National Economic Outlook for Small Business Financing

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Thank you, Joseph. Good morning, everyone. I would like to begin by adding my own welcome to those of Joseph, Sandy, and Chairman Bernanke. It is a great pleasure for me to have the opportunity to participate in this meeting, and I look forward to what promises to be a very interesting and productive day.

Over the past 16 years, my work at the Federal Reserve Board has focused primarily on issues relating to the structure of the financial services sector; the nature of competition, both among banks, and between banks and other financial service providers; and factors affecting the performance of depository institutions. I have been particularly interested in understanding community banks and the special role they play in our financial system, providing loans and other financial services to small businesses within their local communities. About two years ago, the director of the Board's Division of Research and Statistics asked me to become more involved in analyzing, and providing policy support on, small business finance issues. I gladly accepted this responsibility, having no clue that the availability of credit to small businesses, or the lack thereof, was about to become one of the hottest topics of discussion and debate in Washington.

Economists' and policymakers' understanding of the credit conditions facing small businesses is based largely on data collected in regulatory reports and in surveys conducted by a number of different entities, including private-sector firms, trade associations, and government agencies. These reports and surveys can be extremely valuable, as they provide an opportunity to gather information from a large number of market participants in a systematic and statistically sound way. However, as Chairman Bernanke noted a moment ago, there are limits to what we can learn from these sources. Supplementing the report and survey data with the kind of detailed, case-specific information provided by participants in the series of meetings hosted by the Federal Reserve System over the past several months allows us to develop a much more complete and nuanced understanding of small business credit conditions. In some cases, the stories we heard at the meetings corroborated what we had already been seeing in the data; in other cases, the meetings brought to light issues or problems of which we would not otherwise have been aware. This outcome is not surprising, and it is indicative of the complementary nature of these alternative methods for acquiring information. I hope that some of the issues that have been raised by participants in the System's small business meetings will help shape the questions asked in future small business credit surveys.

With that thought in mind, I would like to kick off today's discussion by (1) briefly summarizing what some of the latest survey data suggest regarding the current state of credit conditions for small businesses and (2) highlighting some of the findings from the System's small business meetings.

Summary of Survey Data

Overall, the survey data seem to suggest that current economic conditions for small businesses, though still quite challenging, are less dire than they were in 2009.

The Federal Reserve's April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) indicated that standards on commercial and industrial (C&I) loans to small businesses were essentially unchanged in the first quarter, but that the terms on such loans—most notably, premiums on loans to riskier borrowers—tightened somewhat.[1] Figure 1 shows the trends over time for the net percentage of respondents reporting a tightening of standards (the blue line), increasing spreads (the green line), and increasing premiums on riskier loans to small businesses (the red line). As you can see, all of these indicators have been trending downward for several quarters. In addition, as shown in figure 2, although a significant number of domestic banks continued to tighten standards on commercial real estate (CRE) loans, the net percentage doing so has declined sharply since its peak in the fourth quarter of 2008.

At the same time, as shown in figure 3, modest net percentages of banks reported that demand for C&I loans from small firms (the blue line) and demand for CRE loans (the green line) had continued to weaken over the prior three months, though these percentages were well below those seen over the past few quarters.

In sum, the SLOOS data suggest that both supply constraints and weakening demand have contributed to the decline in outstanding bank loans to small businesses mentioned earlier

[1] See Board of Governors of the Federal Reserve System (2010), national summary of the April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, May 3, www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/fullreport.pdf.

by Chairman Bernanke, but that the rate of deterioration in these metrics has diminished markedly in recent months.

Turning next to a National Federation of Independent Business (NFIB) report, *NFIB Small Business Economic Trends,* the May 2010 data show an increase in the index of small business optimism to a level that, though still somewhat weak, is the highest it has been since the fall of 2008 (figure 4).[2] Among the 36 percent of firms reporting that they had had borrowing needs over the three months prior to the survey, slightly more than one-fifth (that is, 8 percent of all firms) indicated that their needs had *not* been satisfied. And, as shown in figure 5, for those firms that obtained short-term loans in early 2010, the interest rates paid were, on average, fairly low by historical standards.

The May NFIB data also indicate, as shown in figure 6, that only 3 percent of respondents cited financing and interest rates as their single most important problem (the green line), compared with 30 percent citing weak sales (the blue line). When considering these data, I think it is important to recognize that, even though a very small percentage of firms cite financing as their *single most important* problem, there are likely many more firms for which financing presents a significant challenge.

The take-away message from the NFIB survey seems to be that, for America's small businesses, the worst is over, but the road ahead is likely to be difficult.

[2] See William C. Dunkelberg and Holly Wade (2010), *NFIB Small Business Economic Trends* (Nashville: NFIB Research Foundation, June), www.nfib.com/research-foundation/small-business-economic-trends-(sbet)-archive.

Another source of information regarding credit market conditions for businesses is the Duke University/*CFO* Magazine Global Business Outlook Survey.[3] The most recent survey concluded in June and generated responses from about 1,100 chief financial officers (CFOs), more than 500 of whom were from the United States. Overall, the survey suggests that business conditions in the United States are improving but at a very slow rate. U.S. CFOs responding to the survey reported no net change in borrowing conditions compared with the fall of 2009. Among small firms (those with fewer than 500 employees), a modest net percentage reported a worsening of borrowing conditions over the same period. Just over one-third of all CFOs, and an identical fraction of small-firm CFOs, reported that their companies had restricted capital spending below the desired levels over the past year because of funding difficulties.

