Addressing the Financing Needs of Small Businesses

Summary of Key Themes from the Federal Reserve System's Small Business Meeting Series

Introduction

Since the start of the recession, bank lending to small businesses has contracted significantly: the number of loans to small businesses has dropped from 5.2 million loans in 2007 to 1.6 million in 2009.[1] To address this emerging credit gap, the Federal Reserve System's Community Affairs Offices hosted more than 40 meetings in 2010 as part of an initiative entitled "Addressing the Financing Needs of Small Businesses." The meetings brought together small business owners, small business trade groups, financial institutions and other private lenders, bank supervision officials, community development financial institutions (CDFIs), and other small business support service providers to discuss ways to improve credit flow to viable small businesses. The meetings highlighted numerous challenges related to both the supply of and demand for small business credit, but participants also highlighted possible solutions. This excerpt from the meeting proceedings document provides an overview of the key issues and recommendations that emerged from the convenings. For the full report, visit *Addressing the Financing Needs of Small Businesses,* available online at http://www.federalreserve.gov/events/conferences/2010/sbc/default.htm.[2]

At a meeting in Cincinnati, *small business owners said they were required to make cash payments when reassessments of LTV ratios resulted in insufficient collateral. If the payment was not made, the loan could be subject to default.*

Factors Impacting the Supply of Small Business Credit

One of the key themes that emerged in the stakeholder meetings was the contraction in the supply of small business credit since the start of the recession. The meetings identified several reasons why credit supply has shrunk. First, both small businesses and banks reported that underwriting standards had tightened considerably, leading to higher collateral requirements. For example, small businesses reported that routine re-evaluations of assets that directly or indirectly secure existing loans—including personal residences, commercial property, and equipment—have resulted in additional collateral requirements because of a significant drop in asset values. In addition, in some markets, banks noted they were no longer readily taking real estate as collateral, especially if there was another outstanding lien against the property. Many banks have also reduced their loan-to-value (LTV) thresholds. Banks and small businesses also concurred that strong cash flow is now one of the chief underwriting criteria. Another recent trend has been to require more personal resources and guarantees, such as higher personal credit scores. All of these factors have made it more challenging for small businesses to access credit.

Second, banks also indicated that their own resources have become more constrained during the recession, making it more difficult to process small business loans. For example, banks reported that higher-than-average delinquency and loss rates have taxed their workout units, forcing them to shift seasoned staff to assist with the increased number of problem loans. Some banks, particularly smaller banks, described a temporary suspension of all lending activities while they assess portfolios, manage workouts and distressed loans, and reevaluate collateral. Lack of capacity to process applications has led some banks to limit the types of applications that they will consider. Banks frequently said that they do not have enough time to handle applications with insufficient documentation, such as sparse tax returns or inadequate income statements. Some banks have significantly reduced or eliminated loans below a certain threshold, typically $200,000, as a way to limit time-consuming applications from smaller businesses. Banks also cited the imbalance between time commitment and returns as a reason for not participating in certain SBA loan products, such as the America's Recovery Capital or 7(a) loan programs.

Third, banks cited the regulatory environment and examination-related concerns as important factors in credit availability for small businesses. Banks noted that because of the declining asset values of their balance sheets, they have been required to raise capital to cover potential losses. Some banks also expressed frustration about their perception of conflicting messages from different government stakeholders. On the one hand, the banks feel pressure to lend, but at the same time they are encouraged to apply stricter credit standards and raise their capital requirements. The result is a more cautious approach to lending overall.

As a result of the contraction of small business credit from banks, many small businesses represented at the meetings said that they were turning to alternative, often higher cost, sources of financing. Small businesses described turning to credit cards in lieu of a bank loan, at the same time that their credit limits were being reduced. Businesses described, and several banks confirmed, that in some cases banks are recommending the use of credit cards in response to requests for smaller loans. Some small businesses also said they relied on home equity lines on their personal residence or on retirement savings. Family and friends are another source often mentioned for small business financing, particularly for start-ups.

