Economic Brief

Small Business Lending During the Recession

By Betty Joyce Nash and Kimberly Zeuli

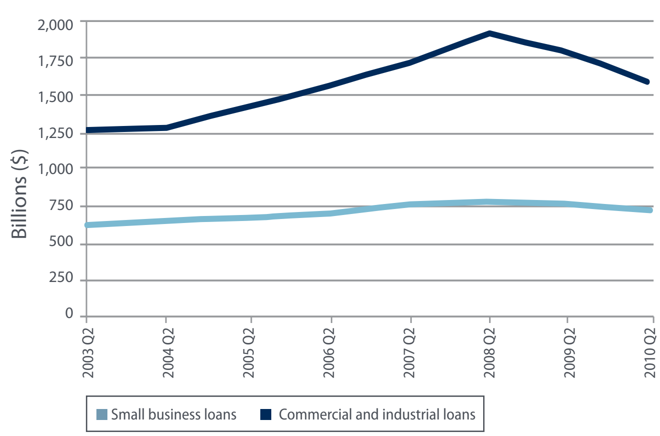
Access to credit enables businesses to smooth income streams and take advantage of growth opportunities. Without credit, a business may be forced to cut production or restrain growth. If credit constraints affect businesses across economic sectors, the result could be widespread declines in production and employment. Since the recession started in 2007, there has been a growing concern that small businesses may lack adequate access to credit. This *Economic Brief* examines the complexity of small business credit issues.

The Supply of Credit to Small Business

Access to credit enables businesses to smooth income streams and take advantage of growth opportunities. Without credit, a business may be forced to cut production or restrain growth. If credit constraints affect businesses across economic sectors, the result could be the widespread declines in production and employment that characterize a business cycle contraction. Small business credit affects a significant portion of the economy; small businesses employ, by some estimates, half of private sector workers.[1] In 2009, there were 27.5 million small businesses in the United States, according to the U.S. Small Business Administration (SBA).[2] Since the recession started in 2007, there has been a growing concern that small businesses may lack adequate access to credit.

A small business loan is defined as any loan of $1 million or less that has been secured by nonfarm nonresidential properties or is a commercial and industrial (C&I) loan that is reported by financial institutions on Schedule RC-C, Part II.[3] The value of small business loans at the end of third quarter 2010 was $700.5 billion, down from $722.1 billion in the second quarter of 2010 and well below the high of $780.6 billion in second quarter 2008. (Prior to 2010, these data were reported annually in the second quarter of each year; quarterly reporting began in the first quarter of 2010.) This number includes agricultural loans as

Figure 1: Small and All Business Lending for All Financial Institutions, 2003-2010



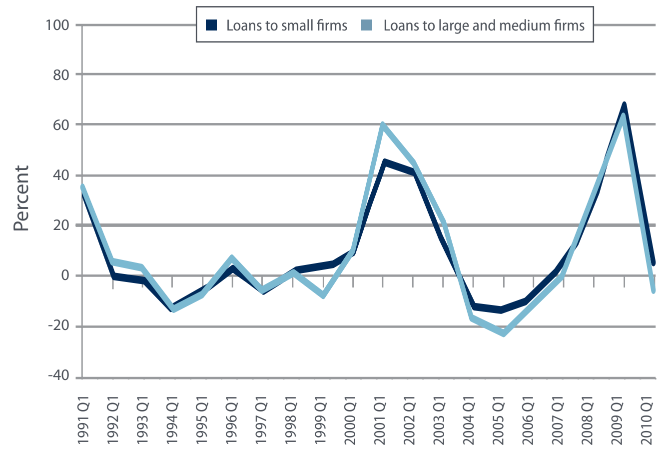
Note: All financial institutions includes commercial banks and savings institutions. The population of financial institutions for each time period varies. The values for C&I loans were calculated using the total amount of C&I loans plus the total amount of small business loans where loans were secured by real estate or used for the purpose of financing agricultural production. These data were collected on an annual basis every second quarter, but are now collected quarterly beginning in 2010. Source: Federal Deposit Insurance Corporation (FDIC) well as C&I loans. In general, the pace of small business borrowing and lending in the market has been weak.[4] It is worth noting that all business lending fell during this same period.