Summary of What We Learned from the Meetings

Now I would like to switch gears and talk about some of the things we learned from the Federal Reserve System's series of more than 40 small business meetings across the country.

Both small businesses and banks reported that a variety of factors have contributed to a contraction in the supply of credit to small businesses.

- Meeting participants generally acknowledged that underwriting standards have tightened relative to those that prevailed prior to the recession. The specific forms of tightening that were mentioned most often included stronger collateral requirements, greater attention to cash flow, and higher personal credit thresholds for business owners. A key question that remains unanswered is whether this tightening represents a return to

[3] See Duke University and *CFO* Magazine, Duke University/*CFO* Magazine Global Business Outlook Survey, www.cfosurvey.org/.

"normal" underwriting standards, following a period of "easy money," or whether the pendulum has swung too far, leading to excessively high standards that are constraining the ability of creditworthy borrowers to obtain the funding they need to expand their businesses.

- Much attention has been focused recently on both the effects of capital constraints on the ability of banks to meet loan demand and the need to devise policies that can help alleviate those constraints. However, meeting participants reported that labor constraints are also an important factor. A number of banks noted that their experienced staff members, including loan officers, have been stretched very thin, spending much of their time dealing with problem loans and trying to keep up with regulatory changes. As a result, senior bank employees have had less time available for processing loan applications, and some banks have become less willing to engage in the labor-intensive activity of making small loans to smaller, less-sophisticated businesses.
- Some small businesses noted that credit availability has been particularly constrained in areas that have experienced bank failures. A colleague and I have been concerned about this issue since mid-2008, when the number of bank failures began to rise precipitously. We have been tracking the geographic areas affected by bank failures. The map in figure 7 shows the number of failed institutions with a branch presence in each state over the period from July 1, 2008, through March 31, 2010. A few states (Georgia, Florida, Illinois, and California) stand out as having been particularly hard hit. Zooming in to a more local level (figures 8 and 9), it is clear that, within each of these states, failures have

been concentrated in a small number of metropolitan areas. The potential effect of bank failures on the availability of credit to firms in these local areas is particularly worrisome.

- A number of bankers participating in the meetings stated that increased regulatory scrutiny of small business loans and uncertainty surrounding assumptions used in classifying assets have limited their ability to lend. And several bankers indicated that concerns about regulators' responses have led them to be extremely cautious about lending to small businesses that have good prospects but are tainted by less-than-perfect credit, a recent history of uneven cash flow, or reduced collateral values. To address these issues and others relating to small business lending, the Federal Reserve and other financial institution regulatory agencies issued in February 2010 a policy statement supporting prudent lending to small business borrowers.[4]

The picture emerging from our meetings regarding demand for small business loans is somewhat mixed.

- On the one hand, some small businesses and banks reported that demand for small business credit has declined. They indicated that many small firms see little reason to borrow because weak sales, declining asset values, and uncertainty about near-term business prospects have caused them to postpone any plans they may have had for capital expenditures, inventory buildup, or expansion of operations.

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[4] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Conference of State Bank Supervisors (2010), "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers," attachment to "Regulators Issue Statement on Lending to Creditworthy Small Businesses," joint press release, February 5, www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm.

- On the other hand, many credit unions and community development financial institutions noted an increase in demand for small business loans, and many small businesses reported having difficulty obtaining or renewing credit. Reductions in lines of credit, combined with declining sales, have left some small businesses struggling to meet intermediate-term financing needs. Many small businesses are finding it difficult to refinance their loans, especially those associated with commercial real estate. Firms requiring small dollar loans (less than $200,000) are having trouble finding lenders willing to participate in this relatively high-cost market segment. And financing for start-ups is virtually impossible to obtain.

