Frederic S Mishkin: Availability of credit to small businesses

Testimony by Mr Frederic S Mishkin, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Small Business, US House of Representatives, Washington DC, 7 November 2007.

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Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee, I am pleased to appear before you on behalf of the Board of Governors of the Federal Reserve System to discuss the availability of credit to small businesses. Small businesses, generally defined as firms having fewer than 500 employees, are critical to the health of the U.S. economy. For example, small businesses employ more than half of private-sector workers, generated well over half of net new jobs annually over the past decade, and create more than half of nonfarm business gross domestic product. Moreover, larger firms often begin as smaller firms that prosper and grow. If small businesses are to continue to provide major benefits to the economy, their access to credit is clearly a high priority.

The first and largest part of my statement will cover the highlights of the Board's most recent periodic report to the Congress on the availability of credit to small businesses, which was submitted on October 26.[1] The second portion of my testimony will address the unusual stress imposed on credit markets in recent months and how that stress may affect small businesses. By necessity, the latter remarks are preliminary and subject to an unusually high degree of uncertainty.

Highlights of the 2007 report to the Congress

As you know, the Board is required by law to report to the Congress every five years on the status of small business access to credit. The current report covers the period from mid-2002 (generally the time of the latest data in the previous report) through June of this year. Looking first at an aggregate level, and using a variety of data sources, our 2007 report indicates that, since 2002, financing flows to both small and large firms generally increased along with economic activity. Credit conditions during the period were favorable for small and large firms, and we have no evidence that creditworthy borrowers faced any substantial constraint on their access to credit. The demand for credit by small businesses generally tracked the pattern for nonfinancial businesses overall. Indicators of financing needs for small businesses suggest that demand picked up in 2004 from low levels in 2003 but moderated in 2006 and early 2007.

Looking more deeply, our report discusses the sources and types of credit used by small businesses, the effects of developments such as bank consolidation, increased use of credit scoring and securitization, and the role of community development activities on the availability of credit to small businesses. Moreover, underlying the congressional mandate to produce this report is a concern that small firms have more difficulty gaining access to credit than do large businesses. The source of this concern may be that lending to small businesses is generally considered riskier and more costly than lending to larger firms. For example, small businesses tend to be much more affected by swings in the economy and have a much higher failure rate than larger organizations.

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[1] Board of Governors of the Federal Reserve System (2007), Report to the Congress on the Availability of Credit to Small Businesses (748 KB PDF), submitted to the Congress pursuant to section 2227 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Washington: Board of Governors, October).

In addition, lenders historically have had difficulty determining the creditworthiness of some applicants for small business loans. The high level of diversity across small firms, together with their widely varying uses of borrowed funds, has impeded the development of general standards for assessing applications for small business loans and has made evaluating such loans relatively expensive. Lending to small businesses is further complicated by the fact that reliable information on the creditworthiness of a small business is often difficult to obtain because little, if any, public information exists about the performance of most small businesses. Small businesses rarely issue publicly traded equity or debt securities, and many small businesses also lack the detailed balance sheets and other financial information used by lenders in making credit decisions.

Financial institutions, especially commercial banks, are thought to have an advantage in dealing with information problems. Through interactions with a firm that uses its services, including the firm's owners and key employees, a financial institution can obtain information about the firm's activities, ownership, financial characteristics, and prospects that is important in deciding whether to extend credit and on what terms. Employing what is often called "relationship finance," banks and other financial intermediaries can use information gathered over time through long-term relationships with small businesses and other members of the local community to monitor the health of the small businesses to which they lend and to build appropriate terms into loan agreements.

Results from the Board's 2003 Survey of Small Business Finances (SSBF) support the view that commercial banks have an advantage in lending to small businesses. The survey data show that, although small businesses obtain credit from a wide range of sources, including savings institutions, credit unions, finance companies, nonfinancial firms, and individuals such as family members or friends, commercial banks are today, as in the past, the leading provider. For example, commercial banks supplied traditional credit – credit lines, loans, and leases – to slightly more than two-thirds of small businesses that obtained such credit from any source. Banks were also the most common source of mortgages and equipment loans, and they were second only to finance companies as the source of automobile loans.

Data from our 2003 survey also indicate that among small businesses, relatively large firms (whether measured by sales, assets, or number of employees), and relatively older firms, were more likely than smaller or younger firms to use a wide range of types of credit, including credit lines, capital leases, motor vehicle loans, mortgages, and equipment loans. The reasons for these differences are unclear; it may be that larger or older firms have more-complex funding needs, or perhaps lenders are simply more willing to extend credit to larger or older firms.

