

July 21, 2010



# **Addressing the Financing Needs of Small Businesses**

*Summary of Key Themes from the  
Federal Reserve System's Small Business Meeting Series*

## **Introduction**

The Federal Reserve System's Community Affairs Offices hosted more than 40 meetings in 2010 as part of an initiative titled "Addressing the Financing Needs of Small Businesses."<sup>1</sup> The goal was to gather information and perspectives to help the Federal Reserve and other stakeholders address the immediate and intermediate credit needs of small businesses.

Some of the meetings took the form of small focus groups or listening sessions. Other meetings were on a larger scale, with more formal agendas focusing on a particular aspect of small business financing, such as minority entrepreneurship, the role of Community Development Financial Institutions (CDFIs), or federal guarantee loan programs. Several meetings focused on a specific industry, such as auto suppliers.

Whether small or large, all of the meetings brought together small business owners, small business trade groups, financial institutions and other private lenders, bank supervision officials, CDFIs, and other small business support service providers to discuss ways to improve credit flow to viable small businesses. Through this initiative, the Federal Reserve sought to deepen its understanding of the dynamics of the supply of and demand for small business credit, to identify specific credit gaps, and to learn of promising practices and suggestions for improvement.

This summary aims to capture the key issues that emerged from the meetings and offer examples of how those issues were reflected in different parts of the country and in different industries. It is not intended to be a comprehensive compilation of all the ideas and views that were expressed. We have grouped the comments under the categories of credit supply, credit demand, and credit gaps. In addition, we have included key recommendations for potential next steps that were identified by participants at the July 12 capstone event at the Board of Governors as well as throughout the System's series of meetings.

## **Factors Impacting the Supply of Small Business Credit**

Small businesses and banks generally reported that lending contracted significantly during the recession for a variety of reasons. These comments are consistent with data indicating that outstanding loans to small businesses dropped from more than \$710 billion in the second quarter of 2008 to less than \$670 billion in the first quarter of 2010.<sup>2</sup> In addition, some banks noted that some of the contraction in lending is related to broader concerns about capital adequacy. Comments related to the supply of credit to small businesses fell into four broad categories: 1) tighter bank underwriting standards; 2) resource constraints on lending; 3) impact of regulatory guidance; and 4) utilization of alternative funding sources.

**Underwriting standards** – At most meetings, both small businesses and banks acknowledged that underwriting standards had tightened. Some small businesses reported that underwriting

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<sup>1</sup> A list of meeting locations, dates, and topics can be found in Attachment A.

<sup>2</sup> Data are from the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Report), where loans to small businesses, as reported in the reporting forms FFIEC 031 and 041, schedule RC-C, part II, are defined as loans with original amounts of \$1 million or less that are secured by nonfarm nonresidential properties or are commercial and industrial loans. *Correction: On July 27, 2010, this footnote was revised to remove "plus loans with original balances of \$500,000 or less that are secured by farmland or are for agricultural production."*

changes made access to credit more difficult, but not impossible, while others found the changes to be a significant hurdle to obtaining credit. Many banks acknowledged that lending standards had become more flexible prior to the economic downturn and that they since have returned to more traditional underwriting practices.

Recurring issues related to underwriting standards included the following:

- ***Additional collateral requirements*** – For existing loans, small businesses reported that routine collateral re-evaluations of assets that directly or indirectly secure loans – including personal residences, commercial property, and equipment – often result in additional collateral requirements because of a significant drop in asset values. In addition, in some markets, banks noted they were no longer readily taking real estate as collateral, especially if there was another outstanding lien against the property. Many banks have also reduced their loan-to-value (LTV) thresholds, increasing the amount of equity businesses need for new and refinance loans.
  - At a meeting in Cincinnati, small business owners said they were required to make cash payments when reassessments of LTV ratios resulted in insufficient collateral. If the payment was not made, the loan could be subject to default. For new loans, small businesses cited heavy collateral requirements, including personal guarantees, which made them reluctant to secure the loan.
  - In Detroit, auto suppliers emphasized their concern about the values that lenders are placing on their collateral, particularly equipment. An official with an auto supplier trade group confirmed that many of his group’s members have reported issues relating to banks’ current lower valuation of assets that back existing loans or that are being assessed for new loans.
  
- ***Greater focus on cash flow*** – Some banks acknowledged that prior to the economic crisis, credit scores or collateral values, often inflated, were sometimes more important than cash flow in underwriting a small business loan. Banks and small businesses both concurred that strong cash flow is now one of the chief underwriting criteria.
  - At the Baltimore meeting, several bankers said that they understand the frustration of small businesses that may be experiencing reduced cash flow during the recession but that had a solid track record before the downturn. They noted, however, that generally they cannot extend credit if there is no recent history of positive cash flow. According to one banker, even if a business has strong collateral, banks do not want to be in the business of taking collateral to recoup loan principal.
  - In Dayton, a small business owner stated: “If you have the money you need [i.e., good cash flow and collateral], then they’ll loan to you.”
  
