred lender chooses to accept the loan application, the SBA then must "originate, underwrite, close, and service" the loan. Small Business Financing and Investment Act of 2009, H.R. 3854, 111th Cong. § 111 (2009).

• *Status*: Passed House (November 7, 2009); Referred to the Committee on Small Business and Entrepreneurship (November 9, 2009)

• *Summary*: (1) Requires intermediary lenders in the Microloan Program to report relevant borrower information to credit reporting agencies; (2) Removes "short-term only" requirement from the Microloan Program; (3) Broadens eligibility for intermediary lenders; (4) Increases limits on loans to intermediaries to $1 million (from $750,000) in the first year and to $7 million (from $3.5 million) in remaining years; (5) Increases maximum percentage of grant funds (from 25 percent to 35 percent) that may be used by intermediaries for information and technical assistance to small businesses; (6) Increases maximum loan amount to small businesses that qualify for a reduced rate (from $7,500 to $10,000); (7) Authorizes the SBA to make interest assistance grants to intermediaries to lower rates for small businesses; and (8) Authorizes the SBA to make microloan technical assistance loans, direct loans, and interest assistance loans for FY2010–2011.

American Small Business Innovation Act, introduced September 30, 2009 (H.R. 3684)

• *Sponsor*: Joe Sestak (D–PA–7)

• *Status*: Referred to the Committee on Small Business (September 30, 2009)

• *Summary*: (1) Requires the SBA to expand the New Market Venture Capital Fund by approving at least one venture fund in each region, adding additional requirements to the funds, and authorizing SBA grants to assist the funds; and (2) Establishes Office of Angel Investment within the SBA and requires the Office to fund approved angel groups and make grants to increase awareness and education about angels.

Small Business Lending Promotion Act of 2009, introduced September 9, 2009 (H.R. 3546)

• *Sponsor:* Joe Sestak (D–PA–7); *Original Co-Sponsor*: Steve Kagen (D–WI–8), Madeleine Bordallo (D–Guam)

• *Status*: Referred to the Committee on Small Business (September 9, 2009)

• *Summary*: Requires the SBA to continue to administer the Community Express Program in the same manner in which it carried out the Community Express Pilot Program.[312]

Promoting Lending to America's Small Businesses Act of 2009, introduced July 29, 2009 (H.R. 3380)

• *Sponsor*: Paul Kanjorski (D–PA–11); *Original Co-Sponsor*: Edward Royce (R–CA–40)

• *Status*: Referred to the Committee on Financial Services (July 29, 2009)

• *Summary*: Under the Federal Credit Union Act, (1) Increases the total permissible amount of member business loans by an insured credit union to a limit of 25 percent of the credit union's total

[312] The Community Express Pilot Program required lenders to ensure that a borrower had received satisfactory technical assistance before providing SBA-guaranteed loans.

assets; (2) Increases, from $50k to $250k, the maximum total extension of credit before a member loan is considered a member business loan; and (3) Removes the requirement that credit unions increasing business lending be adequately capitalized, now requiring only approval from NCUA; (4) Narrows definition of "member business loan."

Job Creation through Entrepreneurship Act of 2009, introduced May 12, 2009 (H.R. 2352)

• *Sponsor:* Heath Shuler (D–NC–11); *Original Co-Sponsors*: Blaine Luetkemeyer (R–MO–9), Nydia Velázquez (D–NY–12), Glenn Thompson (R–PA–5), Kathleen Dahlkemper (D–PA–3), Vern Buchanan (R–FL–13), Glenn Nye III (D–VA–2), Aaron Schock (R–IL–18), Joe Sestak (D–PA–7), Dennis Moore (D–KS–3), Yvette Clarke (D–NY–11), Jason Altmire (D–PA–4), Michael Michaud (D–ME–2), Deborah Halvorson (D–IL–11), Kurt Schrader (D–OR–5)

• *Status:* Passed House (May 20, 2009); Referred to the Committee on Small Business and Entrepreneurship (May 21, 2009)

• *Summary:* (1) Requires the SBA to establish the Veterans Business Center Program to provide business training and counseling to veterans; (2) Broadens the Women's Business Center Program by removing restrictions and requiring certain studies and disclosures; and (3) Modernizes the Small Business Development Center Program by providing grant funding to increase access to capital, add contract procurement and green technology training, and create helplines for advice and resources.

Small Business Microloan Modernization Act of 2009, introduced March 26, 2009 (H.R. 1756)

• *Sponsor:* Dean Heller (R–NV–2)

• *Status:* Referred to the Committee on Small Business, Finance and Tax subcommittee (March 26, 2009)

• *Summary:* (1) Requires intermediary lenders in the Microloan Program to report relevant borrower information to credit reporting agencies; (2) Removes "short-term only" requirement from Microloan Program; (3) broadens eligibility for intermediary lenders; (4) Increases maximum loan amount to a small business that qualifies for reduced rate (from $7,500 to $10,000); and (5) Increases maximum percentage of grant funds (from 25 percent to 35 percent) that may be used by intermediaries for information and technical assistance to small businesses.

To increase participation in 7(a) Loans, introduced January 15, 2009 (H.R. 575)

• *Sponsor:* Jim Gerlach (R–PA–6)

• *Status:* Referred to the Committee on Small Business, Finance and Tax subcommittee (January 15, 2009)

• *Summary:* Expands the number of loans eligible for greater SBA participation by raising the threshold loan amount from $150,000 to $500,000.

Veteran-Owned Small Business Promotion Act of 2009, introduced January 8, 2009 (H.R. 294)

• *Sponsor:* Steve Buyer (R–IN–4); *Original Co-Sponsors*: Gus Bilirakis (R–FL–9), John Boozman (R–AK–3), Thomas Rooney (R–FL–16), Vern Buchanan (R–FL–13), Ginny Brown-Waite (R–FL–5)

• *Status:* Referred to the Committee on Veterans' Affairs, subcommittee on Economic Opportunity (January 9, 2009); Hearings held (September 24, 2009)

• *Summary:* (1) Reinstates the Veteran-owned Small Business Loan Program under the Department of Veterans Affairs; (2) Repeals authority to make direct loans and replaces it with authority for loan guarantees; (3) Increases the maximum loan amount from $200,000 to $500,000; (4) Authorizes Department of Veterans Affairs to subsidize lenders to lower interest rates by 0.5 percent; and (5) Allows treatment of veteran-owned businesses as disadvantaged for purposes of contract awards under the Small Business Act.

ANNEX II: STATE SMALL BUSINESS CREDIT PROGRAMS ESTABLISHED IN RESPONSE TO THE CRISIS[313]

Colorado

Date of Inception: May 7, 2009
Program: Access to Capital

Colorado's Access to Capital initiative provides public funding of $2.5 million to restart the state's Colorado Credit Reserve Program. This program contains a pooled loan-loss reserve fund that banks may access to recover losses on eligible loans. By reducing risk for participating banks, the program seeks to generate an estimated $50 million in private bank loans for state businesses.[314]

Delaware

Date of Inception: April 20, 2009
Program: Small Business LIFT (Limited Investment for Financial Traction) Program

The LIFT program enables eligible small businesses, with an existing line of credit and between 3 and 50 employees, to defer principal and pay no interest on amounts drawn from the line of credit over a two-year period.[315] Under the terms of the program, the Delaware Economic Development Office, using up to $5 million from the state's strategic fund, pays to the bank the monthly interest on a borrower's line of credit up to $25,000, until June 30, 2011, after which the borrower makes the required principal payments during the next five years.

Illinois

Date of Inception: October 16, 2008
Program: Treasurer's Access to Capital Program

As an expansion to the existing Treasurer's Access to Capital Program, the Illinois Treasurer will reallocate an additional $1 billion in state investments to interest-bearing deposit accounts at small and medium-sized banks and credit unions. By increasing these financial institutions' capital bases, the state seeks to spur

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[313] State responses to the contraction in small business lending continue to be largely constrained by fiscal pressures. Steep declines in state tax receipts coupled with balanced budget requirements led to substantial spending cuts and draws on existing reserves, limiting states' flexibility to expand or create new programs. The Panel contacted the Small Business Administration's Small Business Development Centers and each state's Chamber of Commerce for a list of new or expanded small business credit programs. The programs in this Annex represent a compilation of their responses and internal research: these programs are not tracked at the federal level and this list may not be comprehensive. As noted in Section D.3, *supra*, numerous state and local programs existed prior to the financial crisis to support small business lending; programs in this Annex constitute only those that have been created or expanded in direct response to the credit crunch, and only those that rely on financial intermediaries to deploy capital as of the date of this report.

[314] The program originally ended in 2006 due to lack of funding. *See* Office of Governor Bill Ritter, Jr., *Governor Ritter Signs 'Access To Capital' Business Bill* (May 7, 2009) (online at www.colorado.gov/cs/Satellite?c=Page&cid=1241701582408&pagename=GovRitter%2FGOVRLayout).

[315] Delaware Economic Development Office, *Delaware Small Business LIFT Program FAQ* (Apr. 20, 2009) (online at dedo.delaware.gov/pdfs/business/Business__LIFT__program.pdf).

lending to businesses and consumers. Under the new program, banks can request up to an additional $25 million.[316]

Maryland

Date of Inception: December 7, 2009
Program: Small Business Credit Recovery Program

Maryland established the Small Business Credit Recovery Program within the Maryland Industrial Development Financing Authority (MIDFA). The program directs $10 million to MIDFA's existing conventional loan guaranty program to target small businesses by reducing maximum loan amounts, streamlining the approval process, and waiving half of MIDFA's one percent fee.[317]

Michigan

Dates of Inception: December 7, 2009; February 5, 2010; May 20, 2009
Programs: (1) Michigan CD Stimulus Program; (2) Credit Union Small Business Financing Alliance; (3) Michigan Supplier Diversification Fund

(1) The Michigan CD Stimulus Program places $150 million in certificates of deposit at below market rates with state regulated banks and credit unions, with the condition that 80 percent of the funds will be loaned out to Michigan businesses and consumers.[318]

(2) The Michigan Economic Development Corporation (MEDC) and Michigan League of Credit Unions (MLCU) have entered into a financing alliance with 33 credit unions committing to make $43 million in new small business loans. The MEDC will provide education and technical assistance to small business owners through its 12 regional Michigan Small Business and Technology Development Centers (MI–SBTDC) and help connect borrowers to participating credit unions. Participating credit unions are all certified SBA lenders.[319]

(3) The Michigan Supplier Diversification Fund supports lending to state automotive supply companies through loan participation and collateral support programs. With annual funding of between $12 and $13 million over the past two years, the program targets companies, especially auto parts suppliers, that are transitioning to qualified industries, usually technology-related fields, with the purpose of diversifying the state's industry. In the loan participation component, the MEDC, using proceeds from the Michigan Strategic Fund, purchases a portion of a loan from a lender and defers payment from a borrower on that portion for up to three years. The collateral support component provides cash collateral accounts to lenders to enhance borrowers' collateral coverage. In both compo-

[316] The state deposits are limited to no more than 10 percent of a bank's total deposits with no more than $100 million aggregate total in any one bank. Office of Illinois State Treasurer Alexi Giannoulias, *Giannoulias Commits $1 Billion to Illinois Financial Institutions* (Oct. 16, 2008) (online at www.treasurer.il.gov/news/press-releases/2008/PR16October2008.htm).

[317] Office of Maryland Governor Martin O'Malley, *Governor Martin O'Malley Outlines Economic Agenda to Strengthen Small Business, Create Jobs* (Dec. 7, 2009) (online at www.governor.maryland.gov/pressreleases/091207.asp).

[318] State of Michigan Department of Treasury, *Michigan CD Stimulus Program Guidelines* (online at www.michigan.gov/treasury/0,1607,7-121-1753_37621-153406_,00.html) (accessed May 7, 2010).

