Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

To:	Members, Subcommittee on Economic Growth, Tax and Capital Access
From:	Committee Staff
Date:	December 2, 2013
Re:	Hearing: "Where Are We Now? Examining the Post-Recession Small Business Lending Environment"

On Thursday, December 5, 2013 at 10:00 a.m., the Subcommittee on Economic Growth, Tax and Capital Access of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of exploring the current state of lending to small businesses. The hearing will examine the factors that continue to depress lending by federally regulated financial institutions, the response by conventional lenders, such as commercial banks, and the rise of new and innovative lending platforms that seek to satisfy the demand for debt capital that is currently not being met by banks and other conventional lenders.

I. Introduction

Nearly two-thirds of small business owners seeking capital report that a loan from a bank is their expected source of financing in the next six months.[1] Although commercial bank loans, commonly referred to as a "traditional source" of capital for small businesses, are clearly the most sought after, data compiled from Federal Deposit Insurance Corporation (FDIC) call reports on loans issued under $1 million exhibit a decline in both value and volume from pre-recession levels.[2]

According to the FDIC, in the third quarter of 2013, when adjusted for inflation, the value of commercial and industrial loans less than $1 million was at 78 percent of levels recorded in the third quarter of 2007.[3] The number of issued loans less than $1 million also dropped significantly during this time period, from over 25 million in the second quarter of 2008 to just

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[1] JOHN K. PAGLIA, CRAIG EVERETT, PEPPERDINE UNIVERSITY, PEPPERDINE PRIVATE CAPITAL ACCESS INDEX SURVEY RESPONSES THIRD QUARTER 2013, at 41 (2013) [hereinafter Pepperdine Survey], *available at* http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey/content/q3_2013_pca_index.pdf.

[2] It is not possible to state whether all of the loans under $1 million are made to small businesses. The FDIC requires that call reports specify the total number of loans of less than $1 million. However, those call reports do not require the specification of whether the business is large or small under definitions established by the Small Business Administration. As a result, the total number of loans made under $1 million may be either over- or underinclusive of the total number of small businesses receiving loans from banks subject to federal regulation. In addition, the call report data excludes commercial lending from credit unions since they do not provide call reports to the FDIC. Finally, the SBA loan programs offer loans in excess of $1 million to small businesses. Despite these caveats, the call reporting data represent the best, albeit flawed proxy, for overall (as opposed to lending through SBA guaranteed loans) small business lending by commercial banks.

[3] http://www2.fdic.gov/qbp/timeseries/SmallBusiness&FarmLoans.xls.

over 21 million in the second quarter of 2013.[4] Recently, there has been an upward trend in the number of small loans issued, with 1.7 million more loans under $1 million issued in the second quarter of 2013 than the same time period in 2011.[5] Nonetheless, the most recent data indicates the number of small loans has not returned to pre-recession levels.

This aggregate decline in small commercial loans may be hampering the nation's economic recovery. Small businesses employ half of the private sector, create two-thirds of new jobs, and account for more than 40 percent of the private sector's contribution to gross domestic product.[6] If they are unable to obtain needed debt capital, they will be unable to sustain or expand thereby dampening economic growth.

II. Possible Reasons for Decline in Bank Lending

Analysts point to a variety of converging factors that have caused declines in the availability of credit for small businesses since the recession. They also note that bankers, small business owners, and regulators generally point to different sources to account for the drop in lending.[7]

a. Loan Demand

Bankers and other economists point to lower levels of demand from small business borrowers as a reason lending levels are lower now than before the recession. Data from the Wells Fargo/Gallup Small Business Index, a survey of 600 small business owners with up to $20 million a year in sales,[8] shows that in the third quarter of 2007, 30 percent of small businesses planned to increase capital spending in the next 12 months.[9] By the third quarter of 2013, the number of those seeking to increase capital investment in the next year had fallen to 26 percent.[10]

While demand from small businesses for capital remains at lower levels than before the recession, there is conflicting data on what has happened in the last few years. Data from the Federal Reserve Board shows an increase in loan demand from small business owners from the

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[4] *Id.*

[5] *Id.*

[6] SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS (Sept. 2012), *available at* http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

[7] http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm.