- ***Higher personal credit thresholds, including credit score*** – Small businesses commented that, in response to concerns about declining collateral values and cash flow, the recent trend has been to require more personal resources and guarantees. For many larger banks, automated underwriting driven primarily by credit scores is the only way to profitably offer loans below a certain dollar threshold (e.g., below \$200,000). Many

small businesses reported being denied credit because either the owner's personal credit score had declined or the score no longer satisfied lenders' heightened standards.

- In Boston and Cleveland, small business owners reported that their credit scores declined after credit-limit reductions led to higher debt ratios, despite the fact they were always current with payments. In some cases, the credit score downgrades made it extremely difficult to borrow and resulted in businesses' closure or bankruptcy.
- In Miami, business owners and intermediaries expressed concern that lenders are placing greater emphasis on business owners' personal credit to determine creditworthiness and denying credit to small businesses where the owner has a good business plan but impaired credit.

**Resource Constraints** – In addition to capital challenges, banks pointed to a number of other constraints on their lending resources, such as the following:

- ***Asset management challenges*** – Banks reported that higher-than-average delinquency and loss rates have taxed their workout units, forcing them to shift seasoned staff, including loan officers, to assist with the increased number of problem loans. Some banks, particularly smaller banks, described a temporary suspension of all lending activities while they assess portfolios, manage workouts and distressed loans, and reevaluate collateral.
- ***Regulatory burden*** – Smaller banks pointed out the difficulties involved in staying abreast of new regulations and guidance, understanding them thoroughly, and determining how to best implement them.
  - Because of the complexity associated with administering new or revised regulations, some community banks said that they often must assign senior loan officers to handle the new rules, leaving more junior lenders to handle new loans. Some small businesses commented that they are then left working with junior loan officers who they believe do not understand their businesses, are dismissive, or adhere mechanically to underwriting guidelines.
- ***Programmatic changes*** – Bank lenders described how enhancements to Small Business Administration (SBA) lending programs, including the increase in guarantee authority and fee waivers, helped them to make loans they might not otherwise have made. Credit unions also reported good success in using the 7(a) loan program, which was in high demand. Suggestions for program improvements included an SBA guarantee for loan modifications, more streamlined and faster loan processing, and packaging assistance for the 7(a) program, similar to what is available for the 504 program.
  - In meetings in Nashville and Tampa, several participants expressed the view that uncertainty about the duration, availability, and conditions of SBA program enhancements has made banks reluctant to invest the time to adapt to new program requirements.
- ***Impact on underwriting time*** – Banks frequently said that they do not have enough time to handle applications with insufficient documentation, such as sparse tax returns,

inadequate income statements, or unreliable interim financial statements. Participants noted that some banks significantly reduced or eliminated loans below a certain threshold, typically \$200,000, as a way to limit time-consuming applications from smaller and less sophisticated businesses. Banks also cited the imbalance between time commitment and returns as a reason for not participating in certain SBA loan products, such as the America's Recovery Capital or 7(a) loan programs.

- In Miami, bankers noted that they were spending much more time on due diligence than ever before. The bankers and technical assistance providers agreed this is necessary in a market where fraud is prevalent. However, the extended time it may now take to get a loan approved can hurt small businesses.
- **Impact of bank closures** – Small businesses raised the issue of credit availability in areas that have experienced bank failures. If a financial institution is closed and not replaced, the impact is particularly acute. Small businesses in rural areas and in regions with few banks raised this issue most frequently.
  - In St. Louis, participants described the challenge of “orphaned” loans, when a bank that acquires a failed financial institution chooses not to continue the relationship with the borrower, making future extensions of credit unlikely.

**Regulatory Environment** – Some banks cited examination-related concerns as an important factor in credit availability for small businesses. In addition to general statements attributing tightened credit to increased regulatory scrutiny in light of recent economic conditions, concerns were raised about examiner assessments and the uncertainty surrounding classification of assets.

- **Restrictions on lending** – Some bank participants noted that because of declining asset values of their balance sheets, more banks have been required to raise capital to cover potential losses. Among other strategies, banks can respond by taking on fewer loans in order to meet the capital requirements or raising capital under adverse economic conditions.
  - In St. Louis, participants stated they were unsure whether examiners are requiring a 5 percent tier-1 capital ratio standard or whether a stricter 7 percent standard is being applied.
  - Some banks reported inconsistent treatment of loans by different regulators.
  - Several banks mentioned that they consider their examiner's expected response before making new loans. They also expressed reluctance to do loan workouts because of concerns that examiners will still regard the loan as being impaired.<sup>3</sup>
  - In New York, Atlanta, and Miami, small businesses and other participants expressed the view that banks are citing increased examiner scrutiny when

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<sup>3</sup> Relating to this topic, the Federal Reserve and other federal financial institution regulatory agencies issued a policy statement supporting prudent commercial real estate (CRE) loan workouts in October 2009 [<http://www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm>]. The Federal Reserve complemented these issuances with training programs for examiners and outreach to the banking industry to underscore the importance of sound lending practices. Further, the Federal Reserve recently hosted an “Ask the Fed” session in May 2010, which had participation from more than 1,400 bankers and state bank commissioners, to discuss CRE-related issues, such as credit workouts and troubled debt restructurings. The Interagency Guidance on Lending to Creditworthy Small Business Borrowers raised a similar topic, stating that examiners will not criticize institutions for working in a prudent and constructive manner with small business borrowers.

refusing to lend to certain industries, such as construction, real estate, and retail services.

