Small Business and Entrepreneurship during an Economic Recovery
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DENNIS LOCKHART: When I was told of the idea of this conference, I welcomed the conference on small business and entrepreneurship, because in that title I saw the opportunity for the meeting to address two somewhat distinct, but interrelated or overlapping claims. First, in low- and moderate-income communities, small businesses anchor neighborhoods and generate positive social benefits. And then second, we frequently hear that small businesses account for a great deal of private sector employment and new jobs.

Now, I've been thinking quite a lot recently about the jobs crisis in the country, and the jobs crisis that the country is experiencing, and the role of small business in a solution. In my time this morning I'd like to look at the connection between small businesses and job creation, that is the second of the two claims. In that regard, we also hear often that the small business sector doesn't have enough access to capital, and if only the banks would lend more money, jobs would be created. I'd like to look more deeply into this assertion and try to understand the underlying commercial reality. So my topic this morning is small business, job creation, and bank financing.

As Todd mentioned I'm a former banker. So I think I might add some value to the conference by going into some depth on the subject of how banks actually lend to small businesses with a particular focus on start-ups. It's axiomatic that almost all start-ups are small businesses. It turns out that research shows, as regards to job creation, it's new businesses that make the most difference in creating jobs rather than small businesses broadly defined. The Kauffman Foundation supported this -- supported research -- that came to this conclusion, and I believe this point was made by Carl Schramm yesterday in his passionate call for more start-ups. So, to narrow the focus of my remarks this morning even further, my topic is start-ups, job creation, and bank financing.

Now, let me put start-ups, or new business formation, in the full context of the small business sector. The small business sector, and this point was made by my colleague John Robertson, is extremely heterogeneous. Among the conventional criteria for classifying a business as small are: number of employees, revenues, assets, number of establishments, and sometimes legal structure. Unfortunately, no single metric provides a definition that is adequate for all purposes. I'm told that a report to Congress in the 1970s cited over 700 different possible definitions of small business. The most commonly applied metric as you heard yesterday is number of employees, with cuts at 500 or fewer, and 50 or fewer.

I know many of you are quite familiar with the following picture, but let me quickly review some high-level information. On an employment basis, the vast majority of business enterprises in the United States are small, even, far smaller than 50. According to the 2008 statistics of U.S. businesses, there are about 21 million non-employer businesses in the country. Most are self-employed individuals operating very small, unincorporated businesses which may or may not be the owner's principle source of income. These are important sources of employment for the owners, but clearly are not strong creators of jobs for others. Of the slightly less than 6 million businesses that have paid employees, almost 80% have fewer than 10 employees.

So, back to categorization -- for the purpose of talking about start-ups and their impact on job creation, let me suggest a more qualitative categorization. I think we can put new businesses into two buckets: Scalable, growth businesses versus inherently small-scale firms. The former, that is scalable growth businesses have been referred to in a Kaufman Foundation study as “gazelles,” and again you heard that term yesterday. The latter, the inherently small scale businesses, are sometimes called “mom-and-pops.” Inherently small-scale firms often populate highly-fragmented industries like restaurants, dry cleaners, boutique retail stores, and beauty salons. Occasionally one of these inherently small-scale businesses surprises even the owner by growing beyond expectations; and, occasionally the business concept is unique enough to be franchised and thereby grow to substantial scale. Every once in a while a burger joint in San Bernardino, California becomes McDonald's, but mostly the business people who launch these small-scale enterprises start with the intention of remaining relatively small.

In contrast, the entrepreneurs behind scalable, growth businesses hope their companies will become large. They may expect that success will bring the opportunity to go public or to sell to a larger company. Within the category of small business start-ups, scalable start-ups and scaling young businesses are a driver of job creation. Again, this point was made yesterday. What makes them scalable is that these new businesses address large potential markets, offer products and services with positive scale economies and/or have a business model that is replicable. Of course, many intended scalable growth businesses fizzle out and fail. The DeLorean Motor Company, which was intended to rival the bigger auto firms, quickly and spectacularly disappeared. Interestingly, the name has been resurrected recently by an entirely different company in Houston, Texas. All this points up the tremendous churn of new business formation, failure, and disappearance.