Conclusion

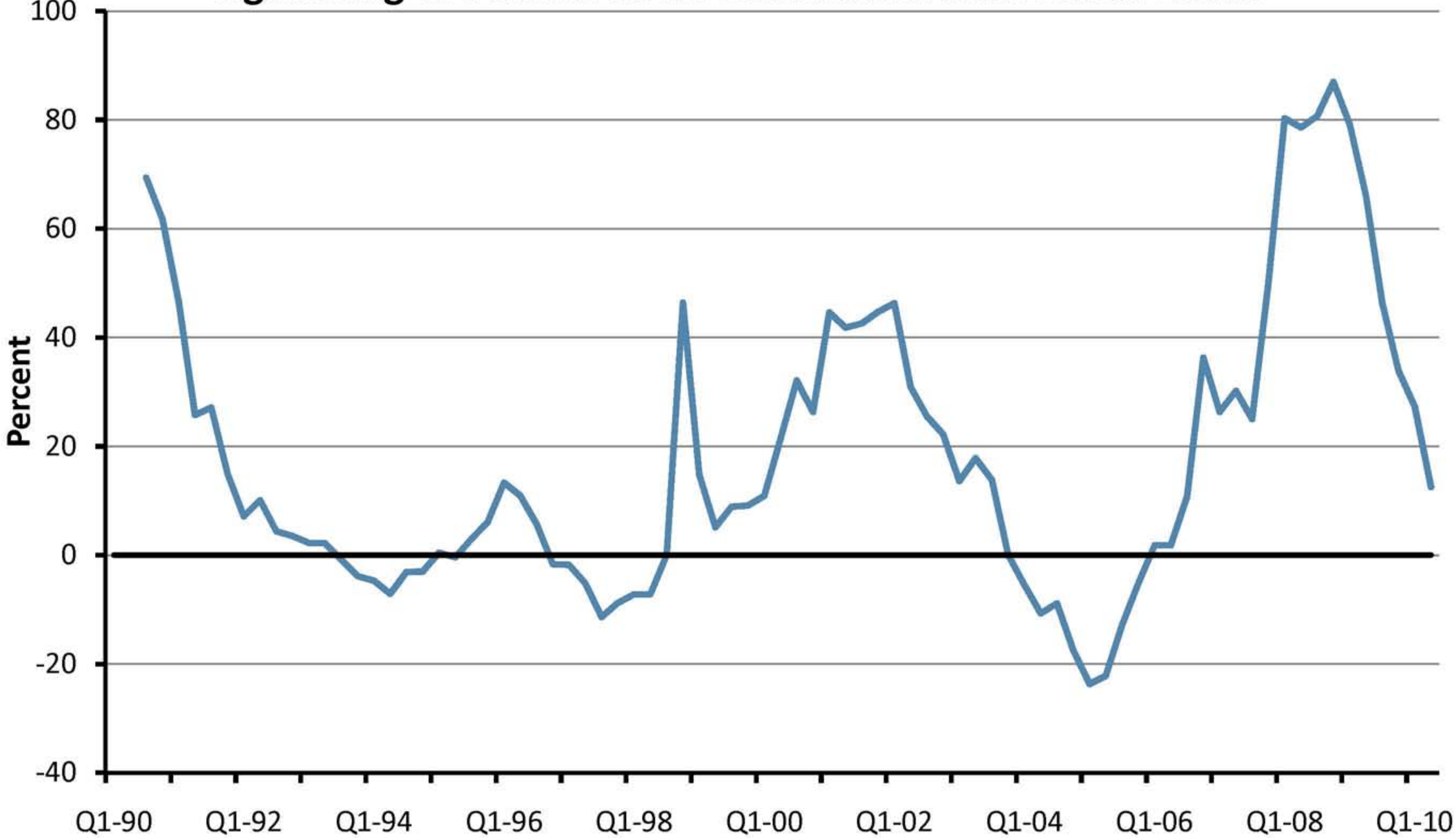
These brief summaries of both the survey data and the stories heard in more than 40 meetings held across the country over the past few months, though far from complete, illustrate the value of obtaining information about credit market conditions from a variety of different sources. As Joseph indicated earlier, our goals for today are to address the key themes and issues that emerged from the System's series of meetings and to consider next steps for addressing the financing needs of small businesses. We are quite fortunate to have a very distinguished group of speakers and panelists to guide us through this process. These individuals bring a wide range of expertise and diverse viewpoints to the questions at hand. I am looking forward to hearing what all of them have to say. Thank you.

Figure 1: Net Percentage of Domestic Banks Reporting a Tightening of Standards or Terms on Loans to Small Businesses

Note: Data are quarterly; not seasonally adjusted.

Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, www.federalreserve.gov/boarddocs/SnLoanSurvey/.

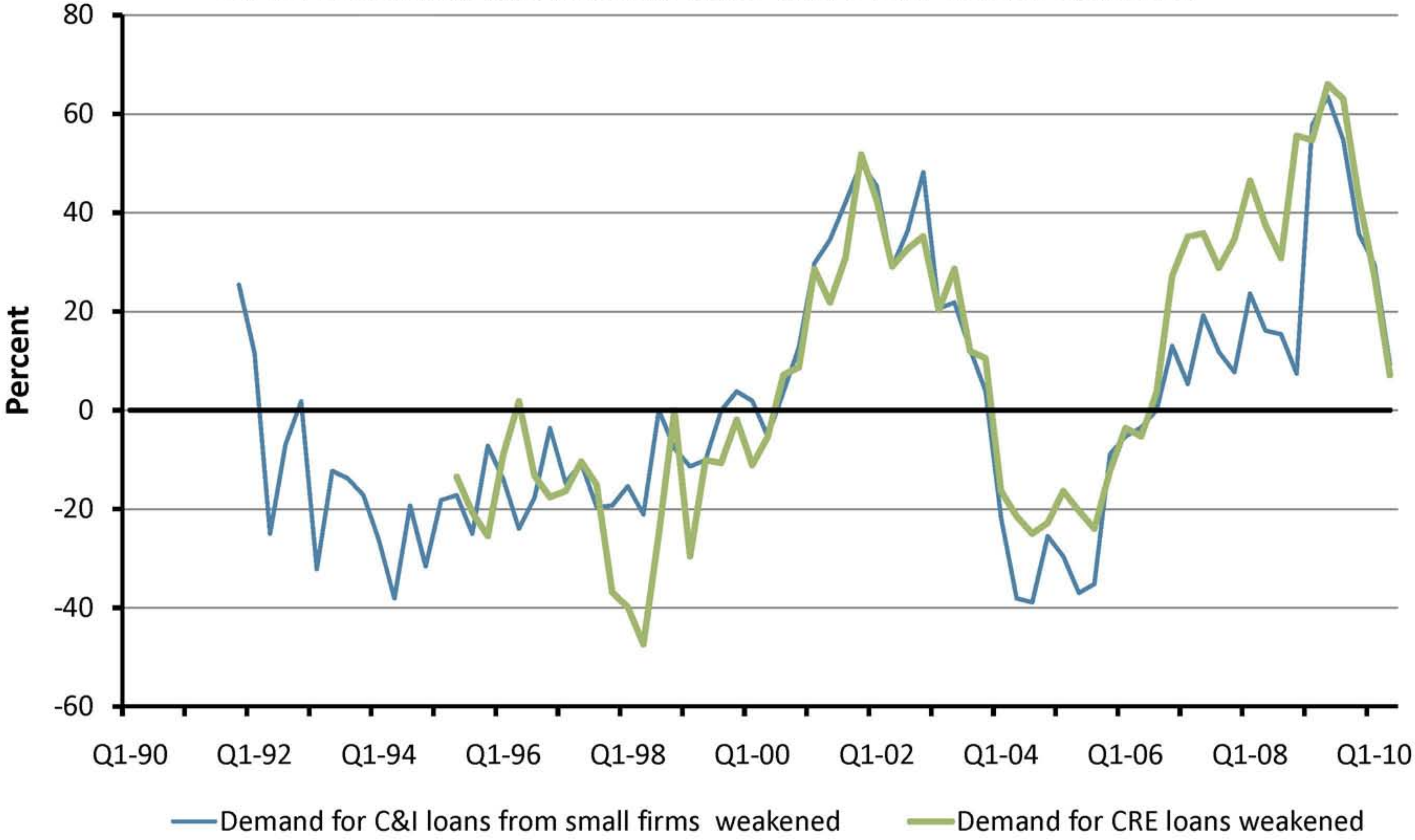
Figure 2: Net Percentage of Domestic Banks Reporting a Tightening of Standards on Commercial Real Estate Loans