- Bank regulators stated that banks in South Florida have significant challenges in maintaining adequate capital levels because of the higher loan-loss reserves related to declining asset values.
- ***Conflicting messages*** – Some bank participants expressed frustration about their perception of conflicting messages from different government stakeholders. On the one hand, the banks feel pressure to lend, but at the same time they are encouraged to apply stricter credit standards. The result is a more cautious approach to lending.
  - Several banks expressed concern about lending to small businesses that they believe have the potential to grow when the economy begins to expand. Their concern is that, although a business may have good prospects, regulators may be wary of loans based on future prospects, particularly if the business has less-than-perfect credit, a recent history of uneven cash flow, or reduced collateral values.<sup>4</sup>

**Use of Alternative Funding Sources** – Meeting participants noted that small businesses that are denied, or perceive they will be denied, credit by banks have turned to alternative sources of financing, which often carry a higher cost.

- ***Increased use of credit cards*** – At many meetings, small businesses described turning to credit cards in lieu of a bank loan. At the same time, many small businesses also described how their credit limits were being reduced. After being denied credit, many tapped their personal and business credit cards, particularly for working capital or as a line of credit. Businesses described, and several banks confirmed, that in some cases banks are recommending the use of credit cards in response to requests for smaller loans. Others attributed the increased use of credit cards to the relative ease of applying for and using a credit card as compared to the time and effort required to secure a bank loan.
  - Some businesses reported incurring additional costs in relying on credit cards. A business owner in Cleveland reported that her bank line of credit, which carried a 7 percent interest rate, was cut. She then turned to a credit card to finance business transactions and subsequently saw the rate on the card substantially increase above her line of credit rate.
- ***Greater reliance on personal resources*** – Small business owners frequently mentioned the need to use personal financial resources to replace business credit. Personal credit cards, in particular, are often used because they are easily accessed. Some small businesses said they also relied on home equity lines on their personal residence or on retirement savings. Family and friends are another source often mentioned for small

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<sup>4</sup> To address this issue and others relating to small business lending, the Federal Reserve and other federal financial institution regulatory agencies issued a policy statement supporting prudent lending to small business borrowers in February 2010 [<http://www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm>]. The guidance states that lenders should understand the long-term viability of the borrower's business, focus on the strength of a borrower's business plan, and analyze a borrower's performance over a reasonable range of future conditions, rather than overly optimistic or pessimistic cases.

business financing, particularly for start-ups. Current economic challenges, however, have restricted the availability of these sources.

- In Annapolis, a small business owner described being denied for a line of credit because her revenues were down in the prior two years. When she looked into refinancing an investment property to tap its equity, lenders said they were not refinancing investment property. As a result, she relied on credit cards and borrowed against her 401(k) savings for working capital.
  - In Los Angeles, meeting participants indicated that Asian Pacific Islander (API) small businesses rely heavily on personal real estate for their financing, and the significant decline in residential property values has led to a reduction in credit and rising delinquencies for API small business loans.
  - Participants in several meetings expressed the view that minority-owned businesses are generally less likely to have an established banking relationship and thus are less likely to receive bank loans. They often turn to friends and family for financing, particularly in the start-up phase.
- ***Adjustment of payment terms*** – Small businesses reported adjusting payment terms in order to preserve cash whenever possible – e.g., shortening payment terms for customers and extending payment terms with suppliers. Small businesses stated that their options were limited when their customers or suppliers, who may also be cash-strapped, are larger firms or the government and thus have more leverage.
    - In Milwaukee, a small business owner summarized the phenomenon: “Receivables have gone up and we have passed that on by stretching our payables. Some customers pay in 70 days, while others pay in 180. My first recommendation: pass a law that says pay in 30 days or pay interest.”
  - ***Alternative financial institutions*** – Many Community Development Financial Institutions (CDFIs) and credit union participants noted an increase in small business loan demand over the last two years. They expressed the view that this may be the result of a tighter supply of credit by larger financial institutions. They noted that their ability to meet increased demand is limited by capital constraints and underwriting capacity. Credit unions also noted the statutory limitation on the percentage of small business loans they may make (12.25 percent of total assets).
    - At several meetings, participants noted that some small businesses are turning toward non-mainstream finance sources such as factoring companies and pay-day loans, which carry higher fees and interest rates, due to the lack of conventional credit sources.
    - In Detroit, credit union service organizations are working to provide scale for making small business loans by centralizing some aspects of the underwriting process.
    - On the other hand, in New York, some credit unions indicated that outsourcing underwriting is not always an effective solution to capacity constraints, stating that they lose control over quality in outsourcing.
    - A credit union in Tampa expressed the view that credit unions that are new to small business lending do not have an established infrastructure to compete with the bigger banks, particularly in areas such as SBA programs.

- In Nashville, it was noted that some CDFIs are receiving loan applications from businesses that they would not expect to hear from, such as more-established businesses whose financial conditions are better than those of clients they served several years ago.
- In Chicago, the Chicago Urban League, which offers bridge loans to companies that have gone through its entrepreneurship training and coaching programs, reported making such loans to businesses that could not get credit from banks. A banker indicated that several banks participating in the meeting were founding investors in the League's loan fund.
- At several meetings, CDFI participants described the challenges in becoming authorized to provide loans under the SBA's 7(a) program.

