Testimony of Robert W. Davenport, President of the National Development Council
Before the
House Financial Services Subcommittee on Financial Institutions and Consumer Credit

March 4, 2009

Mr. Chairman, my name is Bob Davenport and I am the President of the National Development Council based in New York City. I am pleased to be here today, and appreciate the invitation to testify before the distinguished House Financial Services Subcommittee on Financial Institutions and Consumer Credit.

<u>Background on NDC</u>

The National Development Council (NDC) is a 501(c)(3) nonprofit organized in 1968 after the tragic deaths of Dr. Martin Luther King, and Robert F. Kennedy to eliminate discrimination and create economic opportunity in disadvantaged areas. We remain one of the oldest national non-profit community development organizations in the country. Over the last 40 years we have worked to bring financial and technical assistance including professional training, investment in affordable housing, small business credit and direct developer services to communities across the country. Each year NDC trains more than 3,000 economic development and housing development practitioners. We have worked in all 50 states and have experience using a number of housing and small business programs. Because we are a non-profit, we do not raise our lending capital from shareholders, rather private sector lenders make lines of credit or other funding available to us at interest rates we can afford, and we in turn use those funding sources to make loans to our borrowers.

NDC is a certified Community Development Financial Institution (CDFI) and Community Development Entity (CDE) as certified by the Treasury Department and a Small Business Lending Company (SBLC) certified by the Small Business Administration. We received our SBLC license in 1992, our CDFI certification in the late 1990s, and CDE certification in 2003.

<u>History of Business Lending</u>

Recently, NDC has financed New Markets Tax Credit projects totaling $640 million, loaned over $90 million to small businesses for projects with investments of $150 million, invested $350 million in equity for affordable housing or historic preservation projects (leveraging an additional $280 million), and financed and developed $1.1 billion in public and community facilities.

The reason I am testifying here today is because the downturn in the financial marketplace is having a devastating impact on our ability to continue our lending to the businesses we serve, and NDC is now operating in a drastically changed environment in which its traditional sources of capital are pulling back, which means we cannot meet client needs for a range of community development financing products. The sources of capital we have used in the past to provide debt to small businesses, as well as the equity our borrowers have counted on for affordable housing and community development projects is drying up, which leads to serious financing gaps that stall projects or destroy their viability, sacrifice quality, and constrain the ability of mission-driven organizations to meet the nation's housing and community development needs. Notwithstanding the size of our loans and our borrowers, we have an excellent record of success and few defaults.

NDC makes loans to borrowers in difficult lending markets, with smaller average loans or investments and with more complex transactions. Given the low and moderate income communities in which we work, it is simply not feasible, from a business standpoint, for us to pass on to customers the capital costs that are being proposed of late by mainstream money center banks. And our customers have few options to find a lender besides us and other community oriented lenders like us. According to an October 2008 Senior Loan Officer Opinion Survey released by the Federal Reserve Board, nearly 75% of lenders say they have tightened their credit standards for approving applications for commercial and industrial loans to small businesses. This pull back has had the curious result of our receiving even more applications for loans, from very credit-worthy businesses that are being turned down by their regular banks. Accordingly, at a time when our own customers need us, we are being asked to serve new customers, and with the credit freeze, we find it difficult to do either.

I am here today because NDC wants to continue to provide debt financing for its borrowers and to do that, we need to find another source of lending capital until the banks return to this market. We believe the only source for such capital is the federal government.
My testimony today outlines our recommendations for ways to strengthen the Troubled Asset Relief Program (TARP) and the Term Asset-Backed Securities Lending Facility (TALF) to increase liquidity of community financial institutions so they can continue to lend and keep pace with demand, and to use TARP and TALF as a secondary market to acquire federal business loans and those guaranteed by various federal agencies (including Treasury, Housing and Urban Development, Small Business Administration, Economic Development Administration and US Department of Agriculture). This would allow access to Treasury-rate financing for businesses. We recommend this new mechanism for business financing be implemented through proven local delivery system of community financial institutions in cities and states, both urban and rural, and that existing federal regulations for this lending be streamlined to ensure timely impact.