Note: Data are quarterly; not seasonally adjusted.

Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, www.federalreserve.gov/boarddocs/SnLoanSurvey/.

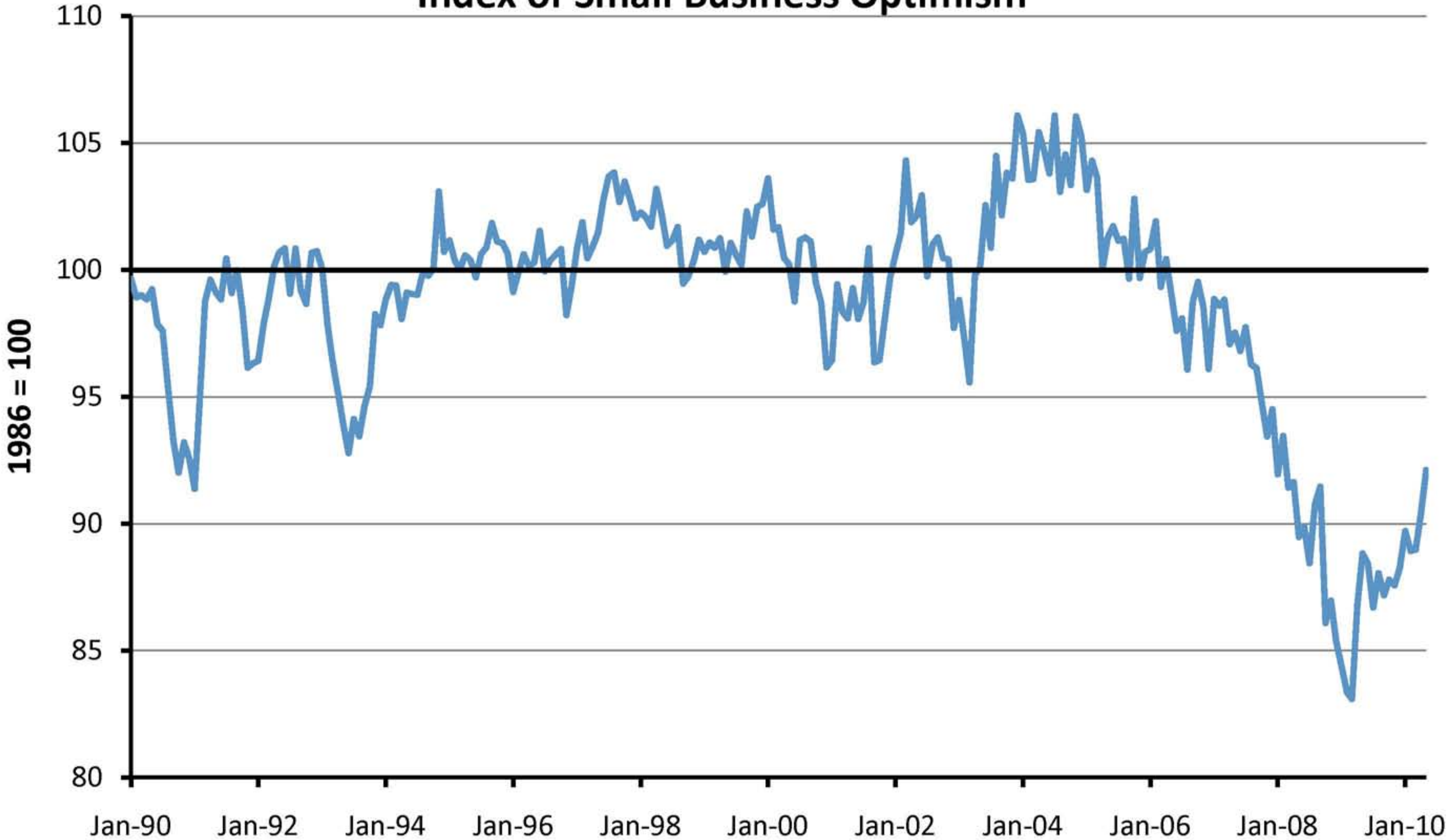
Figure 3: Net Percentage of Domestic Banks Reporting That Loan Demand Weakened over the Prior Three Months



Note: Data are quarterly; not seasonally adjusted.

Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, www.federalreserve.gov/boarddocs/SnLoanSurvey/.

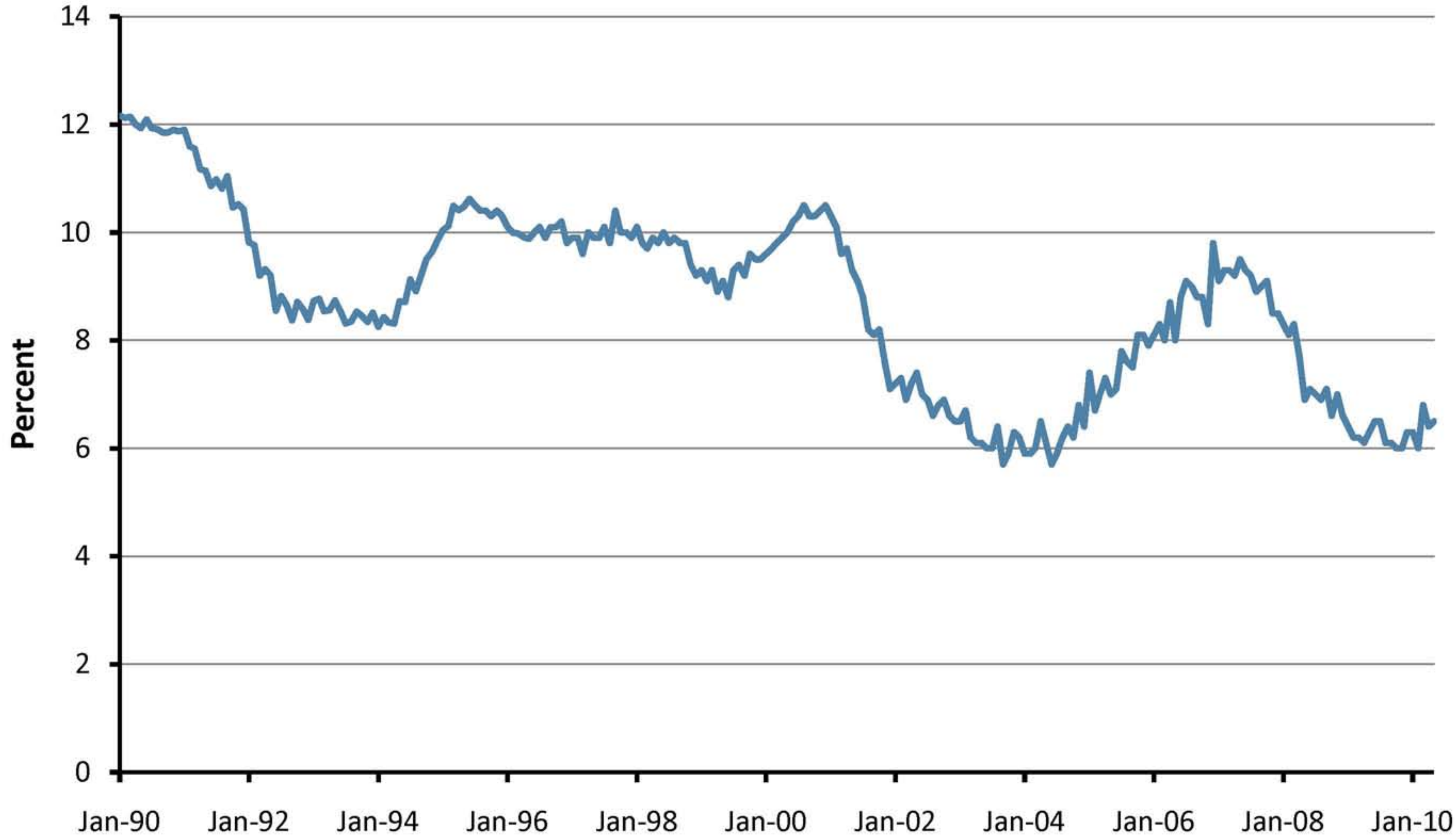
**Figure 4: National Federation of Independent Business:
Index of Small Business Optimism**



Note: Data are monthly; seasonally adjusted.

Source: National Federation of Independent Business, *NFIB Small Business Economic Trends*, www.nfib.com/research-foundation/small-business-economic-trends-(sbet)-archive.