### **Factors Impacting the Demand for Small Business Credit**

Small businesses and bank participants noted that the economic downturn has diminished sales for many small businesses, weakening balance sheets and asset values and thus dampening small business loan demand. Some financial institutions reported weaker quality in loan applications from small businesses. Comments related to credit demand by small businesses included issues of reduced credit quality, reduced confidence, a need for additional technical assistance, and interest in government contracting and entrepreneurship.

**Reduced credit quality** – Banks generally attributed the decrease in overall lending to small businesses to their declining sales and asset valuations. They reported lower overall demand for credit from creditworthy businesses. Some financial institutions also noted that applications for small business credit generally have become weaker as the challenging economic environment continues. Still, as noted previously, many credit unions and CDFIs cited an increase in demand for small business loans from viable small businesses.

**Reduced confidence** – A number of small businesses reported that declining sales made them more cautious about seeking credit. Some commented that the danger in waiting too long was that, by the time they sought a loan, their financial position had deteriorated to a point that raised underwriting concerns. Many small businesses expressed uncertainty about business prospects in the near future, affecting current credit and business decisions. Some owners reported making decisions based on the perception of tight credit without having explored credit options.

- In Annapolis, a former small business owner reported selling her health-care business because of concerns that her line of credit would be cut while addressing challenges associated with the extension of payment terms by her clients. Her core business was fine, but she was concerned about liquidity and the ability to meet obligations, such as payroll, in a timely way.

**Increased demand for technical assistance** – Small businesses described the challenges associated with operating under distressed economic conditions. Many described working with reduced staff and the impact of labor reductions on the resources necessary to manage the credit process. Several bankers indicated that small businesses need help locating suitable lenders and technical assistance to prepare business plans and loan applications. Technical assistance providers indicated that a growing portion of their clients are existing businesses and the long-



time unemployed who hope to start a business. Meeting participants also noted the need for technical assistance among minority-owned businesses, which face particular challenges in accessing credit.

- In St. Louis, a participant stated that demand for technical assistance is up 150 percent at Small Business Development Centers (SBDCs). Some of this demand stems from increased interest in entrepreneurship among recently unemployed or underemployed individuals.
- At several meetings, participants mentioned that minority business owners often do not have strong networks, limiting their access to financial resources, technical assistance, or mentoring.
- In Miami, several meeting participants noted that Hispanic businesses face unique challenges due to the lack of tools and training in Spanish. They stated that Hispanic business owners may not be aware of the programs and resources available to assist small businesses or the types of documentation and information that banks require for credit decisions.
- In Omaha, nonprofit leaders expressed the view that improving the financial management skills of minority business owners is a critical step in enhancing their creditworthiness.

**Interest in government contracting** – Participants at several meetings mentioned that government contracting is an opportunity for minority-owned businesses, yet they need access to credit to fulfill the contracts. Minority-owned businesses often do not have the working capital needed to make up-front purchases or to sustain operations during the significant payment lag with government contracts.

- In Omaha and Nashville, government officials said that they have seen increasing interest among small businesses in becoming a certified minority-owned business for government contracting purposes.
- In Birmingham, an SBDC representative said that government contracting is a great opportunity for minority-owned businesses, but the payment lag is a significant challenge.

**Interest in entrepreneurship** – The high-unemployment environment is generating demand as more individuals who are jobless seek to start their own business.

- Participants in the Morgantown meeting noted that start-ups are being created by retirees, people seeking a second career, and people looking for first or second jobs.
- At the Phoenix meeting, a number of CDFIs and microlenders reported increased interest in their loan products -- one said demand had quadrupled -- from people who lost their jobs and are seeking to start a small business.

### **Identified Credit Gaps**

A combination of disruptions on the supply and demand sides of the small business credit market, as discussed above, has resulted in notable credit gaps.

- ***Lines of credit and working capital*** – Small businesses reported that existing lines of credit had been reduced, hampering their ability to offset lower cash flows that stem from slower sales or slower customer payments. As a result, small businesses reported that they had to scramble to meet intermediate financing needs and change their business models to adapt to less credit availability. Banks, on the other hand, reported reassessing outstanding lines of credit in order to reduce their exposure to losses and minimize their capital needs. Banks also noted that small businesses had changed how they used their lines in the economic downturn, using them for major purchases and salaries rather than as short-term revolving credit. Some banks noted that, in such situations, they have converted lines of credit into term loans, which have higher finance costs.
  - In Detroit, the CEO of one auto supplier noted that while most of the manufacturers in the auto industry have restructured so that they are profitable, the companies toward the bottom of the supply chain are still struggling to obtain working capital and to finance their equipment purchases. Other auto suppliers at the meeting noted that many lines of credit were frozen in 2009 and that banks that had historically provided credit to the industry have continued to limit their lending, such as by reducing lines of credit, pricing them higher, or renewing them for more limited periods of time.
  
