Frederic S Mishkin: Small business lending

Testimony of Mr Frederic S Mishkin, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Small Business and Entrepreneurship, US Senate, Washington DC, 16 April 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Kerry, Ranking Member Snowe, 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 are critical to the health of the U.S. economy. They 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. My testimony today will address the unusual stress imposed on credit markets in recent months and how that stress appears to be affecting small businesses.

Small business access to credit and the current financial market turmoil

As we all know, financial market conditions began to deteriorate quite rapidly in the middle of last August. In response to these and subsequent events, and in recognition that growth of the U.S. economy was slowing, the Federal Reserve has, since last fall, taken a number of strong actions aimed at both restoring the normal functioning of financial markets and at stimulating the real economy.

Although our actions appear to have helped stabilize the situation, financial markets remain under considerable stress. For example, many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and have increased the amount of collateral they require to back short-term security financing agreements. Credit availability has also been restricted because some large financial institutions, including some large commercial and investment banks, have reported substantial losses and asset write-downs, which reduced their available capital. The capacity and willingness of some large banks and other financial institutions to extend new credit has also been limited by the reduced availability of external funding from the capital markets for originated assets. The resulting unplanned increases in their balance sheets have strained their capital, thus reducing lending capacity. The good news is that several of these firms have been able to raise new capital, and others are in the process of doing so. However, market stresses are likely to continue to weigh on lending activity in the near future.

With this general background in mind, let me now address how the financial market turmoil of the past several months appears to have affected access to credit by small businesses. As you may recall, in my testimony before the House Committee on Small Business in November, I concluded that while credit conditions had no doubt tightened since mid-August, small businesses generally seemed to have been able to retain access to credit.[1] However, I emphasized that the uncertainty surrounding that conclusion was unusually high, and it was far too early to draw any firm conclusions. To some extent that is still the case, although we

[1] Frederic S. Mishkin (2007), "Availability of Credit to Small Businesses," statement before the Committee on Small Business, U.S. House of Representatives, November 7.

clearly have more information to work with now in assessing the effects of financial market turmoil on small business access to credit.

In its initial stages, the current financial market turmoil and associated problems in the housing market were focused on markets for securitized assets and affected primarily large financial organizations. In large part because only a small share of small business loans are securitized and because it is the relatively smaller banks that tend to specialize in providing "relationship finance" to small businesses, credit supply to small businesses held up rather well. Still, even in November it was clear that credit conditions had begun to tighten for small businesses.

The trend toward tighter credit supply conditions for small businesses has continued since last fall. For example, in the Board's most recent Senior Loan Officer Opinion Survey, conducted in January, a net one-third of the domestic banks surveyed – a larger net fraction than in the October survey – reported that they had tightened their lending standards on commercial loans to small firms over the previous three months.[2] Significant net fractions of banks also indicated that they had tightened price terms on commercial loans to both small and large firms. The net fractions of banks reporting tighter lending standards and pricing terms on commercial loans in the January survey were relatively high by historical standards going back to 1990.

Actual loan pricing data from our quarterly Survey of Terms of Business Lending are broadly consistent with the qualitative data from the Senior Loan Officer Opinion Survey. For example, data from our most recent survey, taken in February, indicate that the average interest rate on commercial loans relative to the bank's cost of funds (the bank's spread) rose modestly from the corresponding survey week of three months earlier. Of particular importance for small businesses, however, are the facts that these spreads jumped significantly both on loans originated by smaller U.S. banks and on smaller commercial loans – that is, those loans below $100,000.

Despite tighter credit standards and loan terms, growth in the dollar amount of commercial loans at U.S. banks was quite well maintained in the first quarter of 2008. Particularly noteworthy from the point of view of small businesses is the fact that after growing almost 20 percent in the fourth quarter of 2007, commercial loans at small banks continued to expand at a rate of almost 12 percent in this year's first quarter.[3] Thus, although slowing somewhat, commercial loan growth has held up in recent months even though banks' terms have tightened and economic growth has slowed, the latter driving down the demand for small business and other commercial loans. On balance, this suggests that credit is generally available, albeit at a higher cost.

Another source of information about small business credit supply conditions is the monthly survey of the National Federation of Independent Businesses (NFIB). The results of the most recent NFIB survey, conducted in March, suggest that credit supply conditions for small businesses have held up fairly well over the past several months. For example, over the past few quarters only about 3 percent of survey respondents have reported that financing conditions and interest rates were their main business concern, and for March that number was only 2 percent.[4] In addition, according to the NFIB survey, the average short-term interest rate paid by borrowers has remained at the low end of its historical range. On a less

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[2] Board of Governors of the Federal Reserve System (2008), "The January 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices" (January). In October, a net 10 percent of banks reported tightening lending standards to smaller firms. The net percent of banks is defined as the percent tightening less the percent easing standards.