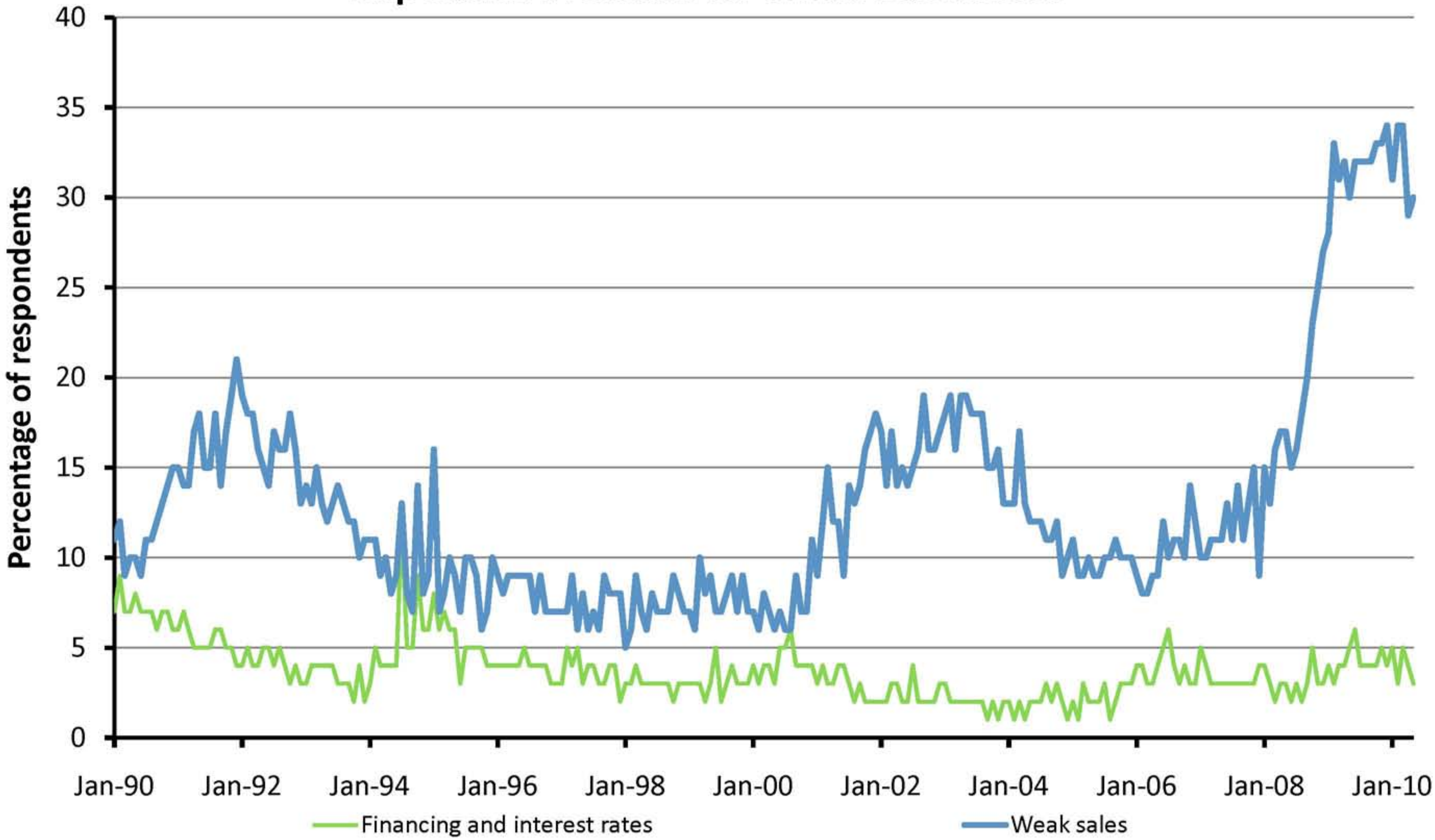
Figure 5: National Federation of Independent Business: Actual Interest Rate Paid on Short-Term Loans by Borrowers



Note: Data are monthly.

Source: National Federation of Independent Business, *NFIB Small Business Economic Trends*, www.nfib.com/research-foundation/small-business-economic-trends-(sbet)-archive.

Figure 6: National Federation of Independent Business: Most Important Problem for Small Businesses

