Small Businesses Need Big Ideas: The Federal Reserve Examines the Challenges of Small Business Financing

According to the U.S. Bureau of Labor Statistics, small businesses accounted for 34 percent of new jobs during the last period of economic growth between 2004 and 2007.[1] However, in the recessionary years between 2007 and 2009, small businesses were responsible for 38 percent of job losses.[2] The clear consensus is that small businesses play a critical role in job creation and economic stability in this country, a truth that is sending researchers and policymakers in search of a better understanding of the challenges small businesses face and the interventions needed to bolster their job creation capacity and overall sustainability.

Access to credit is among the frequently mentioned barriers to the stabilization and growth of small businesses. To learn more about small business credit issues and to inform policymakers about promising practices to address credit needs, the Federal Reserve System engaged in a national initiative called "Addressing the Financing Needs of Small Businesses." This initiative combined qualitative data, collected directly from stakeholders, with academic research and quantitative data to develop targeted policy recommendations.

What Is Driving Small Business Credit Access Issues: Supply or Demand?

Small business owners and lenders agree that credit has tightened for small businesses in the past few years. Data from the Federal Financial Institution Examination Council (FFIEC) indicate that the outstanding volume of small business loans dropped from $710 billion in the second quarter of 2008 to less than $670 billion in the first quarter of 2010. According to lenders participating in the October 2010 Federal Reserve Senior Loan Officer Survey, demand from small businesses was weaker in the last survey period, reportedly due to reduced financing needs for inventories, accounts receivable, and investments in equipment. Lenders also reported for the second consecutive survey that credit standards and terms for small businesses, which had tightened over the past four years, continue to ease. Clearly, supply-and-demand dynamics are at work in small business credit access. The question remains, however, what policies can best bring these dynamics into balance to both encourage safe lending and strengthen small businesses as loan recipients.

The Federal Reserve Approach: Convene, Listen, and Educate

LOCAL STAKEHOLDERS PAINT A PICTURE OF SMALL BUSINESS NEEDS

The Federal Reserve System convened more than 40 regional meetings across the country between February and July 2010 to look at the credit challenges facing small businesses. The events brought together lenders, small business technical assistance providers, small business owners, community development financial institutions (CDFIs), and government agencies to share their perspectives on small business credit access, technical assistance needs, and

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recommendations for addressing challenges. The findings of these regional meetings were compiled and presented before a national audience of decision makers, including representatives from the Federal Reserve Board, the U.S. Small Business Administration, and the U.S. Department of the Treasury's CDFI Fund at a one-day meeting held in Washington, D.C., on July 12, 2010. The Federal Reserve Bank of Atlanta supported this initiative by hosting meetings in all Sixth District states and contributing to a written summary document that served as an addendum to Federal Reserve Chairman Ben Bernanke's semiannual monetary policy testimony later that same month.

Meeting participants across the country generally agreed that the economic crisis had negatively affected small businesses, leading to declining sales, weaker balance sheets, and diminishing asset values. In this inauspicious environment, small businesses have been reluctant to take on new debt. Moreover, the general creditworthiness of many small business owners had declined during the recession, making it much more difficult to be approved for loans.

While there was agreement that demand had weakened, meeting participants differed in their assessment of the availability of credit and what factors may be impacting credit supply. Comments related to credit supply generally fell into four broad areas:

- Tighter bank underwriting standards have made it more challenging to obtain financing.
- Banks have fewer resources for new lending as they struggle to manage problem loans and toxic assets on their books.
- Heightened regulatory scrutiny, whether real or perceived, and increased capital requirements may have made some financial institutions more reluctant to issue new or higher risk loans.
- Small businesses are increasingly turning to alternative financing sources, such as credit cards and CDFIs, in lieu of bank financing.

Several participants suggested that weaker demand for credit does not indicate a diminished need for technical assistance. Technical assistance providers—organizations that support businesses with advisory and planning services—in many of the meetings noted that they had seen a significant increase in demand for their services, from both new and existing businesses. Existing businesses were seeking assistance with managing the challenges of the recession and the tighter credit environment. New entrepreneurs—including the long-term unemployed in some cases—were requesting assistance in launching businesses to improve their earnings and financial stability.