[319] The Credit Union Small Business Financing Alliance, *About the CUSBF*A (online at www.cusbfa.com/About_the_CUSBFA_13.html) (accessed May 7, 2010).

nents, state participation is generally capped at $500,000 per borrower.[320]

New Jersey

Dates of Inception: December 16, 2008
Programs: Main Street Business Assistance Program

The Main Street Business Assistance Program provides financial support and guarantees to participating banks who offer loans to small and medium-sized businesses. The program has two components: a loan participation and/or guarantee offered by the New Jersey Economic Development Authority (EDA) through participating commercial banks; and a line of credit guarantee offered through the EDA's 13 preferred lender partners. Maximum participation in a bank loan is 25 percent, up to $1 million for fixed assets and $750,000 for working capital, and the maximum bank loan guarantee is 50 percent, up to $2 million for fixed assets and $1.5 million for working capital. The interest rate on EDA loan participations is fixed at five percent for a maximum of five years. The line of credit guarantee, which applies to either fixed assets or working capital, covers up to 50 percent of the total transaction, up to $250,000.[321]

New York

Date of Inception: January 21, 2010
Program: "Credit for Success, Second Look" Program

The "Credit for Success, Second Look" Program offers small business owners an appeal process if they have been turned down for lending or had their line of credit reduced. Following the rejection, the small business is referred to the appropriate Small Business Development Center for possible repackaging and resubmittal to a regional lending consortium for a second review. Loans to borrowers are capped at $25,000, cannot exceed more than $150,000, and must be SBA-guaranteed.[322]

Ohio

Dates of Inception: May 6, 2009; January 26, 2010
Programs: Ohio and Huntington Job Growth Partnership

In the Ohio and Huntington Job Growth public-private lending partnership, Huntington Bank committed $1 billion in new loans to small and medium-sized businesses through May 2012. Under the agreement, the state provides administrative assistance and expanded use of its existing programs.[323] In particular, the program

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[320] Michigan Economic Development Corporation, *Michigan Supplier Diversification Fund* (online at ref.michiganadvantage.org/cm/attach/7EBEE373-6CFA-4392-B68B-8A27A5DBC39A/DivFund_LoanProg.pdf) (accessed May 7, 2010).

[321] New Jersey Economic Development Authority, *Financing Programs—Main Street Business Assistance Program* (online at www.njeda.com/web/Aspx_pg/Templates/Npic_Text.aspx?Doc_Id=939&menuid=1298&topid=718&levelid=6&midid=1175) (accessed May 11, 2010).

[322] New York Business Development Corporation, *Credit For Success: The Regional Lending Consortia Program* (online at nybdc.com/documents/RegionalLendingConsortiums-WebContentwithLogo.pdf) (accessed May 7, 2010).

[323] The partnership creates the Huntington Bank Business Advisory Council, with a dedicated Ohio Department of Development liaison, and commits the "state's regional economic development coordinators to administer projects and provide free, confidential underwriting analysis and consulting services." The partnership expects to also leverage the Ohio 166 Loan, Ohio Cap-

Continued

expects to make use of the Treasurer's GrowNow linked deposit program, which offers small business owners a three percent rate reduction on bank interest rates on loans of up to $400,000. Under GrowNow, the Ohio Treasury deposits funds at below-market rates with participating lenders, who pass along the rate reductions to qualifying small business owners.[324]

Virginia

Date of Inception: March 30, 2009
Program: Local Government Investment Pool Act

Virginia's House Bill 2583 requires that ten percent, or an estimated $400 million, of the Local Government Investment Pool's assets (LGIP) be deposited in Virginia financial institutions. The LGIP offers the state's public entities participation in a specially structured investment fund managed by the Investment Division of the State Treasurer's office.

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ital Access Program, and federal SBA loan programs to maximize the availability of funds. Ohio Department of Development, *State of Ohio and Huntington Bank Launch $1 Billion Partnership to Grow, Retain and Attract Businesses and Jobs* (May 6, 2009) (online at development.ohio.gov/newsroom/2009PR/May/GovernorsOffice/4.htm).

[324] Ohio Treasury Department, *We're Growing Ohio's Small Businesses NOW* (online at tos.ohio.gov/ForBusiness/Default.aspx?Section=GrowNow) (accessed May 7, 2010).

SECTION TWO: ADDITIONAL VIEWS

A. J. MARK MCWATTERS AND PAUL S. ATKINS

We concur with the issuance of the May report and offer the additional observations noted below. We appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

In order to suggest a solution to the challenges currently facing the commercial credit and small business lending markets, it is critical that we thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis, it is likely that we may craft an inappropriately targeted remedy with adverse, unintended consequences.

The problems presented by today's commercial credit and small business lending markets would be easier to address if they were solely based upon the undersupply of commercial and small business credit in certain well-defined regions of the country. Unfortunately, the commercial credit and small business lending markets must also assimilate a drop in demand from borrowers who have suffered a reversal in their business operations and prospects over the past two years. In our view, there has been a decrease in demand for commercial and small business credit and many potential borrowers have withdrawn from the credit markets due to, among other reasons:

- their desire to de-leverage;
- the introduction of enhanced underwriting standards by lenders and their regulators;
- the diminishing opportunity for prudent business expansion;
- the crippling effects of the recession; and
- the increasing tax and regulatory burdens facing small and large businesses.[325]

In a recent hearing on commercial credit and small business lending held by the Panel in Phoenix, one of the witnesses, Candace Wiest, the president and CEO of West Valley National Bank (WVNB), remarked in her written testimony:

> The question of demand is difficult. WVNB certainly has room to expand lending, given that we have 39% Tier 1 capital and almost 50% leverage capital. Explained another way, we have originated $25,000,000 in loans and still have $16,000,000 in capital. We could grow the Bank by $100,000,000 in new assets and not need any new capital. . . . Our lack of loan growth is a reflection of the impact of the recession on the small businesses in this state. While the rest of the country has experienced varying degrees of recession, I believe Arizona has been functioning in a depression. . . . As a result, we have not met our

[325] Taxes decrease cash flow that is available for debt service.

Compliance with new regulatory requirements increases the fees and expenses a business must pay to its attorneys, CPAs, consultants, and, quite often, new employees hired to manage the process. Funding these fees and expenses is particularly burdensome for small businesses that do not operate with the economies of scale necessary to spread compliance costs over a significant revenue base.

All other inputs being equal, taxes and compliance costs decrease cash flow available for debt service and thus decrease the level of debt a firm may undertake. In addition, less leverage may decrease a firm's return on equity and market capitalization.

> lending projections. Last year we funded approximately $10,000,000 in new credits. We would do more, but it is difficult to find anyone who has not been impacted and remains creditworthy.

While WVNB is apparently ready, willing and able to extend credit, Ms. Wiest is struggling to identify qualified borrowers that are in need of additional debt capital. In other words, WVNB is not suffering from an undersupply of capital to lend but from the diminished demand for commercial and small business credit.[326]

Evidence from the borrower side of the lender-borrower equation supports this anecdotal evidence. The Panel's report discusses a survey by the National Federation of Independent Businesses, which concludes that "access to credit is not the primary concern of small businesses at this time. Only eight percent of those surveyed identified access to credit as their most pressing concern, although, of course, these respondents may nonetheless have sought credit during this period."[327]

Conversely, the Administration has focused on the undersupply of commercial and small business credit[328] and, not surprisingly,

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[326] Another witness at the hearing, James H. Lundy, President and CEO of Alliance Bank of Arizona, stated in his written testimony:

> While Alliance Bank of Arizona is running against industry norms and adding net loan growth when many banks are not, I don't want to leave the impression that this is not an extremely difficult lending environment. The recession has sharply decreased loan demand from many Arizona businesses. Every bank portfolio experiences normal runoff, and, in this environment, a higher level of charge-offs than normal. Thus, increasing loan outstandings in the current environment is quite challenging. Considered in combination with requests from regulators for more capital and the heavy emphasis on rapidly reducing real estate concentrations it is no surprise that loan totals are shrinking at many banks.

Congressional Oversight Panel, Written Testimony of James H. Lundy, president and chief executive officer, Alliance Bank of Arizona, *Phoenix Field Hearing on Small Business Lending*, at 3 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-2710-lundy.pdf).

The third bank officer to testify at the hearing, Lynne B. Herndon, Phoenix City President of BBVA Compass, stated in her written testimony:

> In the 4th Quarter of 2008, business owners experienced a dramatic halt in revenues. During this quarter and in 2009, business owners struggled to reset the expense structures of their companies in response to the 50–75% reduction in top line revenues. Liquidity and capital were drained as businesses needed excess reserves to fund losses. Companies put expansion plans on hold and tried to curb borrowing where possible. Loan demand dropped dramatically during this period.
>
> BBVA Compass continued to make business loans during 2008 and 2009 and is doing so currently. While the bank's structure and terms were similar to previous years, it was and is challenging to underwrite borrowers in the current economic environment. Most companies recorded a loss in 2009 and some in 2008. 2010 looks to be breakeven at best for many companies. These profitability trends are challenging for banks given that we have to maintain higher levels of capital in order to carry watchlist loans. In other words, banks must have higher levels of capital in order to continue to bank existing credits that have had poor performance or in order to entertain new loans to companies coming off of poor performance.
>
> In order to compensate for poor performance in previous years, BBVA Compass is placing more emphasis on strong sponsorship, higher levels of equity in real estate or excess availability in borrowing bases. Underwriting the economic risk is more difficult and access to liquidity is important. Companies still in business in 2010 have probably weathered the worst and should be survivors. These borrowers are most likely creditworthy. Banks are now able to obtain appropriate pricing for market risk in deals.

Congressional Oversight Panel, Written Testimony of Lynne B. Herndon, city president—Phoenix, BBVA Compass Bank, *Phoenix Field Hearing on Small Business Lending*, at 2 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-herndon.pdf).

[327] *See* Section E.1(a)(i).

[328] *See* Donna Borak, *Fed Survey: Some Big Banks Loosen Underwriting Criteria*, American Banker (May 4, 2010) (online at www.americanbanker.com/issues/175_84/underwriting-criteria_1018530-1.html); *see* Joshua Zumbrun and Scott Lanman, *Fed Says Most Surveyed Banks Didn't Tighten Lending Standards*, Bloomberg.com, (May 4, 2010) (online at www.bloomberg.com/apps/news?pid=20601068&sid=aVfYj2OMrV7U#).

has proposed a government-sponsored program to remedy the putative problem. If instituted as proposed, the Small Business Lending Fund (SBLF) will permit a subset of commercial and small business lenders to obtain capital from the federal government at very favorable rates, provided the lenders agree to use the proceeds to extend credit to small business borrowers.[329] We are troubled that providing financial institutions with capital at below-market rates may lead to imprudent lending activity[330] and, perhaps, the inflation of a series of government sanctioned and subsidized asset bubbles. If the government convinces—or pressures—financial institutions to accept cheap credit based on financial incentives for the recipients to off-lend the proceeds, then we fully anticipate the government will accomplish just that. Yet, is this not what we recently experienced in the sub-prime and securitized debt lending crisis—too much money chasing transactions of diminishing credit quality?

The Administration's proposal appears to share much of its design and business model with those adopted by Fannie Mae and Freddie Mac. Treasury should have learned from Fannie and Freddie that the combination of easily accessible below-market credit matched with pressure to lend—regardless of credible demand or the employment of prudent underwriting standards—serves as the perfect recipe for the extension of problematic loans and the creation and implosion of asset bubbles. The Administration's program also seems at cross-purposes with the recent actions of federal and state banking regulators who have become increasingly cautious—perhaps overly cautious—regarding extensions and renewals of credit by regulated financial institutions. It is indeed ironic for the Administration to propose a program of cheap credit-driven lending, while at the same time federal and state banking regulators in thousands of individual examinations have become excessively onerous in their second-guessing of banks' lending decisions and determinations of status of loans. It is also counterproductive for any government to subsidize loan originations so as merely to increase the "loan count" that may be reported to the taxpayers.

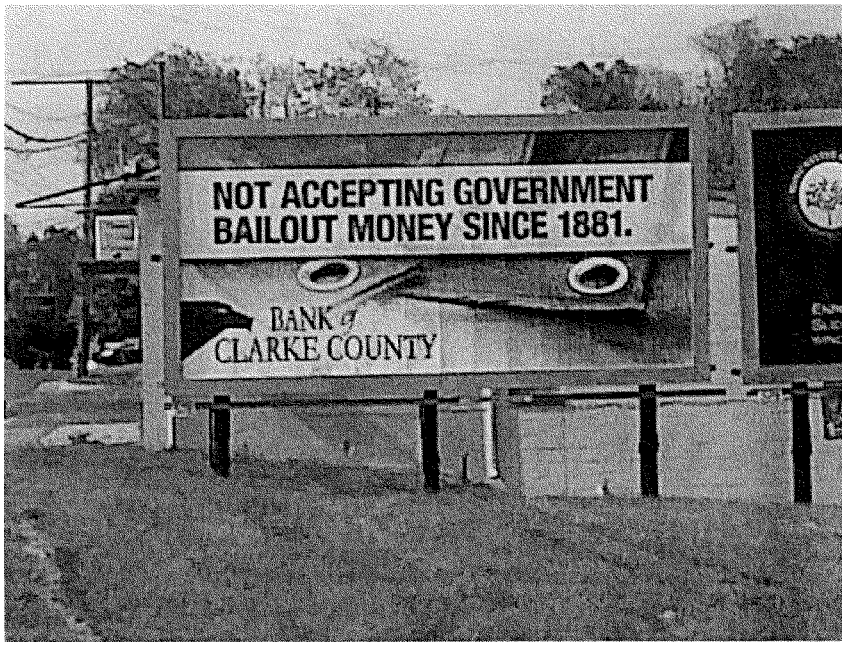
We also very much doubt that the SBLF program will otherwise attenuate the taint and stigma associated with a dusted-off and repackaged "TARP II" or "Son-of-TARP" program. The taxpayers are far too sophisticated to fall for this trick and financial institutions are far too wary from their experience with TARP not to expect that the government will change the terms of the program midstream. The stigma associated with the TARP principally centers

[329] We note that the Administration has yet to announce the source of any offsets for this program. At first, in announcing the program, the Administration stated that the funds for the program were to be repaid TARP funds transferred from the TARP, but the current draft of the proposed legislation provides instead that the source of the offsets for the program will be negotiated with Congress.