An NDC Lending Model

We have a lending unit called Grow America Fund (GAF) that is a wholly owned subsidiary of NDC. GAF's mission is to stimulate investment in low income communities, to create jobs for the unemployed, and to spur entrepreneurship, especially among women and minority owned businesses.

Over our history, GAF has made nearly $100 million of loans. We are a small lender, averaging $10 million of loans annually. Our typical loan is under $300,000. Half of our borrowers are businesses owned by minority or women entrepreneurs. Because our mission is to build entrepreneurship, we make fewer loans and work closely with our borrowers to build their capacity to succeed as a business. Our loan loss rates average six tenths of one percent, which is extremely low given the fact that more than half of all small businesses fail within five years of start-up.

Because banks are not lending on the terms or at the rates of the past, loan applications to GAF have burgeoned. One business we helped finance just last month is a furniture manufacturer located in Brooklyn, New York.

In 1986 a woman started her own company making custom furniture products. She formed the business to facilitate the manufacturing and sale of the pieces of furniture and accessories she created. Today, her hand made products range from chandeliers, lamps and other ornamental pieces to bedroom sets. The owner works with interior designers, decorators and architects to produce custom pieces in addition to those made for sale in her retail boutique.

In 2004 the owner formed a retailing arm of her business in New York City. The company leases a 600 sq. ft. space where her pieces are for display only. A catalog is available at the store from which orders may be placed. The $488,000 GAF loan proceeds were used to refinance short-term working capital loans in the amount of $339,000 and provide $125,000 in permanent working capital to support the company's expansion through additional showrooms and $23,897 to finance project related soft and closing costs. The company employs fourteen people and is expected to add two full time jobs as a result of this 10-year, 5% loan.

GAF closed this loan in January, 2009. Recently, however, market conditions have changed.

How Bank Pullback has Affected Our Lending

Last fall, a money-center bank with which NDC had a long standing borrowing relationship received TARP funds. Recently, that same bank raised our borrowing rates. In addition, the bank imposed lending conditions with which we could not legally or operationally comply. These actions forced us to terminate this relationship at a time when we needed the money.

As an SBLC or "non-bank lender" GAF is authorized to make Small Business Administration (SBA) guaranteed loans nationwide. We are regulated by the SBA and audited for safety and soundness by the Farm Credit Administration. We have always received laudatory audits from Farm Credit Administration for safety and soundness and the policies and procedures we employ to carry out our mission. The SBA's Overall Lender Risk Ranking for GAF is 1, the best possible rating, evidencing the lowest risk ranking in the nation.

Our relationship with a particular Bank goes back more than 10 years. The Bank financed the 75% guaranteed portion of the loans made by GAF in the Bank's CRA assessment areas. By financing only the guaranteed portions of GAF's loans, they in essence have a 100% guarantee from the SBA on their loans to GAF. Because of the low risk and CRA credit they received, they loaned to GAF at LIBOR plus 25 basis points. They have never suffered a loss or a late payment from GAF and have always indicated to us that our relationship was very satisfactory to the Bank.

In late 2008, without prior warning, the Bank raised its interest rate to GAF by 1% to LIBOR plus 1.25. No reason was given for the rate increase. We had just completed our best ever audit with Farm Credit Administration and showed a continued Overall Risk Rating of 1 from the SBA. If anything, we were expecting a decrease in the rate for the successful management of this business. We nonetheless accepted the increase, to enable us to continue our lending.

Then, in January 2009 the Bank imposed two new conditions, which they were unwilling to put into writing. First, the Bank demanded a direct security interest either in the loans we made or in the SBA guarantee of the loans we made. To accommodate this request would have been a violation of SBA regulations and would lead to GAF losing its SBA license.