- ***Refinancing credit*** – Small businesses expressed concern about their ability to refinance loans, particularly those related to commercial real estate. In some cases, business owners faced an immediate need for cash to repay the balance of their maturing balloon loans, even where the firm still had an ability to repay the loan, because of reduced collateral values or tightened underwriting standards. To address their immediate needs for credit, many small businesses reported using credit cards and personal credit resources, such as 401(k)s and home equity lines of credit. As a result, many small businesses noted the need for loans to refinance these credits at lower rates.
  
- ***Small-dollar loans*** – Several small business participants cited the need for smaller dollar loans, particularly in amounts under \$200,000. Microlenders in some markets were able to help address the need for loans under \$35,000. Larger bank participants acknowledged that they reduced or curtailed small dollar loans altogether because of the expense in time and resources required to make these loans.
  - In Des Moines and St. Louis, larger banks indicated that they reduced or stopped providing loans under \$200,000 because such loans require as many resources as larger loan amounts but do not provide the needed income to offset these costs.
  - In Tampa, several technical assistance providers reported that very few banks would offer loans under \$100,000, leaving a significant credit gap. The SBA Community Express loan was cited as an option (although some considered it too expensive), but there were no local lenders who offered this product.
  
- ***Commercial real estate*** – Banks reported that they suffered significant losses in their commercial real estate portfolios. One bank stated that 50% to 60% vacancy rates were not uncommon in his area. Many banks reported that they have tightened underwriting standards in this segment, including requirements for higher borrower equity, stronger debt coverage ratios, lower vacancy rates, as well as stronger personal guarantees. Small

businesses confirmed these tighter loan standards and noted that, for existing loans, they were required to pledge additional cash or other assets to make up gaps created by commercial real estate that appraised at lower market values.

- ***Patient capital*** – Both banks and small businesses cited the need for sources of patient capital to assist small businesses in financing equipment and other large purchases. For capital-intensive businesses, such as manufacturing, a larger loan for equipment or materials needs a longer repayment period to provide sufficient time for sales to pick up and generate cash flow for repayment of the loan.
  - In Annapolis, service businesses, such as small law firms, discussed the need to hire staff to meet an expected increase in clients or contracts. They cited a lag between the hiring and the receipt of revenues from services provided. Small business participants indicated that banks are not willing to finance this particular need.
  - In Detroit, a meeting participant pointed out that sustained advancements in technology in the auto supply sector depend on the availability of longer-term financing for the same small businesses that are finding it difficult to finance working capital and the long-overdue replacement of basic equipment.
  
- ***Loans to distressed industries*** – Banks reported that they are reducing their exposure to certain industries with high loss rates.
  - In New York, bankers noted that certain sectors, such as construction, real estate, and services were particularly hard-hit by the recession, making new loans within these sectors more difficult to finance.
  - In Cleveland, bankers reported similar constraints on lending in the residential construction, commercial real estate, and automobile sectors. Small businesses affected by the reduction in credit within these industries expressed frustration over their inability to secure loans regardless of the quality of their financial condition.
  - In Detroit, an automotive supplier industry official noted that credit availability for the tooling required to support new vehicle launches is constrained, given the continued level of industry, customer, and supplier risk. He expressed the view, however, that it is precisely such innovations that will improve the industry's risk/return ratios and investment attractiveness.
  
- ***Start-up capital*** – Small businesses and bankers agreed that start-up businesses have always had difficulty obtaining financing, and that now it is almost impossible to secure bank credit. At several meetings, participants noted an increased demand for this type of financing, particularly given the number of unemployed workers who are now looking to start businesses.
  - In Memphis, start-up capital was identified as a significant need, yet some financial institutions indicated that they lend only to firms with five years of operating experience.
  - A Cleveland meeting that focused on venture capital highlighted the downward trend in the availability of venture capital equity. Participants noted that until

financial returns improve, this avenue for funding new and innovative businesses will likely remain suppressed.

### **Identified Recommendations**

The following are key recommendations for potential next steps that were identified by participants at the July 12 capstone event at the Board of Governors as well as throughout the System's series of meetings. In addition, the Reserve Banks are planning a variety of efforts for the remainder of 2010 to follow up on the information and recommendations from the previous meetings or to hold further meetings in other locations. Attachment B contains a list of some of these activities.

### **Regulatory and Legislative Environment**

- Participants expressed the need for continued and consistent dialogue between financial institutions and examination staff and greater clarity of supervisory expectations from regulators. They recommended continued use of guidance that includes real-world examples. Another suggestion focused on establishing a means through which institutions can report concerns about or appeal an examiner's decision to the regulatory agency through a neutral intermediary such as an ombudsman.
- Some participants emphasized the need for greater Community Reinvestment Act (CRA) consideration for community development loans and investments such as Equity Equivalent Investments (EQ2s) or program-related investments. They also noted that banks should receive greater consideration for investments and grants that increase access to lending capital, loan-loss reserves, loan packaging, and technical assistance. Such favorable consideration could encourage banks to engage in activities such as purchasing SBA loans or a participating interest in notes or portfolios; extending lines of credit for the warehousing of SBA loans prior to sale; or providing operating grants to assist CDFIs in obtaining or maintaining authorization required by the SBA or other licensing bodies.
- There was a recommendation to make the New Markets Tax Credit program more supportive of small business lending by establishing a safe-harbor provision or taking other steps that could encourage investors to make equity investments in community development entities that lend or invest in small businesses.
- There was support expressed for the Administration's proposal for a \$30 billion small business lending fund, including: \$2 billion to support innovative state programs that seek to stimulate and leverage additional private funds, \$1 billion for equity financing for start-ups, and \$300 million for CDFI loan funds.