Reasons for Tighter Credit Supply

Most financial institutions consider lending to small businesses riskier and costlier than lending to larger firms, regardless of economic conditions. While small businesses typically apply for smaller loans, they experience higher rates of failure and are more affected by business cycle downturns. For example, in the Federal Reserve Board's quarterly Senior Loan Officer Opinion Survey on Bank Lending (SLOOS), 65 percent of loan officer respondents reported higher delinquency rates on small business loans compared to large and middle-market firms during fourth quarter 2009.[5] In addition, gleaning financial information about the creditworthiness of small businesses may involve higher transaction costs because there may be little available solid financial information. Banks now also must cope with new lending guidance and regulations; as a result, some loan officers, especially at smaller banks, have reported that they have less time to investigate the creditworthiness of small businesses.[6]

During the recession, banks reported tighter underwriting standards for small firms, but in the July 2010 SLOOS survey, banks reported easing standards on commercial and industrial loans to small firms for the first time since late 2006. In the latest survey, from October 2010, respondents reported mixed views when asked a special question about current levels of lending standards and expectations about future lending standards. When asked about C&I loans to large and middle-market firms, 63 percent of respondents said their standards are not tighter than their average level over the past decade; nearly 89 percent of respondents responded likewise about lending standards to small firms. However, for loans secured by commercial real estate, about 44 percent said they anticipated tighter lending standards for the foreseeable future, though the same percentage reported that current standards remained no tighter than their average over the past decade.

Figure 2: Net Percentage of Domestic Respondents Tightening Standards for C&I Loans



Source: Board of Governors of the Federal Reserve System

The tighter underwriting standards in place during the recession included greater collateral requirements. But values of collateral for many small businesses have declined, affecting the creditworthiness of borrowers. Business owners often use personal residences, commercial property, and equipment as collateral. According to a Federal Reserve Board Survey, 45 percent of the total dollar amount of small business loans in 2003 was collateralized by a real estate asset. And about 17 percent of small businesses use second mortgages as collateral for business loans, according to a forthcoming 2010 year-end survey report from the National Small Business Association (NSBA).[7]

The latest Federal Reserve Survey of Consumer Finances (SCF), in 2007, reveals just how closely small business finances may be tied to the personal finances of owners. The SCF notes that, in practice, balance sheets of family businesses aren't always separated from family finances. Families often use personal assets as business collateral or guarantees. In 2007, about 17.8 percent of families with actively managed businesses reported using personal assets as collateral, and 17.5 percent of families reported lending the business money. Families headed by a self-employed person were more likely to have home equity lines of credit: 20.4 percent of self-employed families, compared with 12.6 percent overall in 2007. Those families were also more likely to borrow against the line: 11 percent for families of the self-employed, compared to 8.5 percent of all families.[8]

In addition, about 95 percent of small employers own real estate, according to a February 2010 report on small business credit by the National Federation of Independent Business (NFIB).[9] That has made such small business owners more vulnerable during this recession, which was characterized by declining real estate values, and may further constrain borrowing ability.

The Role of the Small Business Administration

The U.S. Small Business Administration (SBA) backs small business loans in addition to offering other assistance such as counseling. SBA loans carry a government guarantee of between 50 percent and 85 percent of the outstanding loan balance, although those loans only represent about 1.3 percent of small business loans and 4.1 percent of outstanding small business loan dollars, according to a 2007 study by the U.S. Government Accountability Office.[10]