[8] The Wells Fargo/Gallup Small Business Index's use of sales up to $20 million as representative of small businesses serves as an example of the wide array of often conflicting definitions of "small business" for the purpose of quantifying the number of small businesses seeking loans. Other individuals and organizations use definitions of $1 million in sales, $5 million and sales, and $10 million in sales to serve as a proxy for "small business," further muddying an accurate reading of the small business lending environment. None of these standards coincide with the official definitions of small business adopted by the SBA.

[9] WELLS FARGO/GALLUP, SMALL BUSINESS INDEX 3RD QUARTER 2013, AT 17 [hereinafter Wells Fargo/Gallup], *available at* https://wellsfargobusinessinsights.com/q3-2013-small-business-index-survey-results.

[10] *Id.*

first quarter of 2012 to the third quarter of 2013.[11] Yet Pepperdine University's survey of small business owners with less than $5 million in annual revenues indicated a 5.7 percent decrease in demand for private capital from the third quarter of 2012 to the third quarter of 2013.[12]

One possible reason for a decrease in loan demand from pre-recession levels to today is the belief by many small business owners that capital will be difficult to obtain, preventing them from seeking it in the first place. According to the Pepperdine survey, 62 percent of small business owners with less than $5 million in annual revenues say it will be difficult to raise new debt financing in the next six months.[13] The belief that credit will be difficult to obtain could be an indication of an increasing number of small business owners no longer seeking debt capital from banks.

b. Lending Standards

Increased regulatory scrutiny and lending standards for banks brought on by the recession and the banking failures of 2008 also could be a contributing factor to less loans made to small businesses. According to the Office of the Comptroller of the Currency's annual Survey of Credit Underwriting Practices, banks tightened small business credit standards in each of the three years following the 2008 recession.[14] And in the latest survey conducted in 2012, 70 percent of banks reported no change in their previously tightened standards, while only 14 percent reported easing standards.[15] Additionally, in a June 2012 survey of loan officers by the Federal Reserve Board, nearly 40 percent reported standards are tighter now than at their midpoint in 2005.[16]

Lending standards appear to be loosening recently, but pressure still remains for smaller banks, which account for the majority of lending to small businesses.[17] The July 2013 survey of loan officers by the Federal Reserve Board reported an easing of credit conditions from levels the year before, with domestic banks saying standards have eased over the previous three months.[18] Despite the data from the Federal Reserve Board survey, regulatory pressures on smaller banks will prevent them from relaxing tightened lending standards.[19]

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11 http://www.federalreserve.gov/boarddocs/SnLoanSurvey/.
12 Pepperdine Survey, *supra* note 1, at 9.
13 *Id.* at 40.
14 http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm.
15 OFFICE OF THE COMPTROLLER OF THE CURRENCY, 2012 SURVEY OF CREDIT UNDERWRITING PRACTICES 5, *available at* http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/pub-survey-cred-under-2012.pdf.
16 http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm.
17 Although small and mid-sized banks ($10 billion or less in assets) control only 22 percent of all bank assets, they account for 54 percent of small business lending. http://www.ilsr.org/banks-and-small-business-lending/.
18 Board of Governors of the Federal Reserve System, The July 2013 Senior Loan Officer Opinion Survey on Bank Lending Practices, *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/201308/fullreport.pdf.
19 DELOITTE, 2014 BANKING INDUSTRY OUTLOOK 4,8 (2013) *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us_fsi_DCFS2014BankingIndustryOutlook_111113.pdf.

c. Creditworthiness of Small Businesses

Small businesses are generally viewed as riskier borrowers now than before the recession, though recently, creditworthiness for them has been improving. Dun and Bradstreet reports an increase in the percentage of small business delinquencies from 2 percent in 2007 to 5 percent in 2012.[20] Yet in the last two years, according to Experian/Moody's Analytics Small Business Credit Index, credit quality of small businesses has been rising. This year's third quarter mark of 118.5 is 15 points higher than its reading of just over 103 in the fourth quarter of 2011.[21] Given the finding of Experian/Moody's Analytics, it is not surprising that Dun and Bradstreet's third quarter 2013 Small Business Health Index reported more on-time payments combined with less use of credit cards, and a reduction in credit card delinquency.[22]