In addition, the Bank demanded that if any GAF loan financed under the Bank's line defaulted, GAF must pay the Bank prior to collection of the guaranteed portion from the SBA. No explanation was given for the demand beyond saying that they assumed all our loans would default and they wanted to be paid in a timely fashion.

This condition was both unreasonable – the Bank in essence would not wait for its money even though it was guaranteed by the US Government – and it could not be met because we would have had to maintain idle cash balances in an amount equal to their loan to GAF. In essence, they would loan GAF money, but only if GAF kept it in cash, and did not use it to make loans. Moreover, in light of our continuing good track record of very low loan losses, we feel penalized because we have continued to serve our customers instead of sitting on our cash.

As a result, we have been forced to terminate our borrowing relationship with that particular

Bank, and are retiring their loan to us. The Bank claims they did not deny GAF credit. They claim GAF simply could not meet the conditions of their offer. The fact that they were demanding conditions we could not legally meet, or which made it a loan in name only seems irrelevant to them. The Bank in question changed its terms for us after it received TARP money.

Recommendations

Utilize the Troubled Asset Relief Program (TARP) and the Term Asset-Backed Securities Lending Facility (TALF) to Enhance Lending

Congress must ensure that community based lenders have the same support from Treasury's TARP program, and the Federal Reserve's TALF program as regulated depository institutions do. As evidenced in my example above, community lenders cannot rely on a TARP funding trickle down effect from money center banks. There is a need for TARP funds to increase liquidity of community financial institutions like GAF to expand their lending capacity to meet increasing loan demand and fill financing gaps resulting from banks' retrenchment. There is also a need for TALF so Treasury and the Federal Reserve can set up a facility to acquire guaranteed federal business loans. Here are ways that TARP and TALF might be used for this purpose.

TARP:
Congress passed the Emergency Economic Stabilization Act in October, 2008. The purpose of EESA was "to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States." (Section 2. Purposes). EESA authorizes the Secretary to establish a Troubled Asset Relief Program ("TARP") in Section 101.

Troubled assets are defined as including both mortgages as well as "any securities, obligations, or other instruments that are based on or related to such mortgages" and, "any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability… ." (Section 3(9)(A-B)).

Treasury has created a Capital Purchase Program (CPP) through which it is purchasing securities from financial institutions, in order to provide them more capital in the expectation of promoting financial system stability. Thus far, publicly held regulated financial institutions, privately-held C corporations, and most recently, Subchapter S corporations have been able to apply. Treasury has indicated it is working on a program for mutual associations.

Treasury can similarly create a version of the CPP suitable for the 3,000 to 4,000 seasoned non-profit community oriented lenders such as the National Development Council, who have a demonstrated track record of successful lending. These lenders include Community Development Corporations, CDFIs, non-profit low income credit unions and government-sponsored community lenders. In keeping with the purpose of the CPP, these investments would be just that, a source of capital from the taxpayers which would be paid back. We believe that investments in organizations like ours are consistent with the purposes of the TARP legislation. In Section 103 the legislation states,

> In exercising the authorities granted in this Act, the Secretary shall take into consideration—
> (1) protecting the interests of taxpayers by maximizing overall returns and minimizing the impact on the national debt;
> (2) providing stability and preventing disruption to financial markets in order to limit the impact on the economy and protect American jobs, savings, and retirement security;
> (3) the need to help families keep their homes and to stabilize communities;
> (4) in determining whether to engage in a direct purchase from an individual financial institution, the long term viability of the financial institution in determining whether the purchase represents the most efficient use of funds under this Act;
> (5) <u>ensuring that all financial institutions are eligible to participate in the program, without discrimination based on size, geography, form of organization, or the size, type, and number of assets eligible for purchase under this Act</u>

We recommend the terms of the CPP for community lenders be adjusted, given our much smaller size, and the fact that we are committed to lending and providing technical assistance to our borrowers. Rather than basing the amount of assistance on risk-weighted assets, we believe that the amount of assistance should be based on a percentage of the weighted average lending activity in which the institution has been engaged over the last 5 years. We suggest that a percentage of average annual lending or investing activity over the last three years be used to size the subordinated debt.

