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Committee on Small Business

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Chairman Rice, Ranking Member Chu, and distinguished members of the subcommittee, it is an honor to testify before you today on the state of small business lending. My testimony will focus on the decline in lending to small businesses and the factors that are driving that decline.[1] My remarks represent my own views and are not official views of the Federal Reserve Bank of Cleveland or any other element of the Federal Reserve System.

Background

Recent industry and media reports provide a mix of perspectives on the state of small business lending. Contradictory messages abound, and often result from inconsistent definitions of what constitutes a small business and from the absence of comprehensive and reliable data on small business lending. Banks and government agencies use a wide range of parameters to classify firms as small businesses. One frequently cited definition of what constitutes a small business is so expansive that it includes more than 99 percent of the businesses in the U. S. It should not come as a surprise that we hear so many differing reports about small business conditions when firms of so many different sizes and industries are compared with one another by analysts relying on different definitions of a small business. In addition, the considerable lack of data on small business lending and the variance in the size of firms or loans included in the lending data leads to inconsistency in reporting among the data that are available.

Small business lending has dropped substantially since the Great Recession. While some measures of small business lending are now above their lowest levels since the economic downturn began, they remain far below their levels before it. For example, in the fourth quarter of 2012, the

[1] The analysis presented in this Statement draws extensively from the Federal Reserve Bank of Cleveland publication, “Why Small Business Lending Isn’t What It Used To Be,” Ann Marie Wiersch and Scott Shane, 2013. (http://www.clevelandfed.org/research/commentary/2013/2013-10.cfm).

value of commercial and industrial loans of less than $1 million – a common proxy for small business loans – was 78.4 percent of its second-quarter 2007 level, when measured in inflation-adjusted terms.[2]

Some policymakers are concerned that the decline in small business lending may be hampering the economic recovery. Small businesses employ roughly half of the private sector labor force and provide more than 40 percent of the private sector's contribution to gross domestic product. If small businesses have been unable to access the credit they require, they may be underperforming, slowing economic growth and employment.

Industry participants, including small business owners, bankers, and regulators have offered differing reasons for the decline in lending. However, recent analysis by the Federal Reserve Bank of Cleveland shows that there is no single explanation, but rather a number of factors driving this trend. Fewer small businesses are interested in borrowing than in years past, and at the same time, small business financials have remained weak, depressing small business loan approval rates. In addition, collateral values have stayed low, as real estate prices have declined, limiting the amount that small business owners can borrow.

Furthermore, increased regulatory scrutiny has caused banks to boost their lending standards, resulting in a smaller fraction of creditworthy borrowers. Finally, shifts in the banking industry have had an impact. Bank consolidation has reduced the number of banks focused on the small business sector, and small business lending has become relatively less

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[2] As reported by the Federal Deposit Insurance Corporation (http://www2.fdic.gov/qbp/). This report focuses on traditional commercial bank lending, as it is the most frequently utilized source of small business credit. According to a 2011 survey by the National Federation of Independent Businesses (http://www.nfib.com/research-foundation/surveys/credit-study-2012), 85 percent of businesses reported that a commercial bank was their primary financial institution, while only 5 percent has such a relationship with a nondepository financial institution (such as private finance companies).

profitable than other types of lending, reducing some bankers' interest in the small business credit market.

Because none of these factors is the sole cause of the decline in small business credit, any proposed intervention should account for the multiple factors affecting small business credit.

Weaker Demand for Credit

Small businesses were hit hard by the economic downturn. Analysis of data from the Federal Reserve Survey of Consumer Finances reveals that the income of the typical household headed by a self-employed person declined 19 percent in real terms between 2007 and 2010. Similarly, Census Bureau figures indicate that the typical self-employed household saw a 17 percent drop in real earnings over a comparable period.[3]

Weak earnings and sales mean that fewer small businesses are seeking to expand. Data from the Wells Fargo/Gallup Small Business Index – a measure drawn from a quarterly survey of a representative sample of 600 small business owners whose businesses have up to $20 million a year in sales – show that the net percentage of small business owners intending to increase capital investment over the next 12 months fell between 2007 and 2013. In the second quarter of 2007, it was 16 (the fraction intending to increase capital investment was 16 percentage points higher than the fraction intending to decrease capital investment), while in the second quarter of 2013, it was negative 6 (the fraction intending to decrease capital investment was 6 percentage points higher than the fraction intending to increase it). Similarly, the net percentage of small