[330] Recipients of SBLF investments may operate with a cost of capital that is lower than non-subsidized financial institutions and, as such, may develop a distinct competitive advantage over their peers. Since borrowers will prefer to obtain credit from the lowest cost provider of financial services, it's quite possible that non-subsidized lenders will be priced out of the market. As the market for subsidized loans increases the government may be tempted to invest additional taxpayer resources in a "successful" program which may drive additional non-subsidized lenders from the market. After a few cycles, private sector lenders may serve as mere originators and servicers of loans with substantially all of the risk of default shifted to the taxpayers. In addition, the guarantee programs offered by the Small Business Administration serve as another example of small business lending that is subsidized by the government.

on the risk that the government may change the rules mid-stream and subject the recipients to adverse rules and regulations. Candace Wiest noted in her written testimony before the Panel that WVNB withdrew its application for TARP funds because "we saw new conditions being added daily and witnessed the growing stigma being directed at TARP banks. Because we did not want to enter into an agreement with a government who could alter the terms at any time, we chose to withdraw our application."

This photograph taken in Northern Virginia near the Washington, DC area succinctly tells the story.



From our perspective, the SBLF is just another government sanctioned subsidy to—and bailout of—the financial community that will create a host of adverse, unintended consequences. In addition to the adverse unintended consequences that may arise from a newly instituted SBLF, similar questions are presented by those programs pursuant to which the Small Business Administration (SBA) is authorized to guarantee a significant percentage of any losses generated from certain eligible loans. In the Panel's recent hearing, an SBA official stated in his written testimony that an SBA guarantee provides "an extra incentive for risk adverse lenders to lend to small businesses."[331] While this is no doubt true, it is critical to recognize that lenders often become risk-averse only after conducting a thorough due diligence and underwriting analysis of their potential borrowers. As a matter of sound public policy, lenders should not commit to extend credit to problematic borrowers solely because the SBA has agreed to absorb a significant

[331] Congressional Oversight Panel, Written Testimony of Robert J. Blaney, district director for Arizona, Small Business Administration, *Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-blaney.pdf).

percentage of any losses arising from such loans. The subprime lending crisis arose in part because originating lenders neglected to perform a thorough due diligence analysis of their prospective borrowers, confident in the belief that, with Fannie Mae or Freddie Mac credit support, they would be able to off-load their sketchy loans to investment banks for inclusion in residential mortgage-backed securities prior to their default. The SBA should continue to develop and implement transparent and fully accountable internal control and underwriting procedures to ascertain that it does not accept risky loans into its guarantee programs.

Further, if it develops that there are no restrictions on combining SBLF and SBA programs, that combination may create a particularly toxic mix for the taxpayers. If a financial institution extends credit sourced from SBLF capital and the SBA assumes 90 percent of the risk of loss from such loan, then the taxpayers will suffer the burden of subsidizing a below market capital contribution to the financial institution and also bear the overwhelming bulk of the loss if the borrower defaults under the loan, while the financial institution pockets any profits from the transaction. This result is particularly perverse if the financial institution was well-capitalized and prepared to extend credit without assistance from the SBLF and SBA programs.

In our view, instead of requiring the taxpayers to subsidize another round of imprudent short-term credit expansion, commercial and small business lenders—in consultation with their regulators where appropriate—should adopt long-term business models and strategies that incorporate objective and transparent due diligence standards that permit well-run borrowers to receive credit on reasonable terms and the lenders to earn an appropriate risk-adjusted rate of return. Regrettably, some potential borrowers will fail the heightened underwriting standards and will not receive their requested extensions of credit. This should not necessarily cause angst, but should indicate that the credit markets have moved away from an "anything-goes" mentality where borrowers often over-extended their leverage and some financial institutions survived through the clever interpretation of accounting rules and the implicit guarantee of their obligations by the American taxpayers.

Any suggested solution to the challenges facing commercial credit and small business lenders and borrowers that focuses only on the undersupply of credit to the exclusion of the economic difficulties facing prospective borrowers appears unlikely to succeed. The challenges confronting the commercial credit and small business lending markets are not unique to that industry, but instead are indicative of the systemic uncertainties manifest throughout the larger economy. Until small and large businesses regain the confidence to hire new employees and expand their business operations, it is doubtful that the demand for properly underwritten commercial and small business credit will sustain a meaningful recovery. As long as businesses are faced with the multiple challenges of rising taxes, increasing regulatory burdens, the threat of frivolous lawsuits arising from an erratic litigation system, enhanced political risk associated with unpredictable governmental interventions in the private sector, and uncertain health care and energy costs, it is unlikely that they will enthusiastically assume the entrepre-

neurial risk necessary for protracted economic expansion and a recovery of the commercial credit and small business lending markets. With the ever-expanding array of less-than-friendly rules, regulations and taxes facing businesses and consumers, we should not be surprised if businesses remain reluctant to hire new employees, consumers remain cautious about spending, and the commercial credit and small business lending markets continue to struggle.

In our view, the Administration could encourage the robust recovery of the commercial credit and small business lending markets—as well as the overall U.S. economy—by sending an unambiguous message to the private sector that it will not directly or indirectly raise the taxes or increase the regulatory burden of commercial credit and small business market participants and other business enterprises. Without such express action, the recovery of the commercial credit and small business lending markets will most likely proceed at a sluggish and costly pace.

Once the demand for credit from qualified borrowers has rebounded, we think private sector financial institutions will return to the credit markets without hesitation. After all, the principal business of these financial institutions is the extension of thoughtfully underwritten credit to financially-stable and prudently-managed borrowers. Locating these borrowers in the current economic environment with the daunting overhang of tax and regulatory uncertainty will remain a challenge for Candace Wiest of WVNB and her peers.

SECTION THREE: CORRESPONDENCE WITH TREASURY UPDATE

Secretary of the Treasury Timothy Geithner sent a letter to Chair Elizabeth Warren on May 3, 2010,[332] in response to a series of questions presented by the Panel regarding restructuring of Treasury's investments under the Capital Purchase Program, and regarding estimates of its remaining exposure to future bank failures among CPP recipients.[333]

On behalf of the Panel, Chair Elizabeth Warren sent a letter on May 6, 2010,[334] to Secretary of the Treasury Timothy Geithner, presenting a series of questions regarding General Motors' April 20th repayment of $4.7 billion of TARP debt, and its public announcement in relation to that repayment. The Panel has requested a written response from Treasury by June 5, 2010.

[332] *See* Appendix I of this report, *infra*.

[333] *See* Appendix I of the Panel's April Oversight Report. Congressional Oversight Panel, *April Oversight Report: Evaluating Progress on TARP Foreclosure Mitigation Programs,* at 227 (Apr. 14, 2010) (online at cop.senate.gov/documents/cop-041410-report.pdf) (hereinafter "COP April Oversight Report").

[334] *See* Appendix II of this report, *infra*.

SECTION FOUR: TARP UPDATES SINCE LAST REPORT

A. TARP Repayments

In April 2010, four institutions completely redeemed the preferred shares given to Treasury as part of their participation in the CPP. Treasury received $1.24 billion in CPP repayments from these institutions. Of this total, Discover Financial Services repaid $1.22 billion. A total of 13 banks have fully repaid their preferred stock TARP investments provided under the CPP in 2010.

B. CPP Warrant Dispositions

As part of its investment in senior preferred stock of certain banks under the CPP, Treasury received warrants to purchase shares of common stock or other securities in those institutions. During April, two institutions repurchased warrants from Treasury for $20 million and Treasury sold the warrants of PNC Financial Services Group, Inc. at auction for $324 million in proceeds. Furthermore, on March 7, 2010, Treasury sold 11,479,592 Comerica common stock warrants through a secondary public offering. Treasury announced that it expects the aggregate net proceeds from this offering to be over $181 million. Finally, Treasury received $237 thousand in proceeds from the sale of additional preferred shares received from two privately held financial institutions. Treasury has liquidated the warrants it holds in 53 institutions for total proceeds of $6 billion.

C. Treasury Secretary Geithner Updates Congress on EESA

On April 23, 2010, Secretary Geithner sent a letter to House and Senate leadership, offering a commentary regarding the current state of the economy with respect to the initiatives put forth by the Emergency Economic Stabilization Act (EESA). Among the points discussed were current TARP commitments and repayments as of April 16, 2010, projected losses from various TARP initiatives, and the state of financial regulation reform. The letter also detailed various government financing programs and plans for the taxpayer's exit from these initiatives.

D. Treasury Releases PPIP External Report

Treasury has released a report detailing the performance as of March 31, 2010 of the Legacy Securities Public-Private Investment Program (PPIP). As of that date, $25.1 billion of capital has been closed, with private funds contributing $6.3 billion. Treasury's exposure includes $6.3 billion of equity capital and $12.5 billion of debt capital. The portfolio holdings of all public-private investment funds (PPIFs) include $8.8 billion in non-agency RMBS and $1.2 billion in CMBS. The cumulative net performance of the eight fund managers since inception ranges from 1.1 percent to 20.6 percent.

E. Treasury Responses to GAO Recommendations on TALF

In February 2010, the Government Accountability Office (GAO) offered three recommendations to Treasury regarding its management of the Term Asset-Backed Securities Lending Facility (TALF).

On April 6, 2010, Treasury, in response to these recommendations, stated that they will continue to work with the Federal Reserve Bank of New York and the Federal Reserve Board to closely monitor any risks associated with CMBS. In addition, Treasury further committed to improving transparency and communication with the Federal Reserve Board and FRBNY with regards to decision-making for TALF.

F. Metrics

Each month, the Panel's report highlights a number of metrics that the Panel and others, including Treasury, the Government Accountability Office (GAO), Special Inspector General for the Troubled Asset Relief Program (SIGTARP), and the Financial Stability Oversight Board, consider useful in assessing the effectiveness of the Administration's efforts to restore financial stability and accomplish the goals of EESA. This section discusses changes that have occurred in several indicators since the release of the Panel's April report.

• **Interest Rate Spreads.** Interest rate spreads have risen slightly since the Panel's April report. The conventional mortgage spread, which measures the 30-year mortgage rate over 10-year Treasury bond yields, increased by 8.3 percent during April. The TED Spread, which is used as a proxy for perceived risk in the financial markets, increased by 62 percent in April.[335] The TED Spread has decreased 95 percent since the enactment of EESA. The interest rate spread for AA asset-backed commercial paper, which is considered mid-investment grade, has decreased by 15.2 percent since the Panel's April report. This metric, down 97 percent since the enactment of EESA, has nearly returned to pre-crisis levels. The interest rate spread on A2/P2 nonfinancial commercial paper, a lower-grade investment than AA asset-backed commercial paper, increased by 16 percent during April.

FIGURE 12: INTEREST RATE SPREADS

Indicator	Current Spread (as of 5/5/10)	Percent Change Since Last Report (4/14/10)
Conventional mortgage rate spread [336]	1.3	8.3
Overnight AA asset-backed commercial paper interest rate spread [337]	0.07	(15.2)
Overnight A2/P2 nonfinancial commercial paper interest rate spread [338]	0.15	16

[336] Board of Governors of the *Federal Reserve System, Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Conventional Mortgages, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Thursday_/H15_MORTG_NA.txt) (accessed May 5, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: U.S. Government Securities/Treasury Constant Maturities/Nominal 10–Year, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Friday_/H15_TCMNOM_Y10.txt) (accessed May 5, 2010).

[337] Board of Governors of the *Federal Reserve System, Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Asset-Backed Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed May 5, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Nonfinancial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed May 5, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

[338] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: A2/P2 Nonfinancial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed May 5, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

• **Housing Indicators.** Both the Case-Shiller Composite 20–City Index as well as the FHFA Housing Price Index decreased

[335] Measuring Perceived Risk—The TED Spread, *supra* note 40.

slightly in February 2010. The Case-Shiller and FHFA indices remain 6.6 percent and 4.5 percent below the levels at the time EESA was enacted, and remain 6.6 percent below and 4.5 percent below, respectively, the levels at the time EESA was enacted. Foreclosure actions, which include default notices, scheduled auctions, and bank repossessions, increased by 19 percent from March. This metric has increased by 31 percent since the enactment of EESA.