### **SBA-Related Issues**

- Participants, particularly banks, expressed strong support for the SBA enhancements that extend fee waivers and increase the guarantee limits for the 504 and 7(a) programs. They also emphasized the need for certainty and clear expectations regarding the duration and terms of the enhancements, noting the challenges of adapting to periodic and temporary changes in the programs.

- Participants recommended improving access for CDFI loan funds to participate as guaranteed lenders in the SBA 7(a) program in order to increase the availability of credit to the underserved markets that CDFIs serve.
- There was general support for more simplification and consistency in SBA regulations, guidelines, and processes to reduce confusion for both lenders and borrowers. One suggestion focused on the possibility of using additional technology, such as a web-based system, to streamline the loan application and notification process.
- Participants commented on the need for more education about SBA programs for financial institution examiners. For example, the Federal Reserve recently partnered with the SBA to conduct this type of training, and similar trainings could be arranged with the other financial institution regulators. Additionally, it was suggested that local and regional SBA field examiners could provide more frequent instruction and guidance to lenders.
- Other recommendations regarding SBA loan programs included setting higher ceilings for loan amounts, such as increasing the microloan limit from \$35,000 to \$50,000, and expanding the Community Express Pilot program to encompass participation by CDFIs and other mission-driven lenders with sufficient capacity. There was also support for allowing the 504 program to be used for refinancing owner-occupied commercial real estate.
- Some participants recommended the issuance of regulatory guidance related to SBA 504 first mortgages, including suspending the requirements for extra reserves for classified loans and allowing the refinancing of owner-occupied businesses, even when the loan-to-value ratio has increased.

### **Lender-Related Issues**

- Participants noted the success of financial institutions' use of "second look" or similar programs to help ensure that viable applicants are not overlooked and that decisions such as credit-line reductions are warranted. Participants recommended broader use of such programs by financial institutions. A lender recommended that, as part of a second-look review, financial institutions consider a borrower's interim financial statements for the most recent six-month period in cases where a borrower has experienced recent improvement and the denial was due to a weaker condition of the borrower as reflected in annual financial statements.
- Lenders emphasized the need to receive complete and accurate documentation from small business loan applicants so that loan decisions can be made in a timely manner. Items such as reliable financial statements and accurate tax identification numbers were highlighted as examples.
- Participants noted the use of innovative credit programs to encourage small business borrowing, such as a "loan-for-hire" program that reduces the interest rate for an existing small business borrower if the business commits to hiring employees.

- Participants also encouraged lenders to demonstrate a greater commitment to and process for referring borrowers to alternative lenders, technical assistance providers, and counselors for appropriate technical assistance and financing solutions.

### **CDFI-Related Issues**

- There was support expressed for more low-cost, longer-term capital for CDFIs. Such capital, for example, would allow CDFIs to add a risk premium and still be able to make small business loans to meet demand from viable small businesses that may not qualify under conventional bank standards and products. In addition, increased grants or other operational subsidies would help CDFIs to cover the costs of providing technical assistance and advisory services to small business clients as well as to boost their loan-loss reserves.
- One participant recommended that policymakers consider capital models for CDFIs that further leverage private dollars and create innovative incentives for the private sector to partner with experienced CDFI fund managers with strong risk-management capacity. For example, the potential allocation of \$300 million to CDFI loan funds as part of the proposed \$30 billion small business lending fund could be efficiently distributed through the CDFI Fund by a competitive process giving more points to proposals that combine experienced CDFI fund managers with private-sector capital sources and that put the private debt in a first-loss position relative to the public-sector debt capital.
- Participants recommended that banks and CDFIs set up more effective and consistent processes for banks to refer small business applicants whose credit needs they cannot meet to CDFIs.
- One participant noted that while CDFIs have demonstrated the ability to successfully underwrite the risks inherent in small business loans, this success has been achieved at relatively small volume levels in comparison to the need. He stated that efforts to significantly increase CDFI small business lending capacity must recognize the critical need for scalability in areas such as the receipt and review of applications and the underwriting, servicing, and collections of small business loans. He recommended that CDFIs consider outsourcing some of their operations to providers with more cost-effective approaches, systems, and technologies, including other CDFIs or mainstream financial institutions.
- Participants urged greater use by financial institutions and investors of existing evaluation and ratings systems for assessing CDFI performance and impact, such as the CDFI Assessment and Ratings System (CARS) administered by the Opportunity Finance Network.
- Other suggestions included expanding the access of CDFIs to government small business lending programs such as the Department of Agriculture's Rural Development Program and CDFI Fund financial assistance. One CDFI participant urged modifications to provide improved access for CDFIs to become members of the Federal Home Loan Bank System as well as greater access to Federal Home Loan Bank affordable capital.
- Some participants expressed the need for limited regulation and oversight of CDFIs to help them improve their performance and access to capital. Comments cautioned against

applying the same framework to CDFIs that currently applies to traditional financial institutions in order to ensure that CDFIs continue to have flexibility in underwriting and can focus on their mission-driven activities.