3 Federal Reserve Survey of Consumer Finances (http://www.federalreserve.gov/econresdata/scf/scf_2010.htm); Census Bureau: Income, Poverty, and Health Insurance Coverage in the United States: 2010 (http://www.census.gov/prod/2011pubs/p60-239.pdf).

business owners planning to hire additional workers over the next 12 months was 24 in the second quarter of 2007, but only 6 in the second quarter of 2013.[4]

Reduced small business growth translates into subdued loan demand. Thus, it is not surprising that the percentage of small business members of the National Federation of Independent Businesses (NFIB) who said they borrowed once every three months fell from 35 percent to 29 percent between June 2007 and June 2013.

Some of the subdued demand for loans may stem from business owners' perceptions that credit is not readily available. According to the Wells Fargo/Gallup Small Business Index survey, in the second quarter of 2007, 13 percent of small business owners reported that they expected that credit would be difficult to get in the next 12 months. By the second quarter of 2013 that figure had increased to 36 percent. By contrast, 58 percent of small business owners said credit would be easy to get during the next 12 months when asked in 2007, compared to 24 percent six years later.

Reduced Credit Supply

Lenders are approving fewer small business loan applications, since many firms lack the cash flow, credit scores, and collateral that banks require. According to the latest Wells Fargo/Gallup Small Business Index, 65 percent of small business owners said their cash flow was "good" in the second quarter of 2007, compared to only 48 percent in the second quarter of 2013.

[4] Wells Fargo Gallup Small Business Index (https://wellsfargobusinessinsights.com/research/small-business-index).

Small business credit scores are lower now than before the Great Recession. The Federal Reserve's 2003 Survey of Small Business Finances indicated that the average PAYDEX score of those surveyed was 53.4.[5] By contrast, the 2011 NFIB Annual Small Business Finance Survey indicated that the average small company surveyed had a PAYDEX score of 44.7. In addition, payment delinquency trends point to a decline in business credit scores. Dun and Bradstreet's Economic Outlook Reports chart the sharp rise in the percent of delinquent dollars (those 91 or more days past due) from a level of just over 2 percent in mid-2007 to a peak above 6 percent in late-2008. While delinquencies have subsided somewhat since then, the level as of late 2012 remained at nearly 5 percent, notably higher than the pre-recession period.

More lending is secured by collateral now than before the Great Recession. The Federal Reserve Survey of Terms of Business Lending shows that in 2007, 84 percent of the value of loans under $100,000 was secured by collateral. That figure increased to 90 percent in 2013. Similarly, 76 percent of the value of loans between $100,000 and $1 million was secured by collateral in 2007, versus 80 percent in 2013.[6]

The decline in value of both commercial and residential properties since the end of the housing boom has made it difficult for businesses to meet bank collateral requirements. A significant portion of small business collateral consists of real estate assets. For example, the Federal Reserve's 2003 Survey of Small Business Finances showed that 45 percent of small business loans were collateralized by real estate.

On the residential side, Barlow Research, a survey and analysis firm focused on the banking industry, reports that approximately one-quarter of small company owners tapped their

[5] 2003 Survey of Small Business Finances (http://www.federalreserve.gov/pubs/oss/oss3/ssbf03/ssbf03home.html).
[6] Survey of Terms of Business Lending (http://www.federalreserve.gov/releases/e2/default.htm).

home equity to obtain capital for their companies, both at the height of the housing boom and in 2012. The value of home equity has dropped substantially since 2006. According to the Case-Shiller Home Price Index, the seasonally adjusted composite 20-market home price index for April 2013 was only 73.8 percent of its July 2006 peak.

On the commercial side, the Moody's/Real commercial property price index (CPPI) shows that between December 2007 and January 2010, commercial real estate prices dropped 40 percent. While prices have recovered somewhat since then, the index (as of May 2013) is still 24 percent lower than in 2007.