The tightened lending standards have forced banks to secure more loans based on collateral than in the past. According to the Federal Reserve Board, in the third quarter of 2007, 77 percent of loans under $1,000,000 were secured by collateral, compared to 83 percent in the third quarter of 2013.[23] As collateral is increasingly required by banks, the value of the most common form of collateral - real estate -- has decreased, further limiting the capacity of small businesses to obtain debt capital.[24]

Cash balances held by small businesses are lower now than before the recession, further reducing the number of small businesses that are deemed creditworthy by banks. According to the Wells Fargo/Gallup Small Business Index, in the third quarter of 2007, 65 percent of small businesses rated their current cash-flow as "good;" in the third quarter of 2013, only 48 percent reported it favorably.[25] Though lower than pre-recession levels, this number is still significantly higher than the low of 36 percent reporting favorable cash-flows in the third quarter of 2010.[26] It is clear that many forces are acting in unison to affect levels of bank lending to small businesses.

III. Emerging Alternative Lending Options

It is important to note new alternatives to bank lending for small business owners that are arising in part due to lending levels that have not yet returned to where they were before the

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[20] http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm.

[21] EXPERIAN/MOODY'S ANALYTICS, SMALL BUSINESS CREDIT INDEX Q3 2013, at 3 (2013), *available at* http://www.experian.com/assets/business-information/experian-moodys-small-business-credit-index/experian-moodys-analytics-small-business-credit-index-q3-2013.pdf.

[22] http://www.dnb.com/content/dam/english/dnb-solutions/risk-management/small_business_health_index_2013_10.pdf.

[23] http://www.federalreserve.gov/releases/E2/current/default.htm.

[24] According to the Case-Shiller Home Price Index, although higher than its lowest point in 2011, the seasonally-adjusted home price index for April 2013 was 73.8 percent of its highest point in July 2006. http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm.

[25] Wells Fargo/Gallup, *supra* note 8, at 11.

[26] *Id.*

recession.[27] Lending Club, a peer-to-peer lender that has helped facilitate over $2.5 billion in personal loans, is launching a small business lending platform in early 2014 with a goal of being an alternative to bank financing.[28] Backed by individual investors, investment funds, and institutional investors, the platform is able to operate with lower costs than traditional banks, primarily due to its internal automated loan approval and disbursement processes.[29]

Another example is Quarterspot. The company recently began an online lending platform to provide small businesses with loans in as little as 24 hours with a five-minute application process.[30] The loans do not require personal guarantees, as all underwriting decisions are based solely on the financial health of the business applying.[31] Merchant processer PayPal recently entered the small business loan market with the establishment of its Working Capital Program.[32] Through the program, PayPal merchants[33] can borrow up to 8% of their revenues, or a maximum of $20,000.

IV. Conclusion

Although recent data show levels of small commercial loans and creditworthiness of borrowers on the rise compared to the previous four years, they are still lower than those of the pre-recession period of 2007 and the first two quarters of 2008. Researchers have pointed to a variety of factors keeping small business lending from returning to pre-recession form. In the meantime, reductions in conventional avenues for borrowing have been filled by new financing vehicles.

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[27] Brock Blake, *Small Business Lending: Banks and Credit Unions Are Getting Left Behind*, CHICAGO TRIB., Oct. 21, 2013, *available at* http://www.chicagotribune.com/business/chi-nsc-small-business-lending-banks-and-credit-unions-20131021,0,1326461.story.

[28] Tomio Geron, *With IPO In Sight, Lending Club Looks To Upend Banking Industry*, FORBES, Oct. 18, 2013, *available at* http://www.forbes.com/sites/tomiogeron/2013/10/18/with-ipo-in-sight-lending-club-looks-to-upend-banking-industry/.

[29] *Id.*

[30] Quarterspot, *QuarterSpot Launches New Small Business Lending Platform*, YAHOO FINANCE, June 20, 2013, *available at* http://finance.yahoo.com/news/quarterspot-launches-small-business-lending-120600007.html.

[31] *Id.*

[32] Patrick Clark, *PayPal Breaks Into Small Business Lending*, BUSINESSWEEK, Sept. 24, 2013, *available at* http://www.businessweek.com/articles/2013-09-24/paypal-breaks-into-small-business-lending.

[33] PayPal merchants are those business that use PayPal's merchant processing services in order to receive payment online, through mobile devices, or in retail locations. https://www.paypal.com/webapps/mpp/merchant.