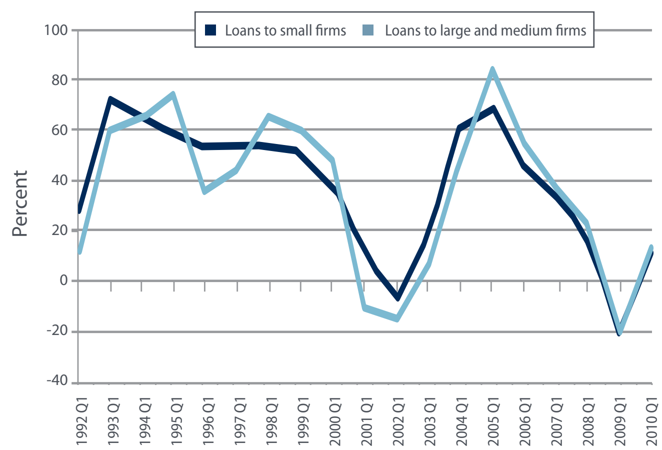
The 2010 Small Business Jobs Act created a $30 billion lending fund to provide small community banks with low-cost capital if they exceed 2009 small business lending levels. In addition, the Act establishes small business credit initiatives at the state level, funneling $1.5 billion to finance small business lending programs. The Act also extends $14 billion to the SBA Recovery Loan Provisions and permanently increases loan limits, from $2 million to $5 million, for two SBA loan programs. The Act also added eight new small business tax cuts.

Credit Demand and Credit Constraints

Part of the debate around small business credit conditions is whether decreases in supply translate into credit constraints. As sales fall in a down economy, businesses typically decrease inventory and the number of employees; they also postpone capital expenditures, thus decreasing their need for credit lines. During the recession, existing small businesses in general sought less credit in response to poor economic conditions.

The October 2010 SLOOS results indicated that demand for C&I loans had declined over the past three months, especially for firms with annual sales of less than $50 million. Loan officer respondents cited reduced financing needs for inventories and accounts receivable and reduced capital investment. Some small businesses have also reported not seeking credit because of weak sales, uncertainty about health care legislation, and economic trends.[11]

Figure 3: Net Percentage of Domestic Respondents Reporting Stronger Demand for C&I Loans



Source: Board of Governors of the Federal Reserve System

Demand for C&I loans may have declined, but loan officers also reported continued growth in the number of inquiries about new or increased lines of credit. (Unlike a loan, a line of credit is not a fixed amount; a borrower may withdraw funds up to a given credit limit, and only pays interest on the actual amount borrowed.) This may reflect an increasing demand from start-up businesses or existing businesses with cash flow issues. Long-term unemployment has created a new pool of entrepreneurs who are seeking funds to start new businesses. In addition, informal credit flows from friends and family have tightened along with negative economic conditions, potentially driving more people to banks for credit. Small business surveys also show some evidence of customer switching — that is, small businesses seeking out new banks. According to a 2009 NFIB special survey, 52 percent of respondents approached two or more banks for a new line of credit.[12]

The most recent NFIB monthly survey, published in January 2011, found that 91 percent of respondents said either that credit needs were met or that they were not interested in borrowing. Only 30 percent of small businesses reported borrowing regularly. Planned capital spending remained at 37-year lows.[13] And the NSBA found in its 2010 year-end survey that 26 percent of responding members cited lack of available capital as a problem, compared to 29 percent at mid-year and 24 percent at the end of 2009.