In addition to traditional sources of credit, small businesses often use alternative sources, including credit cards, trade credit, and owner loans. Of the alternative sources, only business credit cards registered an appreciable increase in usage between 1998, the year of the Board's previous SSBF, and 2003. Although most small businesses used credit cards and trade credit, the rapid payment of outstanding balances by a large percentage of these firms suggests that much of the use of these products was for convenience rather than for longer-term financing.

The amount of credit that the SSBF and other data sources indicate was used by small businesses may have been less than the amount those firms desired, especially smaller and younger firms. According to our survey, about 20 percent of small businesses applied for new credit between 2000 and 2003, and more than 80 percent of those firms had an application approved. Relatively larger small businesses (again, whether measured in terms of sales, assets, or employees) were more likely than smaller firms to apply for new credit and were more likely to have their applications approved. In addition, although the proportion of small businesses applying for credit did not vary much by age of the firm, younger firms were more likely than older ones to be denied credit. The finding that both smaller and younger firms have their loan applications denied more frequently is consistent with the conventional view that these firms are riskier, have shorter credit histories or less collateral to pledge as security, and are generally harder for lenders to evaluate because they are less transparent.

Because banks are the leading source of traditional credit to small business, much attention has been paid to developments in banking that may influence credit availability. The substantial consolidation of the banking industry over the past twenty years is one such development. Mergers and acquisitions have dramatically reduced the number of banks, thereby increasing the concentration of industry assets and the importance of large institutions. Although larger banks supply the majority of bank loans to small businesses, small business loans tend to comprise a smaller proportion of assets at larger banks than at smaller banks. Hence, the changing structure of the industry has raised concerns about possible reductions in the availability of credit to small businesses.

Studies that directly analyze the relationship between bank consolidation and the availability of credit to small businesses tend to suggest that, although mergers and acquisitions may sever existing bank-firm relationships and may introduce some short-term uncertainty, bank consolidation overall has not reduced credit availability to small businesses. After a merger, any reduction in small business lending by the newly consolidated bank is generally offset by an increase at other banks. In addition, the evidence suggests that the thousands of small banks still in operation continue to account for a meaningful share of small business lending. For example, in 2006, about three-fourths of banks had assets of $250 million or less. Although such banks accounted for only 5 percent of all banking assets, they held a disproportionately large share of all small loans issued by banks to businesses: 16 percent for loans of $1 million or less and 21 percent for loans of $100,000 or less.

As was true of our 2002 report, the 2007 report emphasizes the importance to small businesses of geographic proximity to their source of credit. For example, our data indicate that in 2003 the median distance between a small business and its lender of any type was 11 miles (4 miles for depository institution lenders); and the lender was located within 30 miles of the firm's headquarters in 66 percent of all small business lending relationships (in 83 percent of relationships with depository lenders).

The importance of local providers of credit to small businesses underscores the need to preserve competitive banking markets at the local level. Despite the significant consolidation in the banking and thrift institution industry, the data indicate that competitive conditions in the nation's local banking markets have remained quite stable. For example, since 2002, measures of average market concentration in both urban and rural banking markets have either declined slightly or remained the same. In short, the slight reduction in concentration seen in local markets in recent years suggests that the availability of small business credit from commercial banks and thrifts has not declined.

Credit scoring has been used for more than thirty years in underwriting consumer loans, but it has become common in assessing small business credit applications only since the mid-1990s. On the one hand, the use of credit scoring for small business lending has raised concerns that it may disadvantage firms that find it difficult to qualify for loans on the basis of only a formal credit score. On the other hand, credit scoring may increase the availability of credit for small businesses by improving the consistency, objectivity, and speed of credit evaluations while lowering the cost of gathering relevant information. In addition, it may have the potential to increase a lender's ability to accurately predict loan performance and may increase access to capital markets. Evidence to date regarding the effect of credit scoring on credit availability is consistent with the view that the use of scoring models increases the availability of credit to some small businesses.

Additionally, because the use of credit scoring models in small business lending has only recently become more commonplace, at this time, it is not clear how small business credit-scoring models perform relative to traditional reviews of such loans, especially during a major economic slowdown. However, users of the models generally report that, after their adoption,

(1) the riskiness of the small business portfolio either remains about the same or declines, and (2) the quality of the typical credit decision increases.

