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Field Hearing On
Finding Credit for Small and Medium-Sized Businesses

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Introduction

Good morning, Chairman Frank and Members of the Committee. My name is Ed Shea and I am the Business Banking Market Executive for the Boston / MetroWest Market and the Central Massachusetts Market President for Bank of America. I appreciate the opportunity to share our views on the current state of lending to small and medium-sized businesses. The issues being discussed today are of great importance to our local, state, regional and national economy.

Bank of America has a broad, strong and longstanding commitment to serving small and medium-sized businesses. We and our predecessor banks have been serving business clients for well over 200 years. During that time, we have weathered many economic cycles with our clients. Today, we have relationships with more than 4.5 million small and medium-sized businesses across the country and serve these clients with a wide range of products and services, including deposit products, treasury management solutions, loan products, investments and advisory services, as well as a full suite of online banking capabilities. Bank of America provides products and services to all types of businesses, from home-based businesses through Fortune 500 corporations. Our testimony today will focus on our Small Business Banking and Business Banking client segments, representing small and medium-sized businesses with annual revenues of up to approximately $20 million.

Current Business Environment

We are keenly aware of the challenges our business clients are facing during this economic cycle and the ways in which they are adapting to these changes. A recent survey by the National Federation of Independent Business (NFIB), a leading association of small businesses, provides perspective on some of the impacts small businesses are feeling:

- In February, the NFIB index of small business optimism fell to its second lowest data point in the 35 year history of the survey.
- Expectations for growth in sales and profits continue to fall, causing small businesses to cut prices as they focus on liquidating inventory and trimming labor costs. Expectations for future hiring are also at historically low levels, with lower sentiments coming only during the 1974-75 and 1980-82 recessions.

- Reports of capital investments made in the prior six months were flat while plans for capital outlays in the next six months were up slightly. However, since 2006, small businesses have trended toward consistent decreases in actual and planned capital expenditures.
- Small business sales and earnings are lower. The number of small business owners reporting higher sales in the past three months on a seasonally adjusted basis was down a net 28 percent -- one of the worst readings in survey history.

Separately, a recent report by VISA on business failures and bankruptcies found that bankruptcies are expected to increase 30 to 40 percent in 2009, with a corresponding increase in business closures.

Our own experience with small business clients tells a similar story. In our daily interactions with clients we are seeing first-hand the effects of economic weakness, including loss of customers, greater difficulty in collecting receivables, suppliers who require higher up-front payments and layoffs of long-time employees. Business owners tell us they are delaying or cancelling investments, as well as hiring and expansion plans until times are better. They are eliminating non-essential expenditures and looking for ways to preserve cash.

An example of the hardships our clients are facing can be illustrated by a recent conversation we had with a client who has been in the auto repair business since 1973. This business owner told us that he has seen many ups and downs over the years, but has never experienced anything in his business like he is going through now. His revenues are off almost 50 percent year-over-year and he has been forced to make hard decisions to reduce expenses to off-set lost revenue and keep his business open. Over the past several months, he has laid-off two of his six technicians and is considering eliminating certain employee benefits. Unfortunately, we are hearing these types of stories on a frequent basis in our daily conversations with clients.

Not surprisingly, our small business loan portfolio is also seeing the effects of the downturn. Over the past year, we have seen a steady rise in delinquencies on business loan accounts. More clients are calling to let us know they are facing cash shortfalls and will not be able to make upcoming loan payments. Clients who have made payments consistently for months and years have now fallen behind. Whereas in the past we would expect most delinquent clients to catch up over several months, we are now seeing more who simply cannot pay at all. As a result, our credit losses more than doubled from 2007 to 2008.

In our client interactions and in our data, we see that the recession is having a disproportionate impact on businesses at the smaller end of the small business spectrum – those with revenues less than $500,000. These smaller businesses often serve small geographic or niche markets. They are more often newer businesses with fewer financial resources to fall back on when times get tough. They are sole proprietors or partnerships whose personal income and assets are largely tied up in the businesses. These smaller clients are, in many cases, living “paycheck-to-paycheck” and simply do not have the resources to weather the storm.

Larger, more established businesses are faring better but are also showing signs of financial difficulty, as evidenced by lower capital expenditures, reduction in inventories and lay-offs. The key difference is that these larger businesses tend to have stronger balance sheets, more stable and predictable cash flow and greater access to working capital to manage the contraction of their businesses. As a result, businesses in this segment are not facing the same level of stress as smaller businesses.

Bank of America’s Commitment to Serving Small Businesses

In light of these challenges, we continue to take actions to help small businesses. We continue to actively market our full suite of credit products. And we are working more intensively than ever to restructure loans for clients who are in financial distress. Specifically, in an effort to provide relief to clients struggling to make their small business credit card payments, we have increased the use of our fixed payment programs where we significantly reduce the interest rate and monthly payments. In 2008, we assisted over 40,000 clients with balances in aggregate of approximately $550 million by modifying payment structures to improve their monthly cash flow.

Another way we are helping small businesses is through our commitment to Community Development Financial Institutions. CDFIs play important roles as conduits to provide credit to families, small businesses, multi-cultural organizations, community facilities and non-profits serving low-to-moderate income communities that might not qualify under more traditional credit criteria. Bank of America, inclusive of Merrill Lynch, is the leading financial services investor in CDFIs with more than $450 million in direct lending and investments in 2008.