FIGURE 13: HOUSING INDICATORS

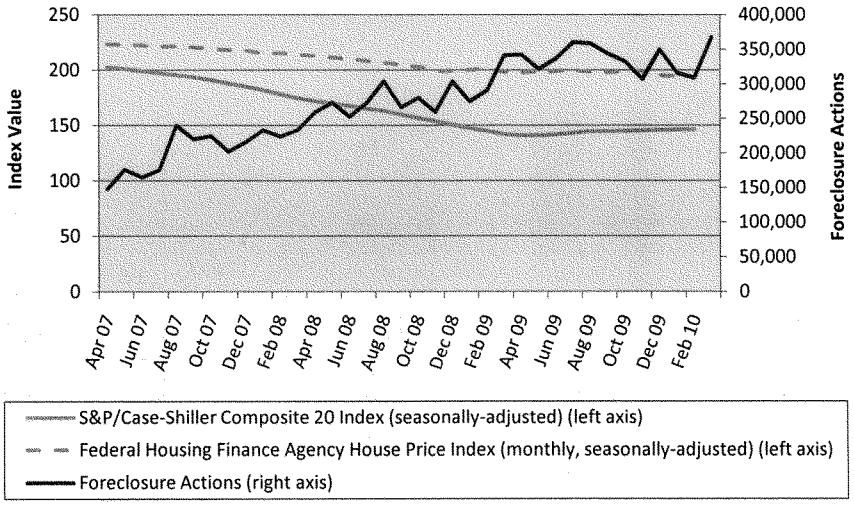
Indicator	Most Recent Monthly Data	Percent Change from Data Available at time of Last Report	Percent Change since October 2008
Monthly foreclosure actions [339]	367,056	19	31
S&P/Case-Shiller Composite 20-City Index [340]	146.1	(.1)	(6.6)
FHFA Housing Price Index [341]	194	(.2)	(4.5)

[339] RealtyTrac, *Foreclosure Activity Press Releases* (online at www.realtytrac.com//ContentManagement/PressRelease.aspx) (hereinafter "Foreclosure Activity Press Releases") (accessed May 5, 2010). Most recent data available for March 2010.

[340] Standard & Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Seasonally Adjusted Composite 20 Index) (online at www.standardandpoors.com/spf/docs/case-shiller/SA_CSHomePrice_History.xls) (hereinafter "S&P/Case-Shiller Home Price Indices") (accessed May 5, 2010). Most recent data available for February 2010.

[341] Federal Housing Finance Agency, *U.S. and Census Division Monthly Purchase Only Index* (Instrument: USA, Seasonally Adjusted) (online at www.fhfa.gov/webfiles/15669/MonthlyIndex_Jan1991to_Latest.xls) (hereinafter "U.S. and Census Division Monthly Purchase Only Index") (accessed May 5, 2010). Most recent data available for February 2010.

FIGURE 14: FORECLOSURE ACTIONS AS COMPARED TO THE HOUSING INDICES (AS OF FEBRUARY 2010) [342]



• **Senior Loan Officer Survey.** On May 3, 2010, the Board of Governors of the Federal Reserve System released the results of its "Senior Loan Officer Opinion Survey on Bank Lending Practices." While the survey results continued to reflect banks' concerns regarding the current status of the commercial real estate (CRE) market, there was marked improvement in the respondents' senti-

[342] Foreclosure Activity Press Releases, *supra* note 339 (accessed May 5, 2010); S&P/Case-Shiller Home Price Indices, *supra* note 340 (accessed May 5, 2010); U.S. and Census Division Monthly Purchase Only Index, *supra* note 341 (accessed May 5, 2010). The most recent data available for the housing indices is as of February 2010.

ments. Figure 15 shows the net percentage of survey respondents who reported tightening standards for CRE loans. While this metric was 12.5 percent during the Q2 2010 reporting period, signaling relatively tight standards for CRE lending, it is now at its lowest level since the Q3 2006 reporting period. Figure 16 further illustrates both the remaining apprehension in the CRE market as well as the relative improvement compared to the height of the crisis. Although the net percentage of respondents who reported stronger demand for CRE loans remains negative, the negative 7.1 percent figure for the Q2 2010 reporting period is the highest level that this measure has been since the Q3 2006 reporting period.

FIGURE 15: NET PERCENTAGE OF DOMESTIC RESPONDENTS TIGHTENING STANDARDS FOR COMMERCIAL REAL ESTATE LOANS (AS OF Q2 2010) [343]

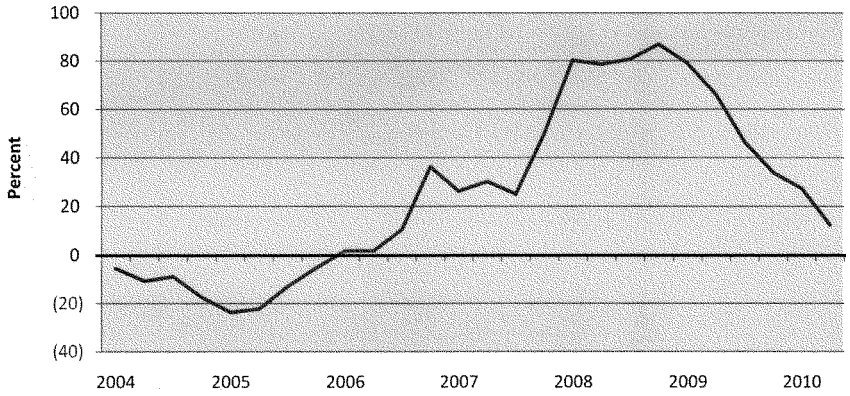
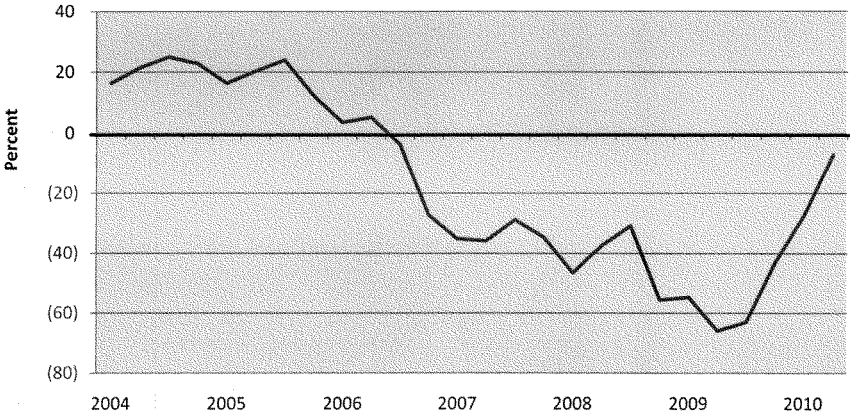


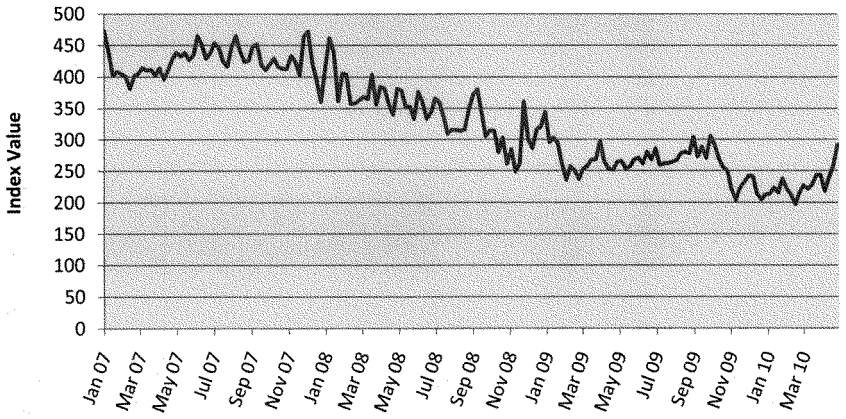
FIGURE 16: NET PERCENTAGE OF DOMESTIC RESPONDENTS REPORTING STRONGER DEMAND FOR COMMERCIAL REAL ESTATE LOANS (AS OF Q2 2010) [344]



[343] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 6.
[344] April 2010 Senior Loan Officer Opinion Survey, *supra* note 19, at 6.

• **Weekly Mortgage Application Survey.** The Mortgage Bankers Association (MBA) Weekly Mortgage Application Survey is comprised of 15 indices covering mortgage applications for a variety of loan types. As Figure 17 illustrates, there has been a marked increase in this measure since the beginning of the year. This metric has increased by 37 percent in 2010, a trend which many analysts ascribe in part to the impact of the Home Buyer Tax Credit, which expired on April 30, 2010.[345]

FIGURE 17: MBA WEEKLY APPLICATIONS SURVEY[346]

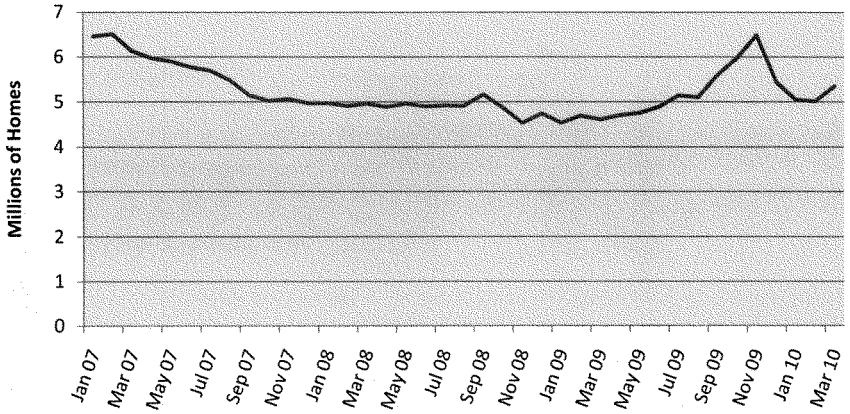


Existing Home Sales. Existing home sales, as tracked by the National Association of Realtors, have increased six percent in 2010. There were 5.35 million existing home sales in March, a seven percent increase from the previous month. The monthly amount of existing home sales has increased 10 percent since the enactment of EESA in October 2008.

[345] Internal Revenue Service, *First-Time Homebuyer Credit* (May 3, 2010) (online at www.irs.gov/newsroom/article/0,,id=204671,00.html?portlet=7).

[346] Mortgage Bankers Association, *Weekly Applications Survey* (online at mortgagebankers.org/ResearchandForecasts/ProductsandSurveys/WeeklyApplicationSurvey) (accessed May 7, 2010). Data accessed through Bloomberg Data Service.

FIGURE 18: EXISTING HOME SALES [347]



G. Financial Update

Each month, the Panel summarizes the resources that the federal government has committed to economic stabilization. The following financial update provides: (1) an updated accounting of the TARP, including a tally of dividend income, repayments, and warrant dispositions that the program has received as of March 31, 2010; and (2) an updated accounting of the full federal resource commitment as of April 29, 2010.

1. The TARP

a. Costs: Expenditures and Commitments

Treasury has committed or is currently committed to spend $520.3 billion of TARP funds through an array of programs used to purchase preferred shares in financial institutions, provide loans to small businesses and automotive companies, and leverage Federal Reserve loans for facilities designed to restart secondary securitization markets.[348] Of this total, $219.4 billion is currently outstanding under the $698.7 billion limit for TARP expenditures set by EESA, leaving $479.4 billion available for fulfillment of anticipated funding levels of existing programs and for funding new programs and initiatives. The $219.4 billion includes purchases of preferred and common shares, warrants and/or debt obligations under the CPP, AIGIP/SSFI Program, PPIP, and AIFP; and a loan to TALF LLC, the special purpose vehicle (SPV) used to guarantee Federal Reserve TALF loans.[349] Additionally, Treasury has spent

[347] National Association of Realtors, *Existing Home Sales* (online at www.realtor.org/research/research/ehsdata) (accessed May 5, 2010). Historical data provided by Bloomberg Data Service.

[348] EESA, as amended by the Helping Families Save Their Homes Act of 2009, limits Treasury to $698.7 billion in purchasing authority outstanding at any one time as calculated by the sum of the purchase prices of all troubled assets held by Treasury. Pub. L. No. 110–343 115(a)–(b); Helping Families Save Their Homes Act of 2009, Pub. L. No. 111–22 § 402(f) (reducing by $1.23 billion the authority for the TARP originally set under EESA at $700 billion).