In a dynamic economy like the United States', businesses start and cease operations all the time for any number of reasons. Data from the U.S. Census Bureau show that the rate of establishment formation -- and I'll use this as a proxy for business formation -- averaged about 12% a year over the period 1992 to 2005. Exit rates averaged about 2 percentage points lower, or 10%, over this period, so the total number of establishments over that period grew over time. A closer look at mortality shows that about 20% of establishments failed in their first year and about half failed within the first five years. Now, the data are not perfect. We heard a call yesterday from Alicia Robb for more and better data, but I think they are reliably suggestive of an economy that is constantly and vigorously creating new businesses and jobs, while at the same time destroying other businesses and jobs, and it's the balance of these that makes for positive or discouraging labor market conditions. Without a continuous flow of new business formation, the U.S. economy would be always shedding jobs, and further many of the jobs that are created by business start-ups are impermanent because of the high failure rate.

We know that the rate of business failures grew sharply during the recession. More troubling, though, is that the rate of new business formation fell sharply during the recession and seems to have been very slow to recover. According to data of the Bureau of Labor Statistics, the number of new establishments decreased from a peak of about 870,000 in the year 2006, to 700,000 in 2009, and to 720,000 in 2010. So in broad strokes, here is the picture -- virtually all start-ups are small, whether so called "mom-and-pops" or "gazelles," they create some jobs at inception. Inherently small enterprises either fail or sustain operations, but tend to level off in terms of employment.

The growth businesses, the "gazelles," ramp up creating initial employment, they may fail in time, or they may grow to what is still small-scale and level off, or they may break out and grow to large-scale. A 2010 study by the Kauffman Foundation shows that just 1% of employer businesses, those growing the fastest, generate roughly 40% of new jobs in a given year. Three-quarters of those businesses are less than five years old. The takeaway point in my opinion is this: If we want to grow jobs, one place we should look is to start-ups and young businesses, especially scalable growth businesses that often set out to commercialize innovation. Scalable start-ups need capital. So what is the role of banks in providing start-ups with needed financial capital?

Commercial banks play a significant, but not dominant role in start-up financing. The information is a little dated but according to the 2007 Survey of Business Owners conducted by the Census Bureau, 19% of employer-firms said that a business loan from a bank was a source of start-up or acquisition capital. 11% cited using credit cards, and 8% used home equity loans. Despite the not insignificant role of banks, it turns out that the most commonly used source of start-up financial capital was personal savings, used by 62% of respondent firms in the same survey.

In April of this year, my colleague Federal Reserve Governor Elizabeth Duke, spoke on small business credit availability, and in her talk she cited the Federal Reserve's 2010 Survey of Consumer Finances which, despite that name, has some information on sources of funding to start, acquire, or expand closely held businesses. Referencing this survey, she also pointed out that the most frequently used source of start-up finance was personal savings and assets.

When a bank does make a loan specifically to finance a start-up, the bank, regardless of the size of the bank, rarely backs the business per se, or the entrepreneur based on his or her good standing without recourse to what we used to call, or what I called as a banker, a second way out. Banks usually require collateral that represents an independent source of repayment. This typically means collateral unrelated to the business that can be easily liquidated, or a guarantor of independent means. The most prevalent form of hard collateral is real property. Start-up entrepreneurs often hear something like, if you'll put up your house, we'll lend to your new business.