In Massachusetts, we have built strong relationships with a number of CDFIs, such as Boston Community Capital, ACCION USA, New Bedford EDC, Western MA Enterprise Fund and others. Bank of America also has been innovative in support of CDFIs through its Program Related Investments (PRIs). This program provides low-cost loans and investments at below-market rates. These investments, nearly $100 million in 2008, provide long-term capital to CDFIs, ensuring the funds assist underserved and economically distressed individuals and communities. Approximately 21 percent of our nearly $450 million PRI portfolio is invested in small business and microenterprises. Bank of America will continue to demonstrate further leadership and support of CDFIs through grants, loans and investments by leveraging the PRI program together with other resources of our Community Development Banking and Small Business Banking divisions.

In addition to our CDFI commitment, we remain committed to our 10-year $1.5 trillion community development goal. Small business lending and investment is one of the categories that we will report on annually, further underscoring our commitment to and focus on this segment. Our target over the next 10 years is to make at least $250 billion – or 17 percent of the total goal – in loans and investments to small businesses. This includes:

- Small business loans up to $1 million (up to $5 million for those in low- and moderate-income areas);
- Government-guaranteed loans;
- Investments directly in minority-owned businesses; and
- Investments in CDFIs serving small businesses and venture capital funds for minority-owned and inner-city businesses.

Specifically, with respect to small business credit, we continue to actively lend money to businesses every day to finance a wide variety of business projects, investments and working capital needs. In spite of the large increase in small business lending losses within our existing portfolio, Bank of America's overall amount of outstanding loans to businesses is relatively stable.

Current Credit Outlook

However, in contrast to the relative stability in our existing loan portfolio, we do expect to see a decrease in new loan commitments in 2009 to the smaller businesses in the segment. This is due to several factors:

1) Decreased demand for loans overall. Applications for new loans have been declining for well over a year. The primary reason for this trend appears to be an overall reluctance of business owners to take on new debt during a time of economic weakness. Many business owners have shelved investment and expansion plans until the economy improves. In fact, when we proactively call clients to offer business loans, this is the story we often hear.

2) Deteriorating financial condition of loan applicants. We have seen a noticeable increase in applications from clients who have strong past credit history and performance, but have hit a time of serious financial stress in their business and personal finances. Many clients who were deriving good income from their businesses a year ago have since faced a cash crunch. Often, their business income is down significantly from the previous year, and the business is facing a monthly cash shortfall or a large reduction in the owner's take-home pay. In their personal finances, these business owners are sometimes facing increasing expenses that exacerbate the cash crunch. When we underwrite loans for smaller businesses, we look at creditworthiness and current cash flow of both the business owner and the business itself to determine the ability to repay. So when business owners come to us in situations of financial stress – even if their credit scores are still good – we are often not able to approve them within our prudent lending guidelines.

3) Underwriting standards. During the period of 2005 – 2007, Bank of America expanded its focus on small business lending, particularly for the smallest businesses of the segment. Our underwriting guidelines at the time reflected a positive economic outlook as well as the experience of prior years, generally a period of economic strength with relatively low delinquency and loss levels for very small firms. However, as we began approving and booking more loans, we started to see a deterioration in these small businesses' ability to pay us back. The economic downturn exacerbated this problem and has led us to return to more prudent and sustainable underwriting standards to ensure acceptable credit quality for new loans. This is necessary for the future health of our loan book and our ability to continue to invest in new products and services for the small business segment.

From our perspective, these three factors are creating the contraction in new credit that we are seeing in our own client base.

Government assistance in loan programs has made a difference to our clients. Bank of America received a $45 billion preferred stock investment through the TARP program. While we cannot determine whether the next loan we make is funded by that money, we are lending significantly more with that investment than we would be without it.

Bank of America is a long-time participant in SBA loan programs. We are currently the #1 lender (in loan volume) in the SBA's 504 program and were the #1 lender (in units) for 10 years in a row in the SBA 7(a) Express program until last year. (In early 2008, a change in product strategy and underwriting standards began reducing the overall number of applications that were eligible for consideration under the SBA 7(a) Express program, but we remain an active participant in this program). Both the 504 and 7(a) Express programs allow us to provide credit to clients to supplement our conventional small business lending.

However, it is important to note that both programs together comprise only around 5 percent of our total loans outstanding to small businesses. This is because we use our conventional products and underwriting programs to approve the vast majority of clients who demonstrate the creditworthiness and cash flow to repay the loan. Regardless of the guaranty percentage, we need to have confidence in the client's ability to repay before extending credit.

In our view, the recent actions by the Obama Administration to assist small businesses will create new opportunities for lending to small businesses. In particular the 90 percent guaranty on traditional 7(a) loans is a positive development. However, we would encourage the SBA to go one step further and simplify the paperwork and documentation requirements in the 7(a) program. Bank of America has not participated in the traditional 7(a) program for several years because the heavy paperwork burden created dissatisfaction for our customers and significantly increased our origination costs. Bank of America currently works with a third-party non-bank to extend this program to clients who would benefit.

Regarding the 504 program, we would recommend expanding its scope to include refinancing of existing owner-occupied real estate debt. Currently, the SBA only allows for new expansion, purchase and construction, but does not allow debt to be refinanced. Expanding the program to include refinancing would allow businesses to reduce interest rates and payments and use the savings to retain jobs and increase investment in their businesses.

Conclusion

In summary, Bank of America remains committed to small and medium-sized businesses and considers this a very important segment to serve. We continue to market our credit products to the segment and adjust our business model to meet the needs of our clients during this economic downturn. For example, we have increased staffing in many parts of our loan origination process so we can spend more time consulting with clients to find the right credit solutions for their businesses. We are making every effort to approve as many clients as we can during this time, within prudent lending guidelines. While we expect to see many of our small business clients struggle through the next several quarters, Bank of America will continue to extend credit to this very important business segment.

Thank you for the opportunity to share our views today. I look forward to responding to any questions from the Committee.