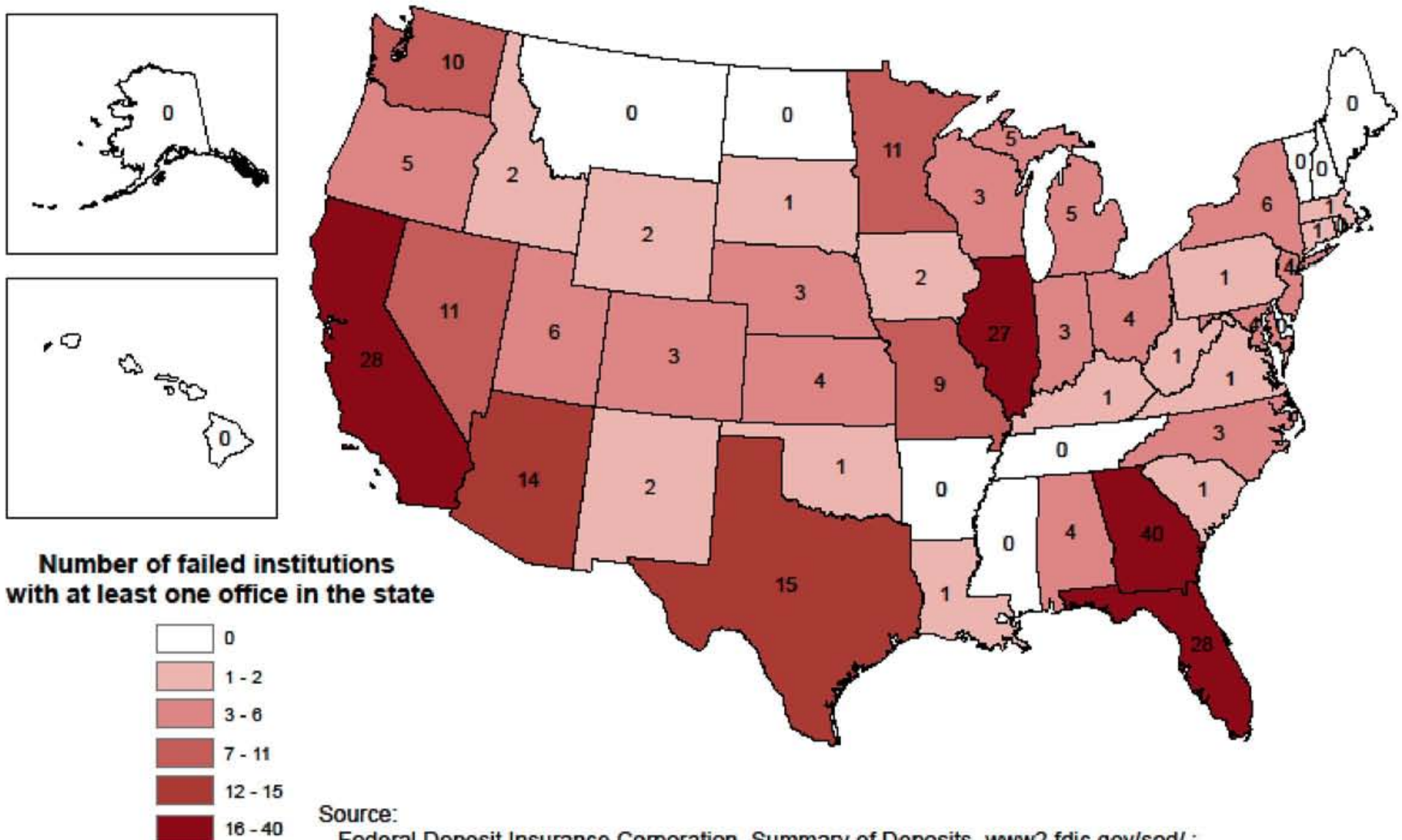


Note: Data are monthly.

Source: National Federation of Independent Business, *NFIB Small Business Economic Trends*, www.nfib.com/research-foundation/small-business-economic-trends-(sbet)-archive.

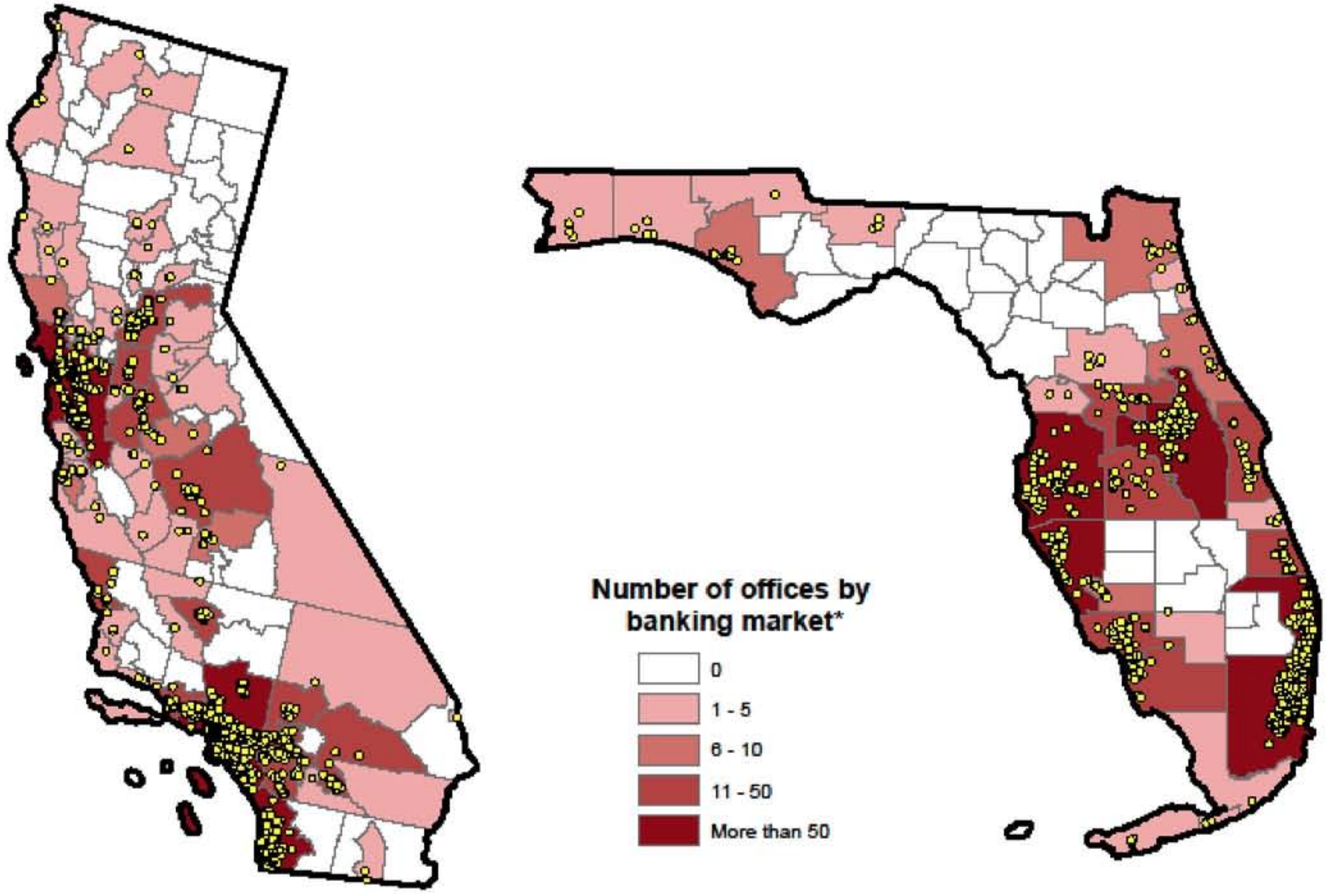
Figure 7: Location of Failed Institutions by State

July 1, 2008, through March 31, 2010



Source:
Federal Deposit Insurance Corporation, Summary of Deposits, www2.fdic.gov/sod/ ;
Federal Reserve System, National Information Center, www.ffiec.gov/nicpubweb/nicweb/nichome.aspx.