The contraction in bank lending has also led to an increased demand for loans from other financial institutions, and many CDFIs and credit union participants noted an increase in small business loan demand over the last two years. However, meeting that demand is a challenge. CDFIs and credit unions have more limited access to capital and underwriting capacity. Credit unions also noted the statutory limitation on the percentage of small business loans they may make (12.25 percent of total assets). At several meetings, CDFI participants described the challenges in becoming authorized to provide loans under the SBA's 7(a) program.

At the Baltimore meeting, *several bankers said that they understand the frustration of small businesses that may be experiencing reduced cash flow during the recession but that had a solid track record before the downturn. They noted, however, that generally they cannot extend credit if there is no recent history of positive cash flow. According to one banker, even if a business has strong collateral, banks do not want to be in the business of taking collateral to recoup loan principal.*

In meetings in Nashville and Tampa, *several participants expressed the view that uncertainty about the duration, availability, and conditions of SBA program enhancements has made banks reluctant to invest the time to adapt to new program requirements.*

Factors Impacting the Demand for Small Business Credit

In addition to highlighting the many constraints to the supply of credit, the stakeholder meetings across the country also identified several ways in which the economic downturn has influenced demand for small business credit. On the one hand, the recession is leading consumers to spend less, which has depressed demand for goods and services. As sales drop, many small businesses are seeing weakened balance sheets and asset values, and a number of small businesses reported that declining sales made them more cautious about seeking credit. Uncertainty about business prospects in the near future further affected their credit and business decisions.

On the other hand, the high-unemployment environment may actually be generating demand as more individuals who are jobless seek to start their own business. Demand for technical assistance and help for new entrepreneurs is particularly high. Several bankers indicated that small businesses need help locating suitable lenders and technical assistance to prepare business plans and loan applications. Participants also noted heightened demand for technical assistance among minority-owned businesses, which may lack strong networks, limiting their access to financial resources, technical assistance, or mentoring.

Existing Credit Gaps

The combination of disruptions on both the supply and demand sides of the small business credit market has resulted in notable credit gaps. Participants pointed to a number of credit gaps, including reduced lines of credit and working capital and the inability to refinance loans (especially related to commercial real estate). Several small business participants cited the need for smaller dollar loans, particularly in amounts under $200,000. In addition, both banks and small businesses cited the need for sources of patient capital to assist small businesses in financing equipment and other large purchases. Start-up capital is particularly difficult to access. Start-up businesses have always had difficulty obtaining financing, but participants agreed that it is now almost impossible to secure bank credit, despite an increased demand for start-up financing as unemployed workers are looking to start businesses.

Identified Recommendations

At each of the meetings, stakeholders also identified policy and regulatory recommendations that could help to increase the flow of small business credit. Participants expressed the need for continued and consistent dialogue between financial institutions and examination staff and greater clarity of supervisory expectations from regulators. Another suggestion focused on establishing a means through which institutions can report concerns about or appeal an examiner's decision to the regulatory agency through a neutral intermediary such as an ombudsman. Some participants emphasized the need for greater Community Reinvestment Act (CRA) consideration for community development loans and investments such as Equity Equivalent Investments (EQ2s) or program-related investments. They also noted that banks should receive greater consideration for investments and grants that increase access to lending capital, loan-loss reserves, loan packaging, and technical assistance.

In Los Angeles, *meeting participants indicated that Asian Pacific Islander (API) small businesses rely heavily on personal real estate for their financing, and the significant decline in residential property values has led to a reduction in credit and rising delinquencies for API small business loans.*

Participants, particularly banks, expressed strong support for the SBA enhancements that extend fee waivers and increase the guarantee limits for the 504 and 7(a) programs, which were extended this fall. They also emphasized the need for certainty and clear expectations regarding the duration and terms of the enhancements, noting the challenges of adapting to periodic and temporary changes in the programs. There was also general support for more simplification and consistency in SBA regulations, guidelines, and processes to reduce confusion for both lenders and borrowers. Participants recommended improving access for CDFI loan funds to participate as guaranteed lenders in the SBA 7(a) program in order to increase the availability of credit to the underserved markets that CDFIs serve.