[349] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010* (May 5, 2010) (online at www.financialstability.gov/docs/trans-

Continued

$57.8 million under the Home Affordable Modification Program, out of a projected total program level of $50 billion.

b. Income: Dividends, Interest Payments, CPP Repayments, and Warrant Sales

As of April 29, 2010, a total of 70 institutions have completely repurchased their CPP preferred shares. Of these institutions, 43 have repurchased their warrants for common shares that Treasury received in conjunction with its preferred stock investments; Treasury sold the warrants for common shares for nine other institutions at auction.[350] In April 2010, four CPP participants repurchased warrants for $20 million. Warrants for common shares of PNC Financial Services Group, Inc. were sold at auction for $324 million in proceeds. In total, Treasury received $344 million in proceeds from the disposition of warrants in April. Treasury received $1.24 billion in repayments for complete redemptions from four CPP participants during April. The largest repayment was $1.22 billion from Discover Financial Services. In addition, Treasury receives dividend payments on the preferred shares that it holds, usually five percent per annum for the first five years and nine percent per annum thereafter.[351] To date, Treasury has received approximately $22.0 billion in net income from warrant repurchases, dividends, interest payments, and other considerations deriving from TARP investments,[352] and another $1.2 billion in participation fees from its Guarantee Program for Money Market Funds.[353]

c. TARP Accounting

FIGURE 19: TARP ACCOUNTING (AS OF APRIL 29, 2010)[354]

TARP Initiative	Anticipated Funding (billions of dollars)	Actual Funding (billions of dollars)	Total Repayments/ Reduced Exposure (billions of dollars)	Funding Outstanding (billions of dollars)	Funding Available (billions of dollars)
Capital Purchase Program (CPP)[355]	$204.9	$204.9	$137.3	[356] $67.6	$0
Targeted Investment Program (TIP)[357]	40.0	40.0	40	0	0
AIG Investment Program (AIGIP)/Systemically Significant Failing Institutions Program (SSFI)	69.8	[358] 49.1	0	49.1	20.7
Automobile Industry Financing Program (AIFP)	81.3	81.3	[359] 8.87	72.5	0
Asset Guarantee Program (AGP)[360]	5.0	5.0	[361] 5.0	0	0
Capital Assistance Program (CAP)[362]	.....	.....	.....	.....	.....
Term Asset-Backed Securities Lending Facility (TALF)	20.0	[363] 0.10	0	0.10	19.9
Public-Private Investment Program (PPIP)[364]	30.0	30.0	0	30.0	0
Supplier Support Program (SSP)[365]	[366] 3.5	3.5	3.5	0	0
Unlocking SBA Lending	15.0	[367] 0.058	0	0.058	14.942
Home Affordable Modification Program (HAMP)	[368] 50	[369] 0.13	0	0.13	49.9
Community Development Capital Initiative (CDCI)	[370] 0.78	0	0	0	0.78
Total Committed	520.3	414	.....	219.4	106.2

action-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf) (hereinafter "Treasury Transactions Report").

[350] *Id.*

[351] *See, e.g.*, Securities Purchase Agreement [CPP]: Standard Terms, *supra* note 199 (accessed May 11, 2010).

[352] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of December 31, 2009* (Jan. 20, 2010) (online at www.financialstability.gov/docs/dividends-interest-reports/December%202009%20Dividends%20and%20Interest%20Report.pdf); Treasury Transactions Report, *supra* note 349.

[353] U.S. Department of the Treasury, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 18, 2009) (online at www.treasury.gov/press/releases/tg293.htm).

FIGURE 19: TARP ACCOUNTING (AS OF APRIL 29, 2010) [354]—Continued

TARP Initiative	Anticipated Funding (billions of dollars)	Actual Funding (billions of dollars)	Total Repayments/ Reduced Exposure (billions of dollars)	Funding Outstanding (billions of dollars)	Funding Available (billions of dollars)
Total Uncommitted	178.4	.....	194.7	.....	[371] 373.1
Total	$698.7	$414.1	$194.7	$219.4	$479.4

[354] Treasury Transactions Report, *supra* note 349.

[355] As of December 31, 2009, the CPP was closed. U.S. Department of the Treasury, *FAQ on Capital Purchase Program Deadline* (online at www.financialstability.gov/docs/FAQ%20on%20Capital%20Purchase%20Program%20Deadline.pdf).

[356] Treasury has classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. Therefore Treasury's net current CPP investment is $65.3 billion due to the $2.3 billion in losses thus far. Treasury Transactions Report, *supra* note 349.

[357] Both Bank of America and Citigroup repaid the $20 billion in assistance each institution received under the TIP on December 9 and December 23, 2009, respectively. Therefore the Panel accounts for these funds as repaid and uncommitted. U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 22, 2009) (online at www.treas.gov/press/releases/20091229716198713.htm) (hereinafter ''Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup'').

[358] AIG has completely utilized the $40 billion made available on November 25, 2008 and drawn-down $7.54 billion of the $29.8 billion made available on April 17, 2009. This figure also reflects $1.6 billion in accumulated but unpaid dividends owed by AIG to Treasury due to the restructuring of Treasury's investment from cumulative preferred shares to non-cumulative shares. American International Group, Inc., *Form 10–K for the Fiscal Year Ending December 31, 2009* (Feb. 26, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000104746910001465/a2196553z10-k.htm); Treasury Transactions Report, *supra* note 349, at 45; information provided by Treasury staff in response to Panel request.

[359] On April 20, 2010, General Motors repaid the remaining $4.7 billion in loans. A $986 million loan remains outstanding to old GM. Treasury Transactions Report, *supra* note 349.

[360] Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation terminated the asset guarantee with Citigroup on December 23, 2009. The agreement was terminated with no losses to Treasury's $5 billion second-loss portion of the guarantee. Citigroup did not repay any funds directly, but instead terminated Treasury's outstanding exposure on its $5 billion second-loss position. As a result, the $5 billion is now counted as uncommitted. Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup, *supra* note 357.

[361] Although this $5 billion is no longer exposed as part of the AGP and is accounted for as available, Treasury did not receive a repayment in the same sense as with other investments. Treasury did receive other income as consideration for the guarantee, which is not a repayment and is accounted for in Figure 20.

[362] On November 9, 2009, Treasury announced the closing of this program and that only one institution, GMAC, was in need of further capital from Treasury. GMAC subsequently received an additional $3.8 billion in capital through the AIFP on December 30, 2009. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html); Treasury Transactions Report, *supra* note 349.

[363] Treasury has committed $20 billion in TARP funds to a loan funded through TALF LLC, a special purpose vehicle created by the Federal Reserve Bank of New York. The loan is incrementally funded and as of March 31, 2010, Treasury provided $104 million to TALF LLC. This total includes accrued payable interest. Treasury Transactions Report, *supra* note 349; Federal Reserve Bank of New York, *Factors Affecting Reserve Balances (H.4.1)* (April 29, 2010) (online at www.federalreserve.gov/releases/h41/).

[364] On April 20, 2010, Treasury released its second quarterly report on the Legacy Securities Public-Private Investment Partnership. As of that date, the total value of assets held by the PPIP managers was $10 billion. Of this total, 88 percent was non-agency Residential Mortgage-Backed Securities and the remaining 12 percent was Commercial Mortgage-Backed Securities. PPIP Program Update—Quarter Ended March 31, 2010, *supra* note 121.

[365] On April 5, 2010 and April 7, 2010, Treasury's commitment to lend to the GM SPV and the Chrysler SPV respectively under the ASSP ended. In total, Treasury received $413 million in repayments from loans provided by this program ($290 million from the GM SPV and $123 million from the Chrysler SPV). Further, Treasury received $101 million in proceeds from additional notes associated with this program. Treasury Transactions Report, *supra* note 349.

[366] On July 8, 2009, Treasury lowered the total commitment amount for the program from $5 billion to $3.5 billion. This action reduced GM's portion from $3.5 billion to $2.5 billion and Chrysler's portion from $1.5 billion to $1 billion. GM Supplier Receivables LLC, the special purpose vehicle (SPV) created to administer this program for GM suppliers has made $290 million in partial repayments and Chrysler Receivables SPV LLC, the SPV created to administer the program for Chrysler suppliers, has made $123 million in partial repayments. These were partial repayments of drawn-down funds and did not lessen Treasury's $3.5 billion in total exposure under the ASSP. Treasury Transactions Report, *supra* note 349.

[367] Treasury settled on the purchase of three floating rate Small Business Administration 7(a) securities on March 24, 2010, and another on April 30, 2010. Treasury anticipates a settlement on one floating rate SBA 7a security on May 28, 2010. As of May 3, 2010, the total amount of TARP funds invested in these securities was $58.64 million. Treasury Transactions Report, *supra* note 349.

[368] On February 19, 2010, President Obama announced the Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets (HFA Hardest Hit Fund), his proposal to use $1.5 billion of the $50 billion in TARP funds allocated to HAMP to assist the five states with the highest home price declines stemming from the foreclosure crisis: Nevada, California, Florida, Arizona, and Michigan. The White House, *President Obama Announces Help for Hardest Hit Housing Markets* (Feb. 19, 2010) (online at www.whitehouse.gov/the-press-office/president-obama-announces-help-hardest-hit-housing-markets). On March 29, 2010, Treasury announced $600 million in funding for a second HFA Hardest Hit Fund which includes North Carolina, Ohio, Oregon Rhode Island, and South Carolina. U.S. Department of the Treasury, *Administration Announces Second Round of Assistance for Hardest-Hit Housing Markets* (Mar. 29, 2010) (online at www.financialstability.gov/latest/pr__03292010.html). Until further information on these programs is released, the Panel will continue to account for the $50 billion commitment to HAMP as intact and as the newly announced programs as subsets of the larger initiative. For further discussion of the newly announced HAMP programs, and the effect these initiatives may have on the $50 billion in committed TARP funds, *see* section D.1 of the Panel's April report. COP April Oversight Report, *supra* note 333.

[369] In response to a Panel inquiry, Treasury disclosed that, as of April 30, 2010, $132.5 million in funds had been disbursed under HAMP. As of April 29, 2010, the total of all the caps set on payments to each mortgage servicer was $39.9 billion. Treasury Transactions Report, *supra* note 349.

[370] On February 3, 2010, the Administration announced an initiative under TARP to provide low-cost financing for Community Development Financial Institutions (CDFIs). Under this program, CDFIs are eligible for capital investments at a two percent dividend rate as compared to the five percent dividend rate under the CPP. In response to Panel request, Treasury stated that it projects the CDCI program to utilize $780.2 million.

[371] This figure is the sum of the uncommitted funds remaining under the $698.7 billion cap ($178.4 billion) and the repayments ($194.7 billion).

FIGURE 20: TARP PROFIT AND LOSS

TARP initiative	Dividends [372] (as of 03/31/10) (millions of dollars)	Interest [373] (as of 03/31/10) (millions of dollars)	Warrant repurchases [374] (as of 04/29/10) (millions of dollars)	Other proceeds (as of 03/31/10) (millions of dollars)	Losses [375] (as of 04/29/10) (millions of dollars)	Total (millions of dollars)
Total	$15,121	$628	$6,043	$2,525	($2,334)	$21,983
CPP	10,658	28	4,772	—	(2,334)	13,124
TIP	3,004	—	1,256	—		4,260
AIFP	1,138	576	15	—		1,729
ASSP	N/A	15	—	—		15
AGP	321	—	0	[376] 2,234		2,555
PPIP	—	9	—	[377] 15		24
Bank of America Guarantee	—	—	—	[378] 276		276

[372] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of March 31, 2010* (Apr. 16, 2010) (online at www.financialstability.gov/docs/dividends-interest-reports/March%202010%20Dividends%20and%20Interest%20Report.pdf) (hereinafter ''Cumulative Dividends and Interest Report as of March 31, 2010'').

[373] *Id.*

[374] Treasury Transactions Report, *supra* note 349.

[375] Treasury classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. A third institution, UCBH Holdings, Inc. received $299 million in TARP funds and is currently in bankruptcy proceedings. Treasury Transactions Report, *supra* note 349.

[376] As a fee for taking a second-loss position up to $5 billion on a $301 billion pool of ring-fenced Citigroup assets as part of the AGP, Treasury received $4.03 billion in Citigroup preferred stock and warrants; Treasury exchanged these preferred stocks for trust preferred securities in June 2009. Following the early termination of the guarantee, Treasury cancelled $1.8 billion of the trust preferred securities, leaving Treasury with a $2.23 billion investment in Citigroup trust preferred securities in exchange for the guarantee. At the end of Citigroup's participation in the FDIC's TLGP, the FDIC may transfer $800 million of $3.02 billion in Citigroup Trust Preferred Securities it received in consideration for its role in the AGP to the Treasury. Treasury Transactions Report, *supra* note 349.

[377] As of March, 31, 2010, Treasury has earned $15 million in membership interest distributions from the PPIP. Cumulative Dividends and Interest Report as of March 31, 2010, *supra* note 372.