### **Small Business Support Services**

- Participants emphasized the importance of both pre- and post-financing technical assistance and the critical need for a dedicated source of funding to adequately compensate providers of such services. They noted the effectiveness of post-loan technical assistance as a risk-mitigation tool, helping to reduce the number of business failures, as well as a way to support business expansion.
- Additional suggestions focused on increased use of the SBA Service Corps of Retired Executives (SCORE) and other similar business counseling program as well as initiatives that connect small businesses with each other to facilitate peer mentoring.
- Participants noted the need for advisory services to provide guidance to small businesses on the type of capital – from equity to debt – that best matches their financial state and funding needs. Some participants noted that the current dialogue about small business finance tends to emphasize debt even in cases where other forms of capital are more appropriate. Participants also noted that the multitude of government, non-profit, and private sector efforts around small business finance should include consideration of the entire capital structure.

### **Research and Data**

- Participants expressed the need for timely, meaningful, and accurate data related to small business lending. Some participants also noted a trade-off between potential benefit of additional data and the increased resources and time needed to gather such data. Potential data collection issues included:
  - More frequent data collection, such as on a quarterly basis;
  - Time-series data, to allow for a more complete understanding of historical trends and more effective comparative analysis;
  - Greater access to private-sector data;
  - Enhanced segmentation of data, such as by firm size (e.g., number of employees) and loan amount; and
  - Greater collaboration and coordination of data collection among federal agencies.
- Some participants noted data gaps and suggested gathering additional information related to a variety of categories of small business lending including:
  - Loan application and origination information;
  - Appraisal and collateral values for commercial and personal real estate;
  - Intangible assets and their valuation, particularly for virtual or knowledge-based businesses;
  - Improved CDFI lending and microfinance activities;
  - Advisory services and other technical assistance for small businesses;
  - Business start-ups and “restarts,” firm size, and firm age; and
  - Factors related to small business growth.

**Attachment A: List of Federal Reserve System Small Business Meetings**

<b>DATE</b>	<b>LOCATION</b>	<b>FED DISTRICT</b>	<b>THEME/DESCRIPTION</b>
2/3/2010	Lexington, KY	Cleveland	--
2/8/2010	Cincinnati, OH	Cleveland	--
2/9/2010	Cleveland, OH	Cleveland	--
2/10/2010	Dayton, OH	Cleveland	--
2/10/2010	Pittsburgh, PA	Cleveland	--
2/11/2010	Cleveland, OH	Cleveland	--
2/23/2010	Omaha, NE	Kansas City	Minority entrepreneurship
2/24/2010	Denver, CO	Kansas City	SBA guaranteed loan programs
2/25/2010	St. Louis, MO	St. Louis	--
3/4/2010	Little Rock, AR	St. Louis	--
3/9/2010	Las Cruces, NM	Dallas and Kansas City	Minority entrepreneurship
3/11/2010	New York, NY	New York	Small focus group meeting
3/12/2010	New York, NY	New York	Small focus group meeting
3/23/2010	Newark, NJ	New York	Small focus group meeting
3/26/2010	Memphis, TN	St. Louis	--
3/31/2010	Louisville, KY	St. Louis	--
4/13/2010	Morgantown, WV	Richmond	Small focus group meeting
4/14/2010	Minneapolis, MN	Minneapolis	Bank's Small Business Council
4/15/2010	Phoenix, AZ	San Francisco	Listening session - CDFI lending
4/20/2010	Chapel Hill, NC	Richmond	--
4/21/2010	Miami, FL	Atlanta	Hispanic-owned businesses
5/6/2010	Pittsburgh, PA	Cleveland	--
5/14/2010	Milwaukee, WI	Chicago	--
5/18/2010	Duluth, MN	Minneapolis	--
5/19/2010	San Francisco, CA	San Francisco	Small business task force
5/19/2010	Davenport, IA	Chicago	Hispanic-owned businesses
5/19/2010	Toledo, OH	Cleveland	--
5/20/2010	Indianapolis, IN	Chicago	--
5/20/2010	Columbus, OH	Cleveland	--
5/24/2010	Cincinnati, OH	Cleveland	--
5/25/2010	Nashville, TN	Atlanta	--
5/26/2010	Cleveland, OH	Cleveland	--
5/27/2010	Milwaukee, WI	Chicago	
6/2/2010	Annapolis, MD	Richmond	Small focus group meeting
6/3/2010	Tampa, FL	Atlanta	--
6/3/2010	Springfield, MA	Boston	Financial institutions
6/3/2010	Detroit, MI	Chicago	--
6/7/2010	Baton Rouge, LA	Atlanta	Small focus group meeting
6/8/2010	Gulfport, MS	Atlanta	Small focus group meeting
6/11/2010	Chicago, IL	Chicago	--
6/14/2010	Baltimore, MD	Richmond	--
6/30/2010	Phoenix, AZ	San Francisco	Small focus group meeting
6/30/2010	Shreveport, LA	Dallas	Small focus group meeting