Loans to small businesses operating in low- and moderate-income areas may be influenced by the obligations of insured depository institutions under the Community Reinvestment Act (CRA). The CRA does not require that banks lend to small businesses, but it reaffirms that federally insured banks and thrifts have continuing and affirmative obligations to help meet the credit needs of all the communities they serve, including low- and moderate-income neighborhoods. Although much of the small business lending of depository institutions in such neighborhoods cannot be directly attributed to the CRA, bankers and community representatives indicate that some of it is the result of individual institutions responding to their CRA obligation. Beyond conducting lending programs that are part of their normal operations, banks often develop or work with specially created entities focused on providing credit in underserved communities. Some of these entities operate wholly within a bank's legal structure, some are partnerships with other service providers, and still others are stand-alone organizations in which banks invest. These programs encourage credit and equity capital to flow where it otherwise might not.

In addition, a number of trends in the community development field either are just beginning to influence the delivery of capital to small businesses or have the potential to do so in the near future. Some of these trends, such as the proliferation of financial literacy and outreach programs, are primarily initiatives of financial services firms themselves. Others result from government actions to stimulate lending. Still others involve new hybrid partnerships among banks and nonbank entities such as local microloan funds, a subject addressed yesterday by Chairman Bernanke in a speech in San Antonio. These trends, should they continue, are likely to result in improved access to credit and capital for small businesses.

A final topic addressed in our report is the securitization of small business loans, a development that could substantially influence the availability of credit to small businesses. Securitization offers potential benefits for lenders, borrowers, and investors. However, the obstacles to securitizing loans to small businesses are large, especially for loans not backed by a guarantee from the Small Business Administration (SBA). As a result, securitization has so far remained modest and is unlikely to increase substantially over the foreseeable future.

Small business finances and recent financial market developments

Financial market conditions began to deteriorate quite rapidly in the middle of August. Although conditions have steadily, albeit gradually, improved over recent weeks, problems could spill over to the market for small business loans. In recognition of this possibility for small businesses and other sectors of the economy, the Federal Reserve's policy actions during this period have been aimed both at restoring financial market liquidity and at helping offset the effects of tighter credit conditions on the broader economy.

I will briefly address the possible effects of the recent turmoil on small business access to credit. I emphasize that the possible effects are complex, that we do not yet have much hard evidence, and that it is far too early to draw any definitive conclusions. Thus, my comments should be viewed as preliminary and subject to an unusually high degree of uncertainty. I assure you, however, that the Federal Reserve is monitoring market conditions closely in an effort to better understand the combined effects of the housing market slowdown and financial market stresses.

There are good reasons to believe, and some evidence to suggest, that the recent financial market disruptions have not seriously harmed access to credit by small businesses, and if the disruptions continue to be resolved in an orderly manner, will be unlikely to do so in the future. For example, the current turmoil has centered on securities backed by nonconforming residential real estate loans and loans or other debts of relatively large firms; so-called collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs). Because, as I discussed earlier, the securitization of small business loans is still quite modest, we would not expect turmoil in the markets for securitized assets to have a large direct effect on small business lending.

In addition, it is the relatively large banks that are deeply involved in the loan securitization markets and that have sometimes chosen to conduct a significant portion of their business through so-called conduits, many of which have contracted rapidly in recent months. In contrast, it is the smaller banks that specialize in "relationship finance" to small businesses.nbsp; These banks are relatively unaffected by disruptions to the securitization markets. Thus, once again, we would expect that the direct effect of current events on small businesses would be limited. Indeed, the data we have on business lending at small banks show that such loans have continued to expand at a fairly robust pace through mid-October. Such data and our conversations with bankers suggest that, at least to date, the supply of credit to small businesses remains healthy.

Although these arguments and evidence are encouraging, recent events have nonetheless almost surely had some negative effects on small business access to credit, and we cannot rule out further effects. We know that risk premiums embedded in interest rates have increased across a wide range of debt instruments, that credit standards have tightened for most types of lending, and that investors are continuing to reassess both the risks of and the prices they are willing to pay for assets they are considering adding to their portfolios. Because loan terms, both risk premiums and credit standards, had previously been unusually low, in many ways these are welcome and healthy developments that, over the longer term, will produce a more efficient and stable financial system. But for many borrowers, including some small businesses, these developments also mean that credit now is, and will probably continue to be, less available and more expensive than it was a few months ago.