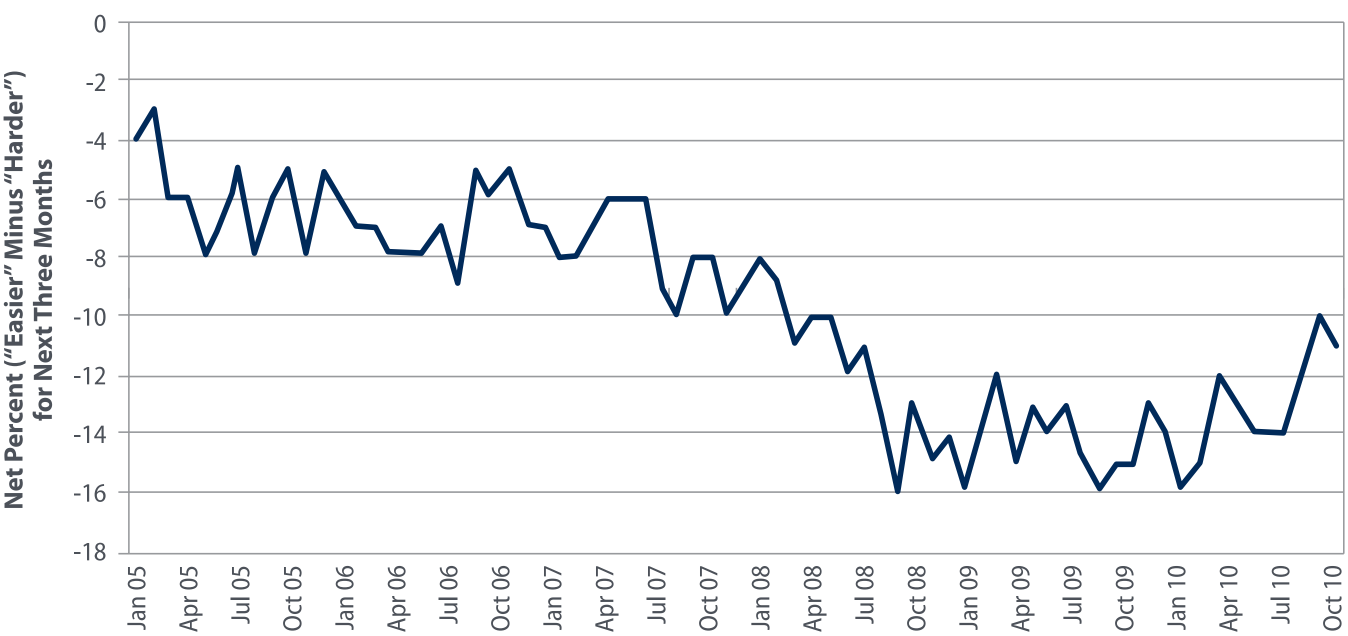
According to the January NFIB survey, the majority of small businesses still expect credit conditions to get harder during the next three months. Expectations hit historic lows during October 2008 through April 2010. This historically negative outlook reflects the fact that access to credit can be challenging for many small businesses, even under robust economic conditions, for the aforementioned reasons.

Though small businesses obtain credit from a variety of informal and formal sources, financial institutions remain a primary source of credit. According to the NSBA's 2010 year-end survey, 45 percent of respondents received credit from banks, up from 43 percent mid-year.[14] Large banks hold the majority of small business loans, but most of the loans made by small banks (defined as banks with assets of less than $250 million) qualify as small business loans. In other words, large banks are an important source of credit to small businesses, but small businesses are more important to small banks.

The NFIB found in its 2001 "Credit, Banks, and Small Business Survey" that the average travel time between a small business and its primary financial institution was 9.5 minutes.[15] Such use of local credit can constrain small firms, who have forged relationships with community banks. They may be more affected by local credit supply conditions than firms willing to search beyond their region for credit, or that have already established relationships with large national banks. Unfortunately, it is difficult to assess spatial credit constraints because the call report data from banks does not indicate the location of the borrower.

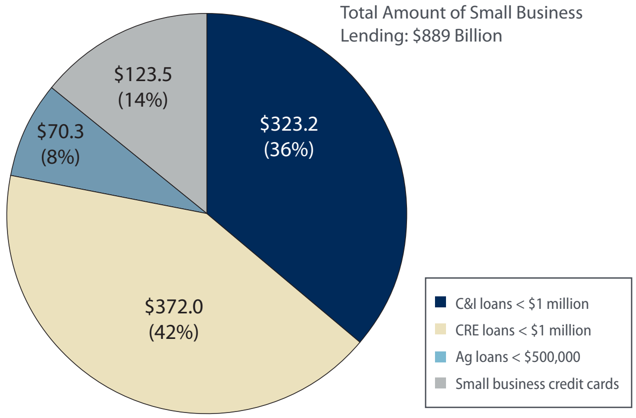
Since 1990, an increasing number of small businesses have used credit cards to help finance operations. Spending on small business credit cards tripled between 2002 and 2007, according to the Nilson Reports, to about $150 billion. Credit cards made up roughly 14 percent of small business credit in 2009.[16]