[378] Although Treasury, the Federal Reserve, and the FDIC negotiated with Bank of America regarding a similar guarantee, the parties never reached an agreement. In September 2009, Bank of America agreed to pay each of the prospective guarantors a fee as though the guarantee had been in place during the negotiations. This agreement resulted in payments of $276 million to Treasury, $57 million to the Federal Reserve, and $92 million to the FDIC. U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Bank of America Corporation, Termination Agreement, at 1–2 (Sept. 21, 2009) (online at www.financialstability.gov/docs/AGP/BofA%20-%20Termination%20Agreement%20-%20executed.pdf).

d. Rate of Return

As of May 5, 2010, the average internal rate of return for all financial institutions that participated in the CPP and fully repaid the U.S. government (including preferred shares, dividends, and warrants) was 10.7 percent. The internal rate of return is the annualized effective compounded return rate that can be earned on invested capital.

e. Warrant Disposition

FIGURE 21: WARRANT REPURCHASES/AUCTIONS FOR FINANCIAL INSTITUTIONS WHO HAVE FULLY REPAID CPP FUNDS AS OF MAY 7, 2010

Institution	Investment date	Warrant repurchase date	Warrant repurchase/sale amount	Panel's best valuation estimate at repurchase date	Price/est. ratio	IRR
Old National Bancorp	12/12/2008	5/8/2009	$1,200,000	$2,150,000	0.558	9.3%
Iberiabank Corporation	12/5/2008	5/20/2009	1,200,000	2,010,000	0.597	9.4%
Firstmerit Corporation	1/9/2009	5/27/2009	5,025,000	4,260,000	1.180	20.3%
Sun Bancorp, Inc.	1/9/2009	5/27/2009	2,100,000	5,580,000	0.376	15.3%
Independent Bank Corp.	1/9/2009	5/27/2009	2,200,000	3,870,000	0.568	15.6%
Alliance Financial Corporation	12/19/2008	6/17/2009	900,000	1,580,000	0.570	13.8%
First Niagara Financial Group	11/21/2008	6/24/2009	2,700,000	3,050,000	0.885	8.0%
Berkshire Hills Bancorp, Inc.	12/19/2008	6/24/2009	1,040,000	1,620,000	0.642	11.3%
Somerset Hills Bancorp	1/16/2009	6/24/2009	275,000	580,000	0.474	16.6%
SCBT Financial Corporation	1/16/2009	6/24/2009	1,400,000	2,290,000	0.611	11.7%
HF Financial Corp.	11/21/2008	6/30/2009	650,000	1,240,000	0.524	10.1%
State Street	10/28/2008	7/8/2009	60,000,000	54,200,000	1.107	9.9%
U.S. Bancorp	11/14/2008	7/15/2009	139,000,000	135,100,000	1.029	8.7%
The Goldman Sachs Group, Inc.	10/28/2008	7/22/2009	1,100,000,000	1,128,400,000	0.975	22.8%
BB&T Corp.	11/14/2008	7/22/2009	67,010,402	68,200,000	0.983	8.7%
American Express Company	1/9/2009	7/29/2009	340,000,000	391,200,000	0.869	29.5%
Bank of New York Mellon Corp.	10/28/2008	8/5/2009	136,000,000	155,700,000	0.873	12.3%
Morgan Stanley	10/28/2008	8/12/2009	950,000,000	1,039,800,000	0.914	20.2%
Northern Trust Corporation	11/14/2008	8/26/2009	87,000,000	89,800,000	0.969	14.5%
Old Line Bancshares Inc.	12/5/2008	9/2/2009	225,000	500,000	0.450	10.4%
Bancorp Rhode Island, Inc.	12/19/2008	9/30/2009	1,400,000	1,400,000	1.000	12.6%
Centerstate Banks of Florida Inc.	11/21/2008	10/28/2009	212,000	220,000	0.964	5.9%
Manhattan Bancorp	12/5/2008	10/14/2009	63,364	140,000	0.453	9.8%
CVB Financial Corp.	12/5/2008	10/28/2009	1,307,000	3,522,198	0.371	6.4%
Bank of Ozarks	12/12/2008	11/24/2009	2,650,000	3,500,000	0.757	9.0%
Capital One Financial	11/14/2008	12/3/2009	148,731,030	232,000,000	0.641	12.0%
JP Morgan Chase & Co.	10/28/2008	12/10/2009	950,318,243	1,006,587,697	0.944	10.9%
TCF Financial Corp	1/16/2009	12/16/2009	9,599,964	11,825,830	0.812	11.0%
LSB Corporation	12/12/2008	12/16/2009	560,000	535,202	1.046	9.0%
Wainwright Bank & Trust Company	12/19/2008	12/16/2009	568,700	1,071,494	0.531	7.8%
Wesbanco Bank, Inc.	12/5/2008	12/23/2009	950,000	2,387,617	0.398	6.7%
Union Bankshares Corporation	12/19/2008	12/23/2009	450,000	1,130,418	0.398	5.8%
Trustmark Corporation	11/21/2008	12/30/2009	10,000,000	11,573,699	0.864	9.4%
Flushing Financial Corporation	12/19/2008	12/30/2009	900,000	2,861,919	0.314	6.5%
OceanFirst Financial Corporation	1/16/2009	2/3/2010	430,797	279,359	1.542	6.2%

FIGURE 21: WARRANT REPURCHASES/AUCTIONS FOR FINANCIAL INSTITUTIONS WHO HAVE FULLY REPAID CPP FUNDS AS OF MAY 7, 2010—Continued

Institution	Investment date	Warrant repurchase date	Warrant repurchase/sale amount	Panel's best valuation estimate at repurchase date	Price/est. ratio	IRR
Monarch Financial Holdings, Inc.	12/19/2008	2/10/2010	260,000	623,434	0.417	6.7%
Bank of America	[379] 10/28/2008	3/3/2010	1,566,210,714	1,006,416,684	1.533	6.5%
	[380] 1/9/2009					
	[381] 1/14/2009					
Washington Federal Inc./Washington Federal Savings & Loan Association	11/14/2008	3/9/2010	15,623,222	10,166,404	1.537	18.6%
Signature Bank	12/12/2008	3/10/2010	11,320,751	11,458,577	0.988	32.4%
Texas Capital Bancshares, Inc.	1/16/2009	3/11/2010	6,709,061	8,316,604	0.807	30.1%
Umpqua Holdings Corp.	11/14/2008	3/31/2010	4,500,000	5,162,400	0.872	6.6%
City National Corporation	11/21/2008	4/7/2010	18,500,000	24,376,448	0.759	8.5%
First Litchfield Financial Corporation	12/12/2008	4/7/2010	1,488,046	1,863,158	0.799	15.9%
PNC Financial Services Group Inc.	12/31/2008	4/29/2010	324,195,686	346,800,388	0.935	8.7%
Comerica Inc.	11/14/2008	5/12/201	[382] 181,102,043	276,426,071	0.655	10.7%
Total			6,154,669,024	6,058,253,403	1.016	10.5%

[379] Investment date for Bank of America in CPP.
[380] Investment date for Merrill Lynch in CPP.
[381] Investment date for Bank of America in TIP.
[382] Auction sale is scheduled to close on May 18, 2010. These are the projected net proceeds to Treasury.

FIGURE 22: VALUATION OF CURRENT HOLDINGS OF WARRANTS AS OF MARCH 26, 2010

Stress test financial institutions with warrants outstanding	Warrant valuation (millions of dollars)		
	Low estimate	High estimate	Best estimate
Wells Fargo & Company	$540.54	$2,209.85	$1,064.25
Citigroup, Inc.	19.99	1,110.40	275.66
SunTrust Banks, Inc.	31.49	400.67	201.59
Regions Financial Corporation	18.28	235.00	128.94
Fifth Third Bancorp	131.51	429.22	257.79
Hartford Financial Services Group, Inc.	532.06	869.84	622.70
KeyCorp	26.64	178.64	105.34
AIG	253.30	1,710.58	1,231.02
All Other Banks	803.13	1,858.64	1,374.15
Total	2,356.93	9,002.84	5,261.44

2. Other Financial Stability Efforts

Federal Reserve, FDIC, and Other Programs

In addition to the direct expenditures Treasury has undertaken through the TARP, the federal government has engaged in a much broader program directed at stabilizing the U.S. financial system. Many of these initiatives explicitly augment funds allocated by Treasury under specific TARP initiatives, such as FDIC and Federal Reserve asset guarantees for Citigroup, or operate in tandem with Treasury programs, such as the interaction between PPIP and TALF. Other programs, like the Federal Reserve's extension of credit through its section 13(3) facilities and SPVs and the FDIC's Temporary Liquidity Guarantee Program, operate independently of the TARP.

Figure 23 below reflects the changing mix of Federal Reserve investments. As the liquidity facilities established to address the crisis have been wound down, the Federal Reserve has expanded its facilities for purchasing mortgage-related securities. The Federal Reserve announced that it intended to purchase $175 billion of federal agency debt securities and $1.25 trillion of agency mortgage-backed securities.[383] As of April 29, 2010, $169 billion of federal agency (government-sponsored enterprise) debt securities and $1.1 trillion of agency mortgage-backed securities were purchased.[384] These purchases are now completed.[385] In addition, $178.5 billion in GSE MBS remain outstanding as of April 2010 under Treasury's GSE Mortgage Backed Securities Purchase Program.[386]

[383] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee*, at 10 (Dec. 15–16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/fomcminutes20091216.pdf) ("[T]he Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt").

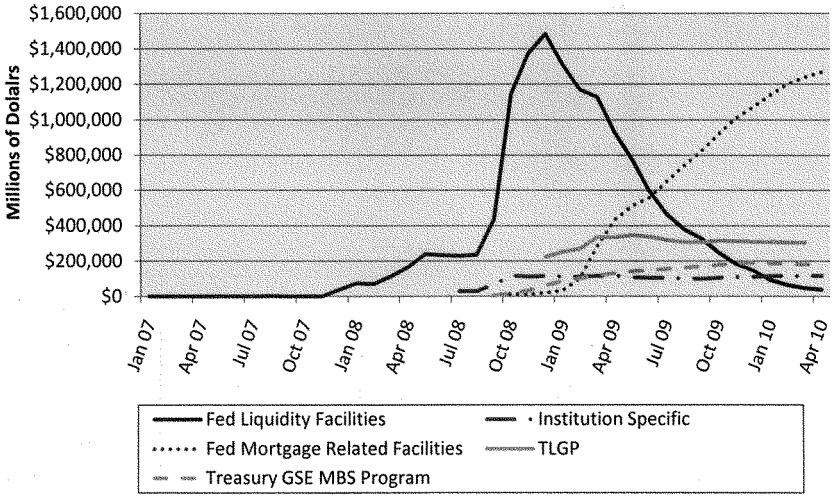
[384] Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (H.4.1) (May 6, 2010) (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (hereinafter "Factors Affecting Reserve Balances (H.4.1)").

[385] Board of Governors of the Federal Reserve System, *FOMC Statement* (Dec. 16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/20091216a.htm) ("In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the end of the first quarter of 2010"); Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (Feb. 4, 2010) (online at www.federalreserve.gov/Releases/H41/Current/).

[386] U.S. Department of the Treasury, *MBS Purchase Program: Portfolio by Month* (online at www.financialstability.gov/docs/Apr%202010%20Portfolio%20by%20month.pdf) (accessed May 6, 2010). Treasury received $42.2 billion in principal repayments $10.3 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (online at www.financialstability.gov/docs/

Continued

FIGURE 23: FEDERAL RESERVE AND FDIC FINANCIAL STABILITY EFFORTS (AS OF APRIL 28, 2010)[387]



3. Total Financial Stability Resources (as of April 29, 2010)

Beginning in its April 2009 report, the Panel broadly classified the resources that the federal government has devoted to stabilizing the economy through myriad new programs and initiatives as outlays, loans, or guarantees. Although the Panel calculates the total value of these resources at nearly $3 trillion, this would translate into the ultimate "cost" of the stabilization effort only if: (1) assets do not appreciate; (2) no dividends are received, no warrants are exercised, and no TARP funds are repaid; (3) all loans default and are written off; and (4) all guarantees are exercised and subsequently written off.

With respect to the FDIC and Federal Reserve programs, the risk of loss varies significantly across the programs considered here, as do the mechanisms providing protection for the taxpayer against such risk. As discussed in the Panel's November report, the FDIC assesses a premium of up to 100 basis points on TLGP debt

Apr%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf) (accessed May 6, 2010).