[3] The first quarter's numbers have been adjusted for some statistical anomalies in February.

[4] These levels are far below their peaks of the early 1980s, when more than one-third of respondents reported that financing conditions were their main concern.

positive note, in recent months the net percentage of NFIB survey respondents that reported credit was harder to obtain over the previous three months and the net percentage that expected credit conditions to tighten over the next three months have been at the upper end of their ranges observed over the past few years. Still, these percentages have remained well below their highs reached in the early 1990s and are below their levels from last September's survey when they temporarily spiked up.

On the demand side, the NFIB survey's results are quite pessimistic. For example, the survey's index of small business optimism has dropped to its lowest level since the monthly surveys began in 1986, as the net percentage of borrowers that believe it is a good time to expand their business has fallen to the bottom of its range over the past two decades. This contrasts sharply with survey responses last September which indicated that the NFIB's index of small business optimism and the fraction of firms that considered the next three months "a good time to expand" had remained at levels similar to those seen in the first half of 2007. If demand conditions continue to deteriorate, reduced demand for loans could lead to future declines in small business loans even if credit supply conditions remain about the same.

A less comforting picture of small business credit supply conditions is provided by the Duke University/CFO Magazine Global Business Outlook survey, conducted most recently in March. About one-third of the chief financial officers (CFOs) of small businesses who responded said credit was more costly, less available, or both as a result of the credit market turmoil. This proportion is up slightly from last September, when that sentiment was reported by about one-fourth of responding small business CFOs. This survey also asks respondents to rank their top three concerns, with the (changing) options given in the survey. "Credit markets/interest rates" was ranked as the second top concern among small business CFOs in both the March 2008 and the September 2007 surveys.[5]

Perhaps one of the most important concerns about the future 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 Survey of Small Business Finances (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.[6] About 37 percent was collateralized by business real estate assets, and 15 percent was secured with "personal" real estate.[7] Looking forward, continuing declines in the value of their real estate assets clearly have the potential to substantially affect the ability of those small businesses to borrow. Indeed, anecdotal stories to this effect have already appeared in the press.

Similarly, declines in the value of real estate assets held by banks and other lenders could affect their willingness and ability to supply loans, as real estate losses use up capital that could otherwise be used for making new loans. Indeed, there are reasons to believe that these forces are currently at work not only at large banks, where the initial problems were observed, but across the full size spectrum of banking organizations. As noted previously, more stringent loan terms are already in place. In addition, banks across all size groups, including community banks, have recently experienced a sharp deterioration in credit quality, mostly within loans secured by real estate. Moreover, if banks continue to place on their

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5 The top concern in March was customer demand, whereas the top concern in September was the cost of labor.

6 Board of Governors of the Federal Reserve System (2003), "2003 Survey of Small Business Finances"; Traci L. Mach and John D. Wolken (2006), "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances (185 KB PDF)," Federal Reserve Bulletin, vol. 92 (October), pp. A167-A195.

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

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.

On a more positive note, the vast majority of U.S. banks remain well capitalized. Going forward, this should help these banks to maintain their lending capacity. In addition, lender constraints on small business loans may be mitigated somewhat by loan guarantees provided by the Small Business Administration (SBA).

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 SSBF documents that, in 2003, almost 47 percent of small businesses used personal credit cards in the conduct of their business. At that time, most of this use appeared to have been for convenience rather than for longer-term borrowing. However, to the extent that small businesses become more reliant on credit cards as a source of funding, perhaps because of a decline in their own financial condition or because of a tightening in other aspects of credit supply, they may end up facing higher interest rates than would otherwise be the case.

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 necessary for that vitality. On balance, since last fall credit supply conditions have almost surely tightened for the vast majority of small businesses. Credit appears to be generally available, but at a higher cost. Only a small fraction of small business owners report that credit is their main business concern. Demand for their products is much more problematic.

Looking forward, continuing declines in the value of small businesses' real estate assets have the potential to substantially affect the ability of those small businesses to borrow. Similarly, declines in the value of real estate may affect the ability and willingness of banks and other lenders to supply loans. Indeed, this is likely already occurring to some extent at some banks across the full spectrum of bank sizes. Lastly, because of interdependencies between small business and household finance, declines in the financial condition of households can also affect both the terms of those households' small businesses loans and their ability to borrow.

For all of these reasons, the Federal Reserve will continue to monitor closely the effects of financial market conditions on small business access to credit. More generally, I assure you that the good health of the small business sector is an important consideration for the Federal Reserve as we strive to fulfill the dual mandate given to us by the Congress to promote both price stability and sustainable economic growth.