Figure 4: Small Business Expectations of Credit Conditions for Next Three Months



Source: National Federation of Independent Business

Figure 5: Small Business Lending in 2009 ($ Billions)



Note: FDIC data were collected on a annual basis every second quarter, but are now collected quarterly beginning in 2010.
Source: FDIC; Nilson Report

Small business credit cards are often offered after pre-screening, and card issuers also use credit bureau reports to assess creditworthiness. Standards for small business credit card approvals have also tightened. In answer to a special question on the April 2010 SLOOS, two-thirds of respondents said standards were tighter than the long-run average. Credit card issuers cite the following as reasons: higher costs for small business cards compared to consumer cards, required judgmental review in addition to automated review, difficulty of fraud detection, larger losses on delinquent card accounts, and concerns about collecting overdue balances.

Conclusion

Small business credit issues are complicated by an array of factors that influence credit supply and demand. While this recession may have left some small firms vulnerable and possibly credit constrained, it is not a straightforward credit supply problem. Financial institutions have also reported low demand from creditworthy small businesses during the recession.

This recession may have constrained the ability and the willingness of small businesses to borrow and spend. But as business picks up, firms will begin to hire as well as invest in plants and equipment. And as banks' balance sheets improve and their familiarity with new guidance and regulations increases, the demand for and supply of small business credit will likely increase. ■

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Endnotes

[1] Ben S. Bernanke, "Restoring the Flow of Credit to Small Businesses." Remarks at the Federal Reserve Small Business Meeting Series, Washington, D.C., July 12, 2010.

[2] The SBA defines a small business as one with fewer than 500 employees. By that metric, 99 percent of all firms in the U.S. would be classified as small businesses.

[3] This is commonly referred to as the Call Report and is available to the public at https://cdr.ffiec.gov/public/.

[4] Some studies also include credit cards as a source of small business credit. See, for example, Board of Governors of the Federal Reserve System, "Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses," May 2010. Online: http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2010/052010_cc_use_smbusiness.htm.

[5] Board of Governors of the Federal Reserve System, "Senior Loan Officer Opinion Survey on Bank Lending Practices," January 2010. Quarterly SLOOS online at http://www.federalreserve.gov/boarddocs/snloansurvey/.

[6] Board of Governors of the Federal Reserve System, "Addressing the Financing Needs of Small Businesses." Forum held July 12, 2010 in Washington, D.C.

[7] National Small Business Association, "2010 Year-End Economic Report," forthcoming. Previous surveys online at http://www.nsba.biz/surveys.shtml.

[8] Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, February 2009.

[9] William J. Dennis, "Small Business Credit in a Deep Recession," National Federation of Independent Business, February 2010. Online: http://www.nfib.com.

[10] U.S. Government Accountability Office, "Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance," July 2007. Online: http://www.gao.gov/new.items/d07769.pdf.

[11] William Dunkelberg and Holly Wade, "NFIB Small Business Economic Trends," January 2011. Online: http://www.nfib.com/Portals/0/PDF/sbet/sbet201101.pdf.

[12] See NFIB, "Small Business Credit in a Deep Recession."

[13] See Dunkelberg and Wade, "NFIB Small Business Economic Trends."

[14] See NSBA, "2010 Year-End Economic Report."

[15] The NFIB survey of its 300,000 to 400,000 members dates from 1974; it has been performed monthly since 1986. Membership may not represent small businesses as it includes many well-established businesses.

[16] Nilson Report, Issue 951, June 2010. Online: http://www.nilsonreport.com/issues/2010/951.htm.