Randall S Kroszner: Effects of the financial crisis on small business

Testimony of Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Small Business, US House of Representatives, Washington DC, 20 November 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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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 are critical to the health of the U.S. economy. They generate more than half of nonfarm business gross domestic product, employ more than half of private-sector workers, and over the past decade have created well over half of net new jobs annually. 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 statement today will address how the ongoing turmoil in the financial sector and the weakening macroeconomy appear to be affecting small businesses' access to credit, while recognizing that the impressive diversity across both industry and geography of the small business sector makes it very difficult to draw too many general conclusions. In addition, I will discuss the policy actions that the Federal Reserve, the Congress, the Treasury, and other government agencies have taken in recent weeks to address the overall functioning of financial markets and deteriorating economic conditions as well as how these policies should assist small businesses going forward.

Recent financial market and economic developments

As you know, the U.S. financial sector has been under severe stress for more than a year as a result of declining house prices, large losses on mortgages and mortgage-related instruments at financial institutions, and an abrupt pullback from risk-taking by investors. These strains intensified in late September and early October, and lending between banks and other financial institutions beyond more than a few days virtually shut down. Withdrawals from money market mutual funds and fears that net asset values would fall further severely disrupted commercial paper and other short-term funding markets, and longer-term credit became much more costly as risk spreads on corporate debt instruments jumped and private interest rates rose. The problems in credit markets and concerns about the economy have caused equity prices to swing sharply and to decline significantly, on net.

Even before the recent heightening of the financial market turmoil, economic activity had shown considerable signs of weakening. In the labor market, private nonfarm payroll employment fell in August by a notably larger amount than in the previous seven months of the year, and in September and October, job losses were even more sizeable. The unemployment rate in October moved sharply higher to 6-1/2 percent. On the spending side, consumption expenditures, business investment outlays, and residential investment spending all declined in the third quarter, and overall real economic activity contracted 1/4 percent. Consistent with the emerging slack in both product and labor markets and a drop in the price of energy and other commodities, headline and core measures of price inflation have both decelerated in recent months. In addition, measures of inflation expectations have also declined.

Small business access to credit in the current environment

With this general background in mind, I will now turn to how current financial and macroeconomic conditions appear to be affecting access to credit by small businesses. As you may recall, former Federal Reserve Governor Frederic Mishkin testified before the Senate Committee on Small Business in April and concluded that credit standards for small businesses had almost certainly tightened since the onset of the crisis, and that much of this tightening appeared to be reflected in an increased cost of credit to small businesses rather than any significant reduction in the availability of credit.[1] He noted, however, the high degree of uncertainty surrounding this assessment, which remains the case now with even more data in hand.

In my statement today, I will discuss how both credit supply and credit demand factors appear to be affecting small business access to credit, while recognizing that, in practice, it is normally quite difficult to separate the effects of these two forces. With respect to credit supply, access to credit for both small and large businesses may be affected by a decline in the willingness of banks and other lenders to make loans to small businesses because of, for example, credit market disruptions or other stresses that financial institutions may be enduring. In addition, small business access to credit can be reduced by a drop in the creditworthiness of small businesses because of, for example, a decline in the value of collateral they can post to back a loan. Alternatively, a drop in the demand for small businesses' products and services resulting from, for instance, weakening macroeconomic conditions will reduce current and expected sales and revenues. The likely resulting pullback in expansion plans will reduce businesses' demand for credit over and above any effects coming from the supply side of the market.

To summarize our conclusions, the information that we have received since April from both banks and small businesses suggest, rather convincingly, that over the last six months it has become more difficult for small businesses to access credit, but that at the same time, small business demand for credit has declined. Commercial banks, the most common source of credit for small businesses, have generally both imposed more-stringent credit standards and increased interest rate spreads and fees. In addition, deteriorating financial positions in both the small business and the household sectors are almost surely reducing the creditworthiness of many small businesses and thereby constraining their access to credit. That being said, the information we have on the volume of small business loans suggests that credit is generally available, albeit on significantly stricter terms. In addition, small businesses generally report that reduced demand for their products and services caused by a lower level of economic activity is a more serious concern than is the tightening of credit supply conditions. Put differently, while credit supply concerns are real, the weakened state of the economy appears to be the more serious challenge facing most small businesses in the current environment. Importantly, there is some evidence that concern over access to credit is relatively stronger at larger businesses. The remainder of my statement discusses the information on which we base these conclusions.