## **Attachment B: Planned Reserve Bank Community Affairs Activities on Small Business**

*The information below describes key activities that Community Affairs Offices of Federal Reserve Banks are planning for the remainder of 2010 in response to issues that were raised at the Federal Reserve System's regional small business meetings or as a way to expand those meetings to other locations. This does not represent a comprehensive list of all Reserve Bank Community Affairs small business activities in 2010.*

### **Federal Reserve Bank of Atlanta**

- Events
  - Research conference on October 26-27 in partnership with the Federal Reserve Bank of Dallas and the Ewing Marion Kauffman Foundation. The conference is titled “Small Business, Entrepreneurship, and Economic Recovery: A Focus on Job Creation and Economic Stabilization.”
  - Banker roundtable in Birmingham, Alabama, on July 28 and a forum in Palm Beach, Florida, in September.
  - August event with the Baton Rouge Area Chamber of Commerce and the LSU Small Business Development Center.
- Research
  - Survey of small businesses owners and intermediaries in the Sixth District, in partnership with the Bank's Research Division.
  - Research on CDFI capacity for small business lending and the state of microenterprise lending in the Sixth District.
  - Discussion papers focusing on the effect of social networks on small business access to financial resources; small business job creation and destruction in the current and previous recessions and recoveries; and small business and neighborhood stabilization.

### **Federal Reserve Bank of Boston**

- Research
  - Analysis of data collected in a survey on small business lending in New England to which more than 125 community banks have responded.

### **Federal Reserve Bank of Chicago**

- Events
  - August meeting with SBA District Directors and State Directors to follow up on meetings held in Illinois, Indiana, Michigan, and Wisconsin.
  - Fall meeting in the Quad Cities area (Davenport, Iowa, and several counties in Northwest Illinois) with a special focus on minority-owned and rural business issues.

- Meeting with Michigan bankers and the Michigan Economic Development Corporation (MEDC) to discuss MEDC's lending program for manufacturers that are having trouble obtaining financing for growth.
- First statewide CDFI conference in Wisconsin in the fall.

### **Federal Reserve Bank of Cleveland**

- Research
  - Survey of Ohio bankers, in partnership with the Ohio Bankers League, focusing on small business credit conditions, trends in lending, and the impact of the regulatory environment on bankers' decisions to lend to small businesses.

### **Federal Reserve Bank of Dallas**

- Events
  - Interagency Small Business Forum in Houston on July 29.
  - Research conference on October 26-27 in partnership with the Federal Reserve Bank of Atlanta and the Ewing Marion Kauffman Foundation.

### **Federal Reserve Bank of Kansas City**

- Events
  - Meeting about guaranteed lending programs in New Mexico on August 19 in Albuquerque.

### **Federal Reserve Bank of Minneapolis**

- Events
  - Meeting on August 13 in South Dakota that will focus on microenterprise, small business, and workforce development on the state's reservations.
  - Meeting of researchers from around the Federal Reserve System in late August to discuss work in the area of small business financing and develop ideas for future lines of inquiry.

### **Federal Reserve Bank of New York**

- Research
  - Survey of small business owners and independent workers in New York, New Jersey, Delaware, and Pennsylvania and report on the findings from the 560 responses.
- Events
  - Briefings on survey findings for New York civic and business organizations and for New Jersey, Delaware, and Pennsylvania community partners in conjunction with the Philadelphia Fed.

- Series of workshops, in partnership with New York City small business agencies, focusing on key technical assistance needs.

### **Federal Reserve Bank of Philadelphia**

- Events
  - Briefing on the findings of a survey conducted by the New York Fed (see above) for New Jersey, Delaware, and Pennsylvania community partners.

### **Federal Reserve Bank of Richmond**

- Events
  - Small business forum on July 22 in Charlottesville, Virginia, in partnership with Tayloe Murphy Center at the University of Virginia's Darden School of Business and the Virginia Bankers Association.
  - Training session for financial institutions about government lending programs in Baltimore on September 29, in partnership with the Maryland Department of Business and Economic Development, the Maryland Bankers Association, and the Retail Merchants Association.
- Research
  - Small business field study in North Carolina and a small business credit conditions report for the Fifth District.

### **Federal Reserve Bank of St. Louis**

- Events
  - Meeting with stakeholders on July 19 to discuss the possibility of creating a small business loan fund for the St. Louis region.

### **Federal Reserve Bank of San Francisco**

- Events
  - July meeting of the California Small Business Task Force, which was formed as a result of the System's series.
  - Four meetings in Washington state to identify the credit needs of small businesses and education stakeholders: July 14 in Richland; July 15 in Yakima; July 20 in Bellingham; and July 22 in Wenatchee.
  - Microenterprise conference on October 15, with the Oregon Microenterprise Network.
  - Workshops on economic development in Indian Country, in partnership with the CDFI Fund and HUD: July 28 in Sacramento; August 17 in Seattle; August 19 in Anchorage; and September 16 in Albuquerque.

- Business Leadership Summit on October 13, in partnership with the Turlock (California) Chamber of Commerce, focusing on small business financing needs in California's Central Valley.
- Research
  - Paper on small business lending in low- and moderate-income census tracts during the financial crisis.