Recent surveys have found evidence that the market for small business credit has tightened. For example, the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, conducted most recently in October, indicates that banks generally tightened loan terms for all types of business borrowers over the previous three months. The most recent monthly survey of small business conditions sponsored by the National Federation of Independent Business (NFIB), conducted in early September, finds that the net percentage of small business respondents that had found credit harder to obtain over the previous three months and the net percentage that expected credit conditions to tighten over the next three months both reached levels not seen since the early 1990s.[2] Likewise, the Duke University/CFO Business Outlook survey for September reported that about one-fourth of the chief financial officers (CFOs) of small businesses that responded found credit to be more costly, or less available, or both following August's financial market turmoil.[3]

While these survey data certainly suggest that some tightening has occurred, it is important to observe that they also suggest that, at least for now, the effects have generally been quite limited. For example, a deeper look at our October Senior Loan Officer Opinion Survey data reveals that the tightening of terms on loans to small businesses was typically less severe than the tightening on loans to larger firms. Moreover, our survey indicates that small business loan demand held up rather well between our July and September surveys. In the NFIB survey, only a very small fraction of business owners cited the cost and availability of credit as their principal business concern. Indeed, in the commentary on its survey results, the NFIB has continually emphasized that borrowing to finance normal production is still running smoothly. In addition, both the NFIB's index of small business optimism and the fraction of firms in the survey that consider the next three months "a good time to expand" have remained at levels similar to those seen in the first half of this year.

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[2] About two-thirds of survey responses were collected before the September 18 policy easing by the FOMC.

[3] The survey was concluded on September 7.

Perhaps one of the most important concerns about the prospects for small business access to credit is that many small businesses use real estate assets to secure their loans. For example, data from our 2003 SSBF indicate that 45 percent of the total dollar amount of small business loans outstanding in 2003 was collateralized by some type of real estate asset. About 37 percent was collateralized by business real estate assets, and 15 percent was secured with "personal" real estate.[4] Looking forward, a reduction in the value of their real estate assets clearly has the potential to substantially affect the ability of those small businesses to borrow.

Similarly, declines in the value of real estate assets held by banks and other lenders may affect their ability to supply loans, as real estate losses use up capital that could otherwise be used for making new loans. In addition, if banks place on their balance sheets some assets that they had expected instead to place in conduits or otherwise sell to investors, the move could crowd out loans to small businesses and other borrowers. In fact, business loans surged in September and October primarily at large banks and banks affiliated with securities firms, institutions that, due to financial market conditions, likely had to retain on their books larger-than-expected portions of syndicated loan deals.

Fortunately, the vast majority of U.S. banks are well capitalized and thus should be able to maintain their lending capacity. In addition, lender constraints on small business loans may be mitigated somewhat by loan guarantees provided by the SBA. In the past, following declines in bank capital, the volume of loans associated with SBA guarantee programs contracted considerably less than the volume of other loans. However, as our report points out, SBA guaranteed loans are only a small portion of total small business loans. Thus, the possibility remains that reductions in real estate values and a permanent reassessment by investors of the risk of various financial market instruments could significantly affect access to credit; the Board will be monitoring the economy for signs of such an effect over the next few months.

The interdependencies between small business and household finance are among the most interesting and least understood aspects of small business access to credit. In addition to personal real estate assets, other household assets such as automobiles may be used as collateral for small business loans, and personal credit cards and savings accounts are sometimes used to help finance a small business. For example, our report documents that, in 2003, almost 47 percent of small businesses used personal credit cards in the conduct of their business. Most of this use appears to have been for convenience rather than longer-term borrowing. Nonetheless, such data suggest that a significant decline in the financial condition of households, should it occur, would be likely to affect economic activity through its influence on small business finances over and above the more traditional effects of such a decline on the aggregate consumption of the household sector. Thus, the interaction of the household and small business sectors is another area that the Federal Reserve will be monitoring over the coming months.

Conclusion

In conclusion, the health of the U.S. economy depends importantly on the vitality of the small business sector, and continued access to credit on competitive terms is central to that vitality. Our 2007 report to you indicates that, since our 2002 report, small business access to credit has been robust. Credit conditions have no doubt tightened since mid-August, but small businesses seem generally to have been able to retain access to credit. However, the effects of recent events are complex, the data are spotty and mixed, and it is far too early to draw

[4] The two components sum to more than 45 percent because some loans are collateralized by both business and personal real estate.

any firm conclusions. Moreover, the current level of uncertainty about the future is unusually high. Thus, the Federal Reserve will continue to monitor closely the effects of current financial market conditions on small business finances as part of its efforts to ensure that distress in financial markets does not spill over into the broader economy. More generally, I assure you that the continued good health of the small business sector is an important consideration for the Federal Reserve as we strive to fulfill the dual mandate given us by the Congress to promote both price stability and sustainable economic growth.