Figure 8: Offices of Failed Institutions in California and Florida
July 1, 2008, through March 31, 2010

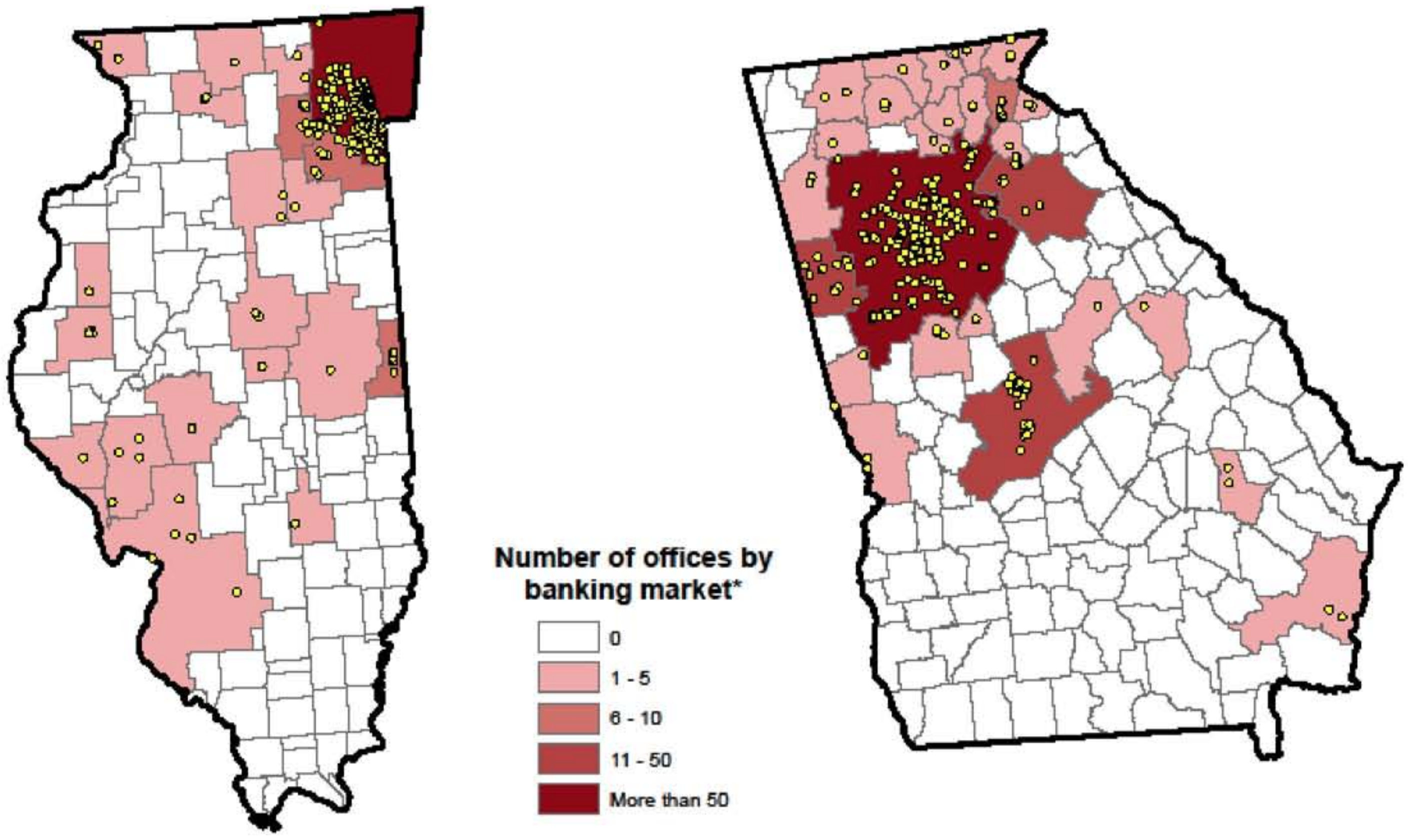


*Markets shown are Federal Reserve banking markets or counties that do not fall into a defined market. Offices are in yellow.

Source:

Federal Deposit Insurance Corporation, Summary of Deposits, www2.fdic.gov/sod/ ;
Federal Reserve System, National Information Center, www.ffiec.gov/nicpubweb/nicweb/nichome.aspx.

Figure 9: Offices of Failed Institutions in Illinois and Georgia
July 1, 2008, through March 31, 2010



*Markets shown are Federal Reserve banking markets or counties that do not fall into a defined market. Offices are in yellow.

Source:
Federal Deposit Insurance Corporation, Summary of Deposits, www2.fdic.gov/sod/ ;
Federal Reserve System, National Information Center, www.ffiec.gov/nicpubweb/nicweb/nichome.aspx.