Tighter Lending Standards

At the same time that fewer small businesses are able to meet lenders' standards for cash flow, credit scores, and collateral, bankers have increased their credit standards, making even fewer small businesses appropriate candidates for bank loans than before the economic downturn. According to the Office of the Comptroller of the Currency's Survey of Credit Underwriting Practices, banks tightened small business lending standards in 2008, 2009, 2010, and 2011.

Loan standards are now stricter than before the Great Recession. In June 2012, the Federal Reserve Board of Governors asked loan officers to describe their current loan standards "using the range between the tightest and easiest that lending standards at your bank have been between 2005 and the present." For nonsyndicated loans to small firms (annual sales of less than $50 million), 39.3 percent said that standards are currently "tighter than the midpoint of the range," while only 23 percent said they are "easier than the midpoint of the range."

Moreover, while banks have loosened lending standards for big businesses during the recent economic recovery, they have maintained tight standards for small companies. The Office of the Comptroller of the Currency's Survey of Credit Underwriting Practices tracks the changes in lending standards for small and large customers between 2003 and 2012. The net tightening of lending standards (the percentage of banks tightening lending standards minus the percentage loosening them) was slightly greater for small businesses than large businesses in 2009 and 2010. However, in 2011 and 2012, there was a net tightening of lending standards for small businesses, despite a net loosening for big businesses.[7]

While banks adjust lending standards for a number of reasons, there is some evidence that heightened scrutiny by regulators had an impact during and after the Great Recession. Recent research quantifies the impact of tighter supervisory standards on total bank lending. A study by Bassett, Lee, and Spiller finds an elevated level of supervisory stringency during the most recent recession, based on an analysis of bank supervisory ratings.[8] This research concludes that an increase in the level of stringency can have a statistically significant impact on total loans and loan capacity for several years – approximately 20 quarters – after the onset of the tighter supervisory standards.

[7] The Office of the Comptroller of the Currency Survey of Credit Underwriting Practices (http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/index-survey-credit-underwriting-practices-report.html).

[8] "Estimating Changes in Supervisory Standards and Their Economic Effects," William F. Bassett, Seung Jung Lee, and Thomas W. Spiller. Federal Reserve Board, Divisions of Research and Statistics and Monetary Affairs, Finance and Economics Discussion Series, no. 2012-55. (http://www.federalreserve.gov/pubs/feds/2012/201255/201255pap.pdf).

Longer-Term Trends

Declines in small business lending also reflect longer-term trends in financial markets. Banks have been exiting the small business loan market for over a decade. This realignment has led to a decline in the share of small business loans in banks' portfolios. The FDIC reports that the fraction of nonfarm, nonresidential loans of less than $1 million has declined steadily since 1998, dropping from 51 percent to 29 percent.

The decades-long consolidation of the banking industry has reduced the number of small banks, which are more likely to lend to small businesses. Moreover, increased competition in the banking sector has led bankers to move toward bigger, more profitable, loans. That has meant a decline in small business loans, which are less profitable because they are banker-time intensive, are more difficult to automate, have higher costs to underwrite and service, and are more difficult to securitize.

Conclusion

The decline in the amount of small business credit since the financial crisis and Great Recession is unmistakable. The most recently available data put the inflation-adjusted value of small commercial and industrial loans at less than 80 percent of their 2007 levels. While different industry participants offer different reasons for the drop in small business credit, a careful analysis of the data suggests that a multitude of factors explain the decline.

The forces unleashed by the financial crisis and Great Recession added to a longer-term trend. Some banks have been shifting activity away from the small business credit market since the late 1990s, as they have consolidated and sought out more profitable sectors of the credit

market. Small business demand for lending has decreased, as fewer small businesses have sought to expand. Credit has also become harder for small businesses to obtain. A combination of reduced creditworthiness, the declining value of homes (a major source of small business loan collateral), and tightened lending standards has reduced the number of small companies able to tap credit markets.

This confluence of events makes it unlikely that small business credit will spontaneously increase anytime in the near future. Given the contribution that small businesses make to employment and economic activity, policymakers may be inclined to intervene to promote greater access to credit for small business owners. When considering means of intervention, however, it is important to be cognizant that multiple factors are affecting small business credit demand and supply. Any proposed solutions should consider the combined effect of all of the factors involved.