Incoming survey data for the banking sector suggest that small businesses access to credit has tightened further over the past half year. For example, in the Board's most recent Senior Loan Officer Opinion Survey on Bank Lending Practices conducted in October, a net 75 percent of the domestic banks surveyed – a larger net fraction than in the July survey – reported that over the previous three months, they had tightened the standards applied when approving commercial and industrial (C&I) loans to small firms.[2] But small businesses were

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[1] See Frederic S. Mishkin (2008), "Small Business Lending", testimony before the Committee on Small Business and Entrepreneurship, U.S. Senate, April 16.

[2] See Board of Governors of the Federal Reserve System (2008), Senior Loan Officer Opinion Survey on Bank Lending Practices, October, and July.

not alone; almost a net 85 percent of the domestic banks surveyed reported having tightened lending standards on C&I loans to large and middle-market firms over the previous three months. In both the July and October surveys, a significant and increasing net fraction of banks noted that they had increased the interest rate spreads over their cost of funds and fees on the C&I loans they had approved for small firms, and a somewhat smaller net fraction of banks reported tightening nonprice conditions, such as collateral requirements and loan covenants. Importantly, in both the July and October surveys, the net fractions of banks reporting tighter lending standards and tighter price terms on C&I loans to small firms were very high by historical standards going back to 1990. These results are also true for loans made to medium-size and large businesses.

Somewhat in contrast to the above results, information from the most recent (August) quarterly Survey of Terms of Business Lending suggested that there has been relatively little net change in average interest rate spreads on C&I loans since late 2006.[3] Loan rate spreads at small domestic banks, which are an important source of financing for small businesses, remained toward the low end of the wide range within which they have fluctuated since 2004. Spreads on C&I loan originations smaller than $100,000 at all banks, which are loans that are likely made to small businesses, have also remained broadly unchanged since 2006. While differences between the two surveys, including their relative timeliness, likely explain part of the contrasting results, on balance, the quarterly Survey of Terms of Business lending results serve to temper the Senior Loan Officer Opinion Survey results.[4]

Data on changes in the quantity of C&I loans at banks also support the view that small businesses have generally maintained their access to bank credit, although new loans and new loan commitments are being subjected to stricter lending standards and terms. Based on a sample of banks of all sizes that report weekly to the Federal Reserve, the dollar volume of outstanding C&I loans at both large and small U.S. commercial banks expanded robustly over the first four months of this year, increased moderately over the months of May through August, and surged dramatically in September. A special set of questions on the October Senior Loan Officer Opinion Survey attempted to help explain these patterns. The results suggested that firms' drawing on unused portions of loans made under previous commitments was not especially important for explaining the September surge in lending at banks with less than $20 billion in total assets. Indeed, over one-third of those smaller banks reported having increased loans not made under previous commitments. However, many of those banks noted that the increased demand was accounted for, in part, by firms that were substituting bank loans for other funding sources.

Incoming data from business surveys also indicate that lending conditions for small businesses have tightened – in some cases, significantly. For example, recent monthly surveys of the National Federation of Independent Businesses (NFIB), which are available through October, suggest that financing conditions for small businesses have deteriorated substantially over the past several months. In particular, the net percentage of respondents that reported that credit was harder to obtain over the preceding three months and the net percentage of respondents that expected credit conditions to tighten over the next three months have climbed to the higher end or the top of their ranges over the past two decades. That said, financing conditions have continued to be ranked as the top business concern by

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[3] See Board of Governors of the Federal Reserve System (2008), Statistical Release E.2, "Survey of Terms of Business Lending", August 4-8.

[4] The majority of loans considered in the Survey of Terms of Business Lending are drawn under pre-existing commitments, which differs from the Senior Loan Officer Opinion Survey that considers changes in the terms and standards being applied to new loans. This difference between the two surveys likely explains in part why the C&I loan spreads reported in the Survey of Terms of Business Lending show little change despite the notable tightening in the price terms on C&I loans reported in the Senior Loan Officer Opinion Survey.

only a modest fraction of small business – 5 percent in October – although this is up from 2 percent last March. However, this modest level of concern may, in part, reflect the dominance of other factors, such as weak demand conditions, a topic to which I will return shortly.

The Duke/CFO Magazine Global Business Outlook Survey, conducted most recently in September, also suggested that the ongoing financial turmoil is having an increasingly adverse effect on small businesses