Real estate related to the business, to the extent the entrepreneur needs such real estate and actually owns it, in fact, can be problematic as collateral because its value may be a function of the business cash flow it helps generate. In such a case, the bankers' primary source of repayment and the second way, out are not independent of each other. Yesterday my colleague John Robertson cited some of this information from our own survey, but it appears that banks have pulled back their direct lending to finance business start-ups in recent years. For example, the Fed's poll of small business credit conditions in the Southeast found that businesses last than six years old were much less likely to have utilized a loan from a bank when they started a business versus older firms and were much more likely to have relied on used personal savings. Beyond personal savings, new and young businesses rely on the owner's personal credit. Sources of personal credit, personal bank credit for starting a business include, as I said earlier, home equity loans and credit cards. The fall in residential real estate values since 2007 is a plausible explanation for some of the drop-off in new business formation during and since the recession. Budding entrepreneurs have less equity in their homes to back a home equity line of credit. Both credit limits and outstanding balances on home equity lines of credit have continued to decline since 2007. According to CoreLogic at the end of June, almost 23% of residential mortgages with a mortgage were in a negative equity position, and in some locations that percentage was much higher.

Also, personal credit card revolving debt has been a source of start-up and early-stage financing. Personal credit cards are a form of unsecured credit and are generally granted on the basis of assessments of repayment factors such as personal credit history and income. Again, the bank is not backing the business idea per se. According to the New York Fed's quarterly report on household debt and credit, both the number of credit card accounts and account limits have increased modestly in 2011, but they remain well below pre-recession levels as credit card delinquencies remain elevated.

Some banks, but I would say a minority of banks, have specialized asset-based lending, or ABL units, that are able to use the business assets, that is, receivables, inventory and equipment, as collateral. But because ABL is a specialized lending business, requiring significant infrastructure and systems investment, many banks are not geared up to do this kind of lending. ABL requires detailed and frequent monitoring of collateral positions and specialized expertise. Such lending techniques have historically been the provenance of non-bank finance companies that fund themselves in the wholesale markets and are not depositories, as are banks and credit unions. The wholesale funding model of finance companies came under severe stress during the financial crisis and its aftermath. Many community banks are not able to afford the investment in asset-based lending infrastructure and specialized lending personnel.

The current economics of the ABL business require substantial scale to absorb the cost of intense collateral monitoring, and in any event business asset-based loans and lines of credit are rarely available to raw start-ups that are not yet proven or established businesses. And this is because predictable and reliable cash flow is always the preferred and happy way that banks get their loans repaid.

So the point is banks are not natural financial backers of a new business idea based on the perceived merits of the idea, or the assets generated by the business in the very early stages of operation. This has been the reality for quite some time, and I would argue the banking community is behaving consistently with the past. The data showing the incidence of failures among start-ups reinforces this point, I think. The more reasonable domain of banks is loans of moderate risk to more established businesses that can demonstrate a track record. Because banks make loans using mostly depositors' money, they have to be right in their credit decisions virtually all the time.

So how, then, are we to get capital to start-ups and early-stage enterprises in the interest of job creation? What parties are appropriate and geared up, to take the risk of start-ups? Well, as already mentioned, personal savings and money from friends and family have been very important sources of start-up financing. In addition, high potential start-ups also look to venture capital firms and angel financing. Business incubators increasingly play a role of organizers and coordinators of angel networks. A recent development, interestingly, is the use of social media to mobilize start-up investment aggregating small dollar investments.

Taken together, this is not a wholly satisfying answer to the question of where do we get start-up financing. Capital formation for scalable start-ups and early-stage businesses, including debt capital, is both a private sector and public policy challenge. The volume of activity is immense, the targets of investment are small, the risk of loss is high, and the market, so to speak, if you can use that term, is atomized, decentralized, and not highly organized.

We know the start-up sector is important and it appears it is sputtering. We need more activity in this area of the economy. It's tempting to look at the commercial banking sector as a fix. My message this morning is I think this is too narrow a view. My purpose today was simply to lay out the commercial reality of this challenge. I think a practical grasp of commercial reality, including the role of banks, is a necessary starting point for generating ideas that will be helpful.

Thank you very much and I think we have a couple minutes that I'd be happy to respond to any questions.
(Applause)