We propose that the subordinated debentures bear interest at a rate equal to no more than the 10-Year Treasury rate at the time of issuance, with the Secretary having the authority to set the rate at as little as 1%, payable in similar fashion to other classes of CPP investments.

No one knows how long the current economic conditions and credit freeze in the private markets will persist. In its term sheet for Subchapter S corporations, Treasury proposed a maturity of 30 years, which we suggest be used for community lenders as well, with Treasury having the ability to redeem starting at the end of 7 years from the date of their issuance, which is 4 years longer than the inception of the redemption period for Subchapter S financial institutions. We believe this additional period is justified in light of the greater difficulties community financial institutions like NDC will have replacing the capital at redemption than traditional financial institutions may experience.

We would agree to the other standard provisions that Treasury is using, including the executive compensation provisions, and would work with them to identify appropriate measures to determine the financial health attributes for community lenders to participate.

We suggest a term that does not currently exist in the CPP agreements with regulated depository institutions, and that is that in return for this debt, we will agree to make loans and provide technical assistance to our borrowers.

TALF:
The TALF combines capital provided by the TARP with funding from the Federal Reserve in order to promote lending by increasing investor demand for securitized loans. As Treasury and the Federal Reserve continue to work on the TALF program we want to ensure that community financial institutions are given full consideration and a means to participate.

On February 10, 2009 Treasury Secretary Geithner announced an expansion of the Term Asset-Backed Securities Lending Facility (TALF) as part of the Administration's Financial Stability Plan. The purpose of this expansion, Secretary Geithner announced, is to "kickstart the secondary lending markets, to bring down borrowing costs, and to help get credit flowing again." He went on to say,

"In our financial system, 40% of consumer lending has historically been available because people buy loans, put them together and sell them. Because this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small.

We have agreed to expand this program to target the markets for small business lending, student loans, consumer and auto finance, and commercial mortgages.

And because small businesses are so important to our economy, we're going to take additional steps to make it easier for them to get credit from community banks and large banks. By increasing the federally guaranteed portion of SBA loans, and giving more power to the SBA to *expedite loan approvals, we believe we can turn around the dramatic decline in SBA lending we have seen in recent months."*

In keeping with Secretary Geithner's proposal to increase guarantees, we recommend that all federal business guarantees be increased on the following scale until the economy recovers:

- 95% guarantee on loans less than $150,000;
- 90% guarantee on loans less than $500,000 and greater than $150,000;
- 85% guarantee on loans less than $2 million and greater than $500,000;
- 80% guarantee on loans up to $5 million and greater than $2 million; and
- Permit SBA to guarantee loans up to $5 million

In addition to raising the amount of federal guarantees, we recommend that Treasury and the Federal Reserve permit community financial institutions to sell their direct loans to TARP or TALF to recapitalize and enhance the liquidity of these lenders who have not stopped lending to businesses. We also recommend that Treasury and the Federal Reserve permit lenders to sell their guaranteed loans at low rates to TARP or through TALF if the established secondary market will not buy the loans because of the concessionary rate.

We believe that just as the Treasury Department is purchasing Fannie Mae and Freddie Mac mortgage-backed securities to promote stability and liquidity in the marketplace, TARP and TALF can and should serve as a secondary market for federal business loan guarantees for the same reason.

Thank you for your consideration of these recommendations. I would be happy to answer any questions that you might have for me. Again, I appreciate the opportunity to testify here today on such an important topic.

Robert W. Davenport
President, National Development Council
708 Third Avenue, Suite 710
New York, New York 10017
Phone: (212) 682-1106
Fax: (212) 573-6118
Email: RDavenport@nationaldevelopmentcouncil.org