SMALL BUSINESSES HAVE A VARIETY OF CREDIT NEEDS

Meeting participants agreed on several important gaps in the credit available to small businesses. Across the country, lines of credit and working capital were identified as the biggest needs. Small business resource providers reported that banks had reduced credit lines for many of their clients, which impaired the ability of small businesses to manage their cash flow. Other practitioners noted that their clients were struggling to get new lines of credit, which they needed to fulfill orders, because of recent financial difficulties. With lenders looking only at historical performance and not future projections, those small businesses in a position to grow were struggling to find financing.

Loans under $200,000, often referred to as small-dollar loans, were identified as another gap in the current credit environment. Large banks have turned to automated underwriting models as the only profitable way to offer small loans. Automated underwriting models are driven primarily by the business owner's credit score. Reportedly, banks denied small business owners their loan requests because they failed to meet the required credit score thresholds. Community banks, credit unions, and CDFIs appear to have greater flexibility in their underwriting standards, which may allow them to help fill this gap.

A further observation that meeting participants made was the impact of declining commercial and residential real estate values, a situation that made it virtually impossible to obtain new loans and refinancing credit for businesses in these sectors. This need is particularly acute in markets like South Florida, where the decline in real estate values has been especially steep. Finally, many participants mentioned

the ever-present need for start-up capital as new business owners struggle to find financing to launch operations.

Money Isn't Everything: Recommendations for Increasing Small Business Financing Options

Six categories of actions for addressing small business credit issues were identified at the national meeting and through the regional forums:

- Make changes to Small Business Administration programs, such as extending indefinitely the higher loan guarantee limits and fee waivers put in place by the 2009 American Recovery and Reinvestment Act.[3]
- Address regulatory concerns to improve communication between banks and regulators in addition to adding more clarity around supervisory practices, and consider providing greater CRA—Community Reinvestment Act—consideration for small business credit and investment activities.
- Encourage lenders to offer "second-look" programs for all denied loan applications and develop a better process for referring businesses to alternative financing and technical assistance resources.
- Increase funding to support lending, operations, and technical assistance for CDFIs, and improve the referral network between banks and CDFIs.
- Provide technical assistance to small businesses before and after they receive financing, and encourage advisory service providers to consider the entire financing continuum from equity to debt.
- Engage in more research and data collection efforts to have more timely and comprehensive data on small business lending activities.

The Federal Reserve System, through its Community Affairs offices, is developing strategies to address the issues identified in these regional forums. Possible initiatives include adding listening tours, developing local small business networks or task forces, and supporting innovative small business research. The Atlanta Fed will focus on hosting additional forums to continue learning about the credit needs in rural and urban markets. The Atlanta Fed will also examine the role of CDFIs in small business lending in greater depth and try to identify ways to improve linkages between banks and small business assistance providers. ■

This article was written by Jessica Farr, Senior Community Development Specialist at the Nashville Branch of the Atlanta Fed.

For more information about the Federal Reserve System initiative "Addressing the Financing Needs of Small Businesses," please visit: http://www.federalreserve.gov/events/conferences/2010/sbc/default.htm.

Small Business Focus: An Online Source

Recognizing that small business has long been one of the primary engines of the economy, the Atlanta Fed has created Small Business Focus. This online resource brings together data, Atlanta Fed initiatives, and research related to small business issues. Our interest in small business focuses on three related issues:

- The role of small business in job creation
- The role of small business in local economic development
- The role of the banking system in small business financing

For more information, go to http://www.frbatlanta.org/research/smallbusiness/.

Endnotes

1 Bureau of Labor Statistics, Business Employment Dynamics, http://www. bls.gov/bdm.

2 Ibid.

3 The Small Business Jobs Act of 2010, signed into law in September 2010, addressed many of the recommended changes related to the Small Business Administration.