Overall, the meetings highlighted many ways in which CDFIs could be strengthened to meet some of the credit gaps, especially for small businesses that may not qualify under conventional bank standards. For example, there was support for more low-cost, longer-term capital for CDFIs. Participants also recommended that banks and CDFIs set up more effective and consistent processes for banks to refer small business applicants whose credit needs they cannot meet to CDFIs.

In St. Louis, *a participant stated that demand for technical assistance is up 150 percent at Small Business Development Centers (SBDCs). Some of this demand stems from increased interest in entrepreneurship among recently unemployed or underemployed individuals.*

Participants also recommended broader use of lender "second look" or similar programs to help ensure that viable applicants are not overlooked and that decisions such as credit-line reductions are warranted. Both pre- and post-financing technical assistance were identified as critical tools for risk-mitigation, helping to reduce the number of business failures, as well as a way to support business expansion. Additional suggestions focused on increased use of the SBA Service Corps of Retired Executives (SCORE) and other similar business counseling programs as well as initiatives that connect small businesses with each other to facilitate peer mentoring.

Participants noted the need for advisory services to provide guidance to small businesses on the different types of capital—from equity to debt—that would best match their financial state and funding needs. Some participants noted that the current dialogue about small business finance tends to emphasize debt even in cases where other forms of capital are more appropriate. Participants also noted that the multitude of government, non-profit, and private sector efforts around small business finance should include consideration of the entire capital structure.

Finally, participants expressed the need for timely, meaningful, and accurate data related to small business lending.

Conclusion

Through the small business stakeholder meetings, the Federal Reserve sought to deepen its understanding of the dynamics of the supply of and demand for small business credit, to identify specific credit gaps, and to learn of promising practices and suggestions for improvement. Within the 12th District, the Federal Reserve Bank of San Francisco will continue to convene local meetings to identify ways to overcome barriers to access to credit for small businesses. CI

New Community Development Working Paper

The Community Reinvestment Act and Small Business Lending in Low- and Moderate-Income Neighborhoods during the Financial Crisis

By Elizabeth Laderman and Carolina Reid, Federal Reserve Bank of San Francisco

This paper examines trends in small business lending in low- and moderate-income (LMI) neighborhoods by large banks regulated under the Community Reinvestment Act (CRA). Since 2007, small business lending has contracted significantly, particularly in areas that have also seen contractions in the housing sector. The results show significant spillover effects of the mortgage crisis into small business lending—for the economy as a whole as well as for LMI areas in particular. Available online at http://www.frbsf.org/publications/community/wpapers/

Endnotes

Making Up for Lost Time: Forging New Connections between Health and Community Development

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Banking Conditions in the 12th District: Has the Recovery Taken Hold?

1. For regulatory purposes, capital is divided into two segments, Tier 1 (core capital) and Tier 2 (supplemental capital). Tier 1 (or core capital) includes: common equity, surplus, and undivided profits (retained earnings); qualifying non perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries; less any amounts of goodwill, other intangible assets, interest only strip receivables and non financial equity investments that are required to be deducted, and unrealized losses on Available for Sale investment equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from Tier 1 capital. Tier 2 capital consists of a limited amount of the allowance for loan and lease losses; perpetual preferred stock that does not qualify for inclusion in Tier 1 capital; certain other hybrid capital instruments; mandatory convertible securities; long-term preferred stock with an original term of 20 years or more; and limited amounts of term subordinated debt, intermediate term preferred stock, including related surplus, and unrealized holding gains on qualifying equity securities.

Addressing the Financing Needs of Small Businesses

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2. Chairman Bernanke addressed the challenges facing small businesses, and the Federal Reserve's response, in his Semiannual Monetary Policy Report to the Congress on July 21, 2010, available at http://www.federalreserve.gov/newsevents/testimony/bernanke20100721a.htm