[387] Federal Reserve Liquidity Facilities include: Primary credit, Secondary credit, Central Bank Liquidity Swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility. Federal Reserve Mortgage Related Facilities include: Federal agency debt securities and Mortgage-backed securities held by the Federal Reserve. Institution Specific Facilities include: credit extended to American International Group, Inc., the preferred interests in AIA Aurora LLC and ALICO Holdings LLC, and the net portfolio holdings of Maiden Lanes I, II, and III. Factors Affecting Reserve Balances (H.4.1), *supra* note 384 (accessed May 6, 2010). For related presentations of Federal Reserve data, *see* Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet*, at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf). The TLGP figure reflects the monthly amount of debt outstanding under the program. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Dec. 2008–Mar. 2010) (online at www.fdic.gov/regulations/resources/TLGP/reports.html). The total for the Term Asset-Backed Securities Loan Facility has been reduced by $20 billion throughout this exhibit in order to reflect Treasury's $20 billion first-loss position under the terms of this program.

guarantees.[388] In contrast, the Federal Reserve's liquidity programs are generally available only to borrowers with good credit, and the loans are over-collateralized and with recourse to other assets of the borrower. If the assets securing a Federal Reserve loan realize a decline in value greater than the "haircut," the Federal Reserve is able to demand more collateral from the borrower. Similarly, should a borrower default on a recourse loan, the Federal Reserve can turn to the borrower's other assets to make the Federal Reserve whole. In this way, the risk to the taxpayer on recourse loans only materializes if the borrower enters bankruptcy. The only loan currently "underwater"—where the outstanding principal loan amount exceeds the current market value of the collateral—is the loan to Maiden Lane LLC, which was formed to purchase certain Bear Stearns assets.

FIGURE 24: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF APRIL 29, 2010) [i]

Program (billions of dollars)	Treasury (TARP)	Federal reserve	FDIC	Total
Total	$698.7	$1,642.6	$670.4	$2,995.2
Outlays [ii]	271.4	1,316.3	69.4	1,630.6
Loans	37.8	326.3	0	380.1
Guarantees [iii]	20	0	601	621
Uncommitted TARP Funds	369.5	0	0	363.4
AIG [iv]	69.8	91.8	0	161.6
Outlays	[v] 69.8	[vi] 25.4	0	95.2
Loans	0	[vii] 66.4	0	66.4
Guarantees	0	0	0	0
Citigroup	25	0	0	25
Outlays	[viii] 25	0	0	25
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Purchase Program (Other)	42.6	0	0	42.6
Outlays	[ix] 42.6	0	0	42.6
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Assistance Program	N/A	0	0	[x] N/A
TALF	20	180	0	200
Outlays	0	0	0	0
Loans	0	[xii] 180	0	180
Guarantees	[xi] 20	0	0	20
PPIP (Loans) [xiii]	0	0	0	0
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	0	0
PPIP (Securities)	[xiv] 30	0	0	30
Outlays	10	0	0	10
Loans	20	0	0	20
Guarantees	0	0	0	0
Home Affordable Modification Program	50	0	0	50
Outlays	[xv] 50	0	0	50
Loans	0	0	0	0
Guarantees	0	0	0	0
Automotive Industry Financing Program	[xvi] 72.5	0	0	72.5
Outlays	59.0	0	0	59.0
Loans	13.5	0	0	13.5
Guarantees	0	0	0	0
Auto Supplier Support Program	3.5	0	0	3.5
Outlays	0	0	0	0
Loans	[xvii] 3.5	0	0	3.5

[388] Congressional Oversight Panel, *November Oversight Report: Guarantees and Contingent Payments in TARP and Related Programs*, at 36 (Nov. 11, 2009) (online at cop.senate.gov/documents/cop-110609-report.pdf).

FIGURE 24: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF APRIL 29, 2010) [i]—Continued

Program (billions of dollars)	Treasury (TARP)	Federal reserve	FDIC	Total
Guarantees	0	0	0	0
Unlocking SBA Lending	[xvii] 15	0	0	15
Outlays	15	0	0	15
Loans	0	0	0	0
Guarantees	0	0	0	0
Community Development Capital Initiative	[xix] 0.78	0	0	0.78
Outlays	0	0	0	0
Loans	0.78	0	0	0.78
Guarantees	0	0	0	0
Temporary Liquidity Guarantee Program	0	0	601	601
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	[xx] 601	601
Deposit Insurance Fund	0	0	69.4	69.4
Outlays	0	0	[xxi] 69.4	69.4
Loans	0	0	0	0
Guarantees	0	0	0	0
Other Federal Reserve Credit Expansion	0	1,370.8	0	1,370.8
Outlays	0	[xxii] 1,290.4	0	1,290.4
Loans	0	[xxiii] 80	0	80
Guarantees	0	0	0	0
Uncommitted TARP Funds	369.6	0	0	369.6

[i] All data in this exhibit is as of April 29, 2010 except for information regarding the FDIC's Temporary Liquidity Guarantee Program (TLGP). This data is as of March 31, 2010.

[ii] The term ''outlays'' is used here to describe the use of Treasury funds under the TARP, which are broadly classifiable as purchases of debt or equity securities (e.g., debentures, preferred stock, exercised warrants, etc.). The outlays figures are based on: (1) Treasury's actual reported expenditures; and (2) Treasury's anticipated funding levels as estimated by a variety of sources, including Treasury pronouncements and GAO estimates. Anticipated funding levels are set at Treasury's discretion, have changed from initial announcements, and are subject to further change. Outlays used here represent investment and asset purchases and commitments to make investments and asset purchases and are not the same as budget outlays, which under section 123 of EESA are recorded on a ''credit reform'' basis.

[iii] Although many of the guarantees may never be exercised or exercised only partially, the guarantee figures included here represent the federal government's greatest possible financial exposure.

[iv] AIG received an $85 billion credit facility (reduced to $60 billion in November 2008 and then to $35 billion in December 2009) from the Federal Reserve Bank of New York. A Treasury trust received Series C preferred convertible stock in exchange for the facility and $0.5 million. As a result, Treasury owns a 77.9 percent voting majority in AIG. The Series C preferred shares are convertible to common stock, which gives the trust 79.9 percent of the common stock from AIG. Treasury received a warrant for two percent of AIG common stock through purchases of Series D. Also, Treasury received 150 warrants translating to 3,000 common equity shares for its purchase of Series F preferred stock. Government Accountability Office, *Troubled Asset Relief Program: Status of Government Assistance Provided to AIG* (Sept. 2009) (GAO–09–975) (online at www.gao.gov/new.items/d09975.pdf).

[v] This number includes investments under the AIGIP/SSFI Program: a $40 billion investment made on November 25, 2008, and a $30 billion investment committed on April 17, 2009 (less a reduction of $165 million representing bonuses paid to AIG Financial Products employees). As of March 31, 2010, AIG had utilized $47.5 billion of the available $69.8 billion under the AIGIP/SSFI and owed $1.6 billion in unpaid dividends. This information was provided by Treasury in response to a Panel inquiry.

[vi] As part of the restructuring of the U.S. government's investment in AIG announced on March 2, 2009, the amount available to AIG through the Revolving Credit Facility was reduced by $25 billion in exchange for preferred equity interests in two special purpose vehicles, AIA Aurora LLC and ALICO Holdings LLC. These SPVs were established to hold the common stock of two AIG subsidiaries: American International Assurance Company Ltd. (AIA) and American Life Insurance Company (ALICO). As of March 31, 2010, the book value of the Federal Reserve Bank of New York's holdings in AIA Aurora LLC and ALICO Holdings LLC was $16.26 billion and $9.15 billion in preferred equity respectively. Hence, the book value of these securities is $25.416 billion, which is reflected in the corresponding table. Federal Reserve Bank of New York, *Factors Affecting Reserve Balances (H.4.1)* (April 29, 2010) (online at www.federalreserve.gov/releases/h41/).

[vii] This number represents the full $35 billion that is available to AIG through its revolving credit facility with the Federal Reserve Bank of New York (FRBNY) ($27.1 billion had been drawn down as of May 6, 2010) and the outstanding principal of the loans extended to the Maiden Lane II and III SPVs to buy AIG assets (as of March 31, 2010, $14.8 billion and $16.6 billion respectively). The figures for the amount outstanding under the Maiden Lane II and III loans from the FRBNY do not reflect the accrued interest payable to the FRBNY. Income from the purchased assets is used to pay down the loans to the SPVs, reducing the taxpayers' exposure to losses over time. Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet*, at 17 (Oct. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200910.pdf). On December 1, 2009, AIG entered into an agreement with FRBNY to reduce the debt AIG owes the FRBNY by $25 billion. In exchange, FRBNY received preferred equity interests in two AIG subsidiaries. This also reduced the debt ceiling on the loan facility from $60 billion to $35 billion. American International Group, *AIG Closes Two Transactions That Reduce Debt AIG Owes Federal Reserve Bank of New York by $25 billion* (Dec. 1, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjE4ODI8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1).

[viii] As of April 29, 2010, the U.S. Treasury held $25 billion of Citigroup common stock under the CPP. U.S. Department of the Treasury. This amount consists of 7.6 billion shares valued on October 28, 2008 at $3.25 per share. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010* (May 3, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf).

[ix] This figure represents the $204.9 billion Treasury disbursed under the CPP, minus the $25 billion investment in Citigroup identified above, and the $137.3 billion in repayments that are reflected as available TARP funds. This figure does not account for future repayments of CPP investments, dividend payments from CPP investments, or losses under the program. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010* (May 3, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf).

[x] On November 9, 2009, Treasury announced the closing of the CAP and that only one institution, GMAC, was in need of further capital from Treasury. GMAC, however, received further funding through the AIFP. Therefore, the Panel considers CAP unused and closed. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html).

[xi] This figure represents a $20 billion allocation to the TALF SPV on March 3, 2009. However, as of April 29, 2010, TALF LLC had drawn only $104 million of the available $20 billion. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (H.4.1) (May 6, 2010) (online at www.federalreserve.gov/Releases/H41/Current/); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010* (May 3, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf). As of March 29, 2010, investors had requested a total of $73.3 billion in TALF loans ($13.2 billion in CMBS and $60.1 billion in non-CMBS) and $71 billion in TALF loans had been settled ($12 billion in CMBS and $59 billion in non-CMBS). Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility:* CMBS (online at www.newyorkfed.org/markets/CMBS_recent_operations.html) (accessed May 5, 2010); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: non-CMBS* (online at www.newyorkfed.org/markets/talf—operations.html) (accessed May 5, 2010).

[xii] This number is derived from the unofficial 1:10 ratio of the value of Treasury loan guarantees to the value of Federal Reserve loans under the TALF. U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan* (Feb. 10, 2009) (online at www.financialstability.gov/docs/fact-sheet.pdf) (describing the initial $20 billion Treasury contribution tied to $200 billion in Federal Reserve loans and announcing potential expansion to a $100 billion Treasury contribution tied to $1 trillion in Federal Reserve loans). Because Treasury is responsible for reimbursing the Federal Reserve Board for $20 billion of losses on its $200 billion in loans, the Federal Reserve Board's maximum potential exposure under the TALF is $180 billion.

[xiii] It is unlikely that resources will be expended under the PPIP Legacy Loans Program in its original design as a joint Treasury-FDIC program to purchase troubled assets from solvent banks. *See also* Federal Deposit Insurance Corporation, *FDIC Statement on the Status of the Legacy Loans Program* (June 3, 2009) (online at www.fdic.gov/news/news/press/2009/pr09084.html); Federal Deposit Insurance Corporation, *Legacy Loans Program—Test of Funding Mechanism* (July 31, 2009) (online at www.fdic.gov/news/news/press/2009/pr09131.html). The sales described in these statements do not involve any Treasury participation, and FDIC activity is accounted for here as a component of the FDIC's Deposit Insurance Fund outlays.

[xiv] As of February 25, 2010, Treasury reported commitments of $19.9 billion in loans and $9.9 billion in membership interest associated with the program. On January 4, 2010, Treasury and one of the nine fund managers, TCW Senior Management Securities Fund, L.P., entered into a ''Winding-Up and Liquidation Agreement.'' U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010* (May 3, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf).

[xv] Of the $50 billion in announced TARP funding for this program, $39.9 billion has been allocated as of April 29, 2010. However, as of February 2010, only $57.8 million in non-GSE payments have been disbursed under HAMP. Disbursement information provided in response to Panel inquiry; U.S. Department of the Treasury, Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010 (May 3, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf).

[xvi] A substantial portion of the total $81.3 billion in loans extended under the AIFP have since been converted to common equity and preferred shares in restructured companies. $18.2 billion has been retained as first lien debt (with $1 billion committed to old GM, and $12.5 billion to Chrysler). This figure ($72.5 billion) represents Treasury's current obligation under the AIFP after repayments.

[xvii] *See* U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 29, 2010* (May 3, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-3-10%20Transactions%20Report%20as%20of%204-29-10.pdf).

[xviii] U.S. Department of Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Oct. 19, 2009) (online at www.financialstability.gov/roadtostability/unlockingCreditforSmallBusinesses.html) (''Jumpstart Credit Markets For Small Businesses By Purchasing Up to $15 Billion in Securities'').

[xix] This information was provided by Treasury staff in response to Panel inquiry.

[xx] This figure represents the current maximum aggregate debt guarantees that could be made under the program, which is a function of the number and size of individual financial institutions participating. $305.4 billion of debt subject to the guarantee is currently outstanding, which represents approximately 51 percent of the current cap. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program: Debt Issuance Under Guarantee Program* (March 31, 2010) (online at www.fdic.gov/regulations/resources/tlgp/total_issuance12–09.html). The FDIC has collected $10.4 billion in fees and surcharges from this program since its inception in the fourth quarter of 2008. Federal Deposit Insurance Corporation, *Monthly Reports Related to the Temporary Liquidity Guarantee Program* (Mar. 31, 2009) (online at www.fdic.gov/regulations/resources/tlgp/fees.html).

[xxi] This figure represents the FDIC's provision for losses to its deposit insurance fund attributable to bank failures in the third and fourth quarters of 2008 and the first, second and third quarters of 2009. Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Fourth Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_4qtr_/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (First Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_1stqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Second Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_2ndqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_09/income.html). This figure includes the FDIC's estimates of its future losses under loss-sharing agreements that it has entered into with banks acquiring assets of insolvent banks during these five quarters. Under a loss-sharing agreement, as a condition of an acquiring bank's agreement to purchase the assets of an insolvent bank, the FDIC typically agrees to cover 80 percent of an acquiring bank's future losses on an initial portion of these assets and 95 percent of losses of another portion of assets. *See, e.g.*, Federal Deposit Insurance Corporation, Purchase and Assumption Agreement Among FDIC, Receiver of Guaranty Bank, Austin, Texas, FDIC and Compass Bank, at 65–66 (Aug. 21, 2009) (online at www.fdic.gov/bank/individual/failed/guaranty-tx_p_and_a_w_addendum.pdf). In information provided to Panel staff, the FDIC disclosed that there were approximately $132 billion in assets covered under loss-sharing agreements as of December 18, 2009. Furthermore, the FDIC estimates the total cost of a payout under these agreements to be $59.3 billion. Since there is a published loss estimate for these agreements, the Panel continues to reflect them as outlays rather than as guarantees.

[xxii] Outlays are comprised of the Federal Reserve Mortgage Related Facilities and the preferred equity holdings in AIA Aurora LLC and ALICO Holdings LLC. The Federal Reserve balance sheet accounts for these facilities under Federal agency debt securities, mortgage-backed securities held by the Federal Reserve, and the preferred interests in AIA Aurora LLC and ALICO Holdings LLC. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (H.4.1) (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed May 5, 2010). Although the Federal Reserve does not employ the outlays, loans and guarantees classification, its accounting clearly separates its mortgage-related purchasing programs from its liquidity programs. *See* Board of Governors of the Federal Reserve, *Credit and Liquidity Programs and the Balance Sheet November 2009,* at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf).

On September 7, 2008, Treasury announced the GSE Mortgage Backed Securities Purchase Program (Treasury MBS Purchase Program). The Housing and Economic Recovery Act of 2008 provided Treasury the authority to purchase Government Sponsored Enterprise (GSE) MBS. Under this program, Treasury purchased approximately $214.4 billion in GSE MBS before the program ended on December 31, 2009. As of March 2010, there was $178.5 billion still outstanding under this program. U.S. Department of the Treasury, MBS Purchase Program: Portfolio by Month (online at www.financialstability.gov/docs/Apr%202010%20Portfolio%20by%20month.pdf) (accessed May 5, 2010). Treasury has received $42.2 billion in principal repayments and $10.3 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (online at www.financialstability.gov/docs/Apr%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf) (accessed May 5, 2010).

[xxiii] Federal Reserve Liquidity Facilities classified in this table as loans include: Primary credit, Secondary credit, Central bank liquidity swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility, and loans outstanding to Bear Stearns (Maiden Lane I LLC). Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed May 5, 2010).

SECTION FIVE: OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of the Emergency Economic Stabilization Act (EESA) and formed on November 26, 2008. Since then, the Panel has produced 17 oversight reports, as well as a special report on regulatory reform, issued on January 29, 2009, and a special report on farm credit, issued on July 21, 2009. Since the release of the Panel's April oversight report, which assessed Treasury's ongoing efforts to mitigate the country's high home foreclosure rate using TARP initiatives, the following developments pertaining to the Panel's oversight of the TARP took place:

• The Panel held a hearing in Phoenix, Arizona on April 27, 2010, discussing the small business credit crunch and ways TARP initiatives could be used to help reinvigorate small business lending. The Panel heard testimony from senior officials from the local field offices of the Federal Deposit Insurance Corporation and the Small Business Administration, as well as from representatives of Phoenix-area community banks and small businesses. A video recording of the hearing, the written testimony from the hearing witnesses, and Panel members' opening statements all can be found online at cop.senate.gov/hearings.

Upcoming Reports and Hearings

The Panel will release its next oversight report in June. The report will examine how one of the largest recipients of TARP financial assistance, American International Group, Inc. (AIG), got into financial trouble, assess some of the regulatory challenges presented by such an entity, and discuss Treasury's ongoing financial assistance to AIG under the AIG Investment Program (AIGIP) and the continued support for the company from the Federal Reserve Bank of New York. It will identify the parties that benefited from the rescue of AIG and will assess the company's progress in its plans to repay the taxpayers and the governmental entities' plans to exit their AIG holdings.

The Panel is planning a hearing in Washington on May 26, 2010, to discuss the topic of the June report. The Panel intends to hear testimony from current and former executives at AIG, counterparties that benefited from government support to the firm, as well as relevant senior policymakers and government regulators.

SECTION SIX: ABOUT THE CONGRESSIONAL OVERSIGHT PANEL

In response to the escalating financial crisis, on October 3, 2008, Congress provided Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stability (OFS) within Treasury to implement the Troubled Asset Relief Program. At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress instructed the Panel to produce a special report on regulatory reform that analyzes "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers." The Panel issued this report in January 2009. Congress subsequently expanded the Panel's mandate by directing it to produce a special report on the availability of credit in the agricultural sector. The report was issued on July 21, 2009.

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Director of Policy and Special Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School, to the Panel. With the appointment on November 19, 2008, of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel. Effective August 10, 2009, Senator Sununu resigned from the Panel, and on August 20, 2009, Senator McConnell announced the appointment of Paul Atkins, former Commissioner of the U.S. Securities and Exchange Commission, to fill the vacant seat. Effective December 9, 2009, Congressman Jeb Hensarling resigned from the Panel and House Minority Leader John Boehner announced the appointment of J. Mark McWatters to fill the vacant seat.

APPENDIX I: LETTER TO CHAIR ELIZABETH WARREN FROM SECRETARY TIMOTHY GEITHNER RE: CPP RESTRUCTURINGS, DATED MAY 3, 2010

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 3, 2010

Ms. Elizabeth Warren
Chair
Congressional Oversight Panel
732 North Capitol Street, NW
Room C-320
Washington, DC 20401

Dear Chair Warren:

Thank you for letter of April 13, 2010, which raises questions regarding restructurings of current Capital Purchase Program (CPP) investments.

As you know, CPP was created in October 2008 to help contain one of the most severe financial crises of the past century, and to prevent further deterioration or collapse. Under this program, Treasury consistently followed a strict application process for approval of all CPP investments. Financial institutions submitted applications to their primary federal banking regulator, who reviewed the applications and then provided Treasury with recommendations. Treasury relied on the expertise of the regulators in making investment decisions, and gave considerable weight to their recommendations. Upon receipt of the regulator's recommendation, Treasury staff reviewed it along with the bank's application and presented them to the Office of Financial Stability's Investment Committee for review. The Investment Committee in turn made a funding recommendation to the Assistant Secretary for Financial Stability. Treasury did not fund an applicant unless it was recommended by the regulators as well as our Investment Committee.

In response to your questions about Treasury's current investments through this program, I note that Treasury continues to estimate that the sum of proceeds and revenues from CPP investments will exceed the amount invested under the program. We invested in over 700 institutions. The bulk of the investment decisions for CPP were made in a time of great economic uncertainty, and not all individual investments will earn a profit. While all institutions were deemed viable at the time of Treasury's investment, it is possible that some institutions have since experienced financial difficulties for any number of reasons, including a loss of value in certain asset classes. Treasury continues to work to minimize losses and maximize recovery to the taxpayer.

The U.S. banking system is better capitalized today than it was entering the crisis. Our larger financial institutions that were subject to the stress tests have raised over $150 billion in high-quality capital and over $75 billion in non-guaranteed unsecured debt since May 2009, when the

stress test results were announced. But the damage to the U.S. banking system over the past few years has been substantial. There have been 183 bank failures since the crisis began.

Treasury actively monitors all investments made under the Troubled Asset Relief Program, including its investments in CPP recipients. This is done with the assistance of external asset managers, who perform an analysis on each recipient's financial condition using publicly available information. Treasury does not receive confidential supervisory information. In addition, Treasury does not have access to the FDIC's problem institutions list.

In assessing the current CPP portfolio, I refer you to the OFS financial statements, released on December 9, 2009. OFS' equity model draws from a composite of all CPP institutions and projects the per-quarter probability that such institutions will continue to perform, will repurchase, or will fail. The dollar amounts are then summed by event to generate performing, prepay, and default cash flows. As of September 30, 2009, the model projected that any portfolio losses will be more than offset by cash inflows, including dividend payments. We will publish an update to this valuation in the near future.

Thank you again for your attention to this important matter; we look forward to working with your office as we continue our efforts to stabilize the financial system. If you have any further questions or concerns, please do not hesitate to contact me or my staff.

Sincerely,

Timothy F. Geithner

APPENDIX II: LETTER TO SECRETARY TIMOTHY GEITHNER FROM CHAIR ELIZABETH WARREN RE: GM REPAYMENT TO TARP, DATED MAY 6, 2010

ELIZABETH WARREN, CHAIR
PAUL S. ATKINS
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

May 6, 2010

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
Room 3300
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

On behalf of the Congressional Oversight Panel, I am writing to you about General Motors' April 20 repayment of $4.7 billion of TARP debt. We are particularly concerned that GM's announcement of the repayment may have given the public a misleading impression about GM's financial condition and its continued reliance on government support.

The Panel's January report, "Exiting TARP and Unwinding its Impact on the Financial Markets," noted that the funds used to make the repayment would not come from GM revenues but from previously escrowed TARP funds. The company's public presentations following the repayment, however, contain a stronger inference. In a television advertisement, GM's President, Ed Whitacre, says:

> [A] lot of Americans didn't agree with giving GM a second chance . . . We want to make this a company all Americans can be proud of again. That's why I'm here to announce that we've repaid our government loan, *in full*, with interest, five years ahead of the original schedule. (Emphasis added.)

Mr. Whitacre does not mention that Treasury continues to hold almost 61 percent of GM's common stock as well as $2.1 billion of its preferred stock. You told the Subcommittee on Financial Services and General Government of the Senate Committee on Appropriations last Thursday that, although you had not seen GM's advertisements on the subject, officials within Treasury "were concerned" that GM's applauding of its repayment was, in this sense, "misleading."

The Panel requests your responses to the following questions by June 5, 2010:

1. What were the specific concerns expressed by Treasury officials that GM's statements were "misleading?"

2. What actions did you or other Treasury officials take to address those concerns? If none were taken, why did Treasury not feel it was necessary or appropriate to do so in light of Treasury's role as representative of the taxpayers' majority stake in GM?

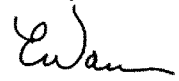
3. On what conditions did Treasury base its determination to approve the April 20 repayment?

4. Both the Panel and SIGTARP highlighted in reports to Congress that were GM to repay the $4.7 billion TARP debt this year, as it did on April 20, such repayment would come from other TARP funds. Did Treasury officials communicate with GM officials regarding how they would describe this repayment?

5. Some commentators have argued that, by implying that this TARP repayment meant the company had repaid taxpayers "in full," GM has done more to harm its reputation than improve it. This could result in a lower or delayed return to taxpayers on the TARP investment in GM. Does Treasury agree with this analysis? If so, did Treasury officials discuss with GM the potential harm to the company's reputation by making "misleading" statements regarding its financial health? If not, did Treasury officials consider the potential harm and discuss this with GM?

The Panel has emphasized since its creation the critical importance of transparency in the administration of the TARP. Without such transparency and accurate characterization of Treasury's strategy and actions, and of actions taken by recipients of TARP assistance, public support for the TARP will suffer further erosion. I hope you will take whatever steps may be necessary to correct any misimpressions about what the GM repayment does, and does not, mean.

Sincerely,



Elizabeth Warren
Chair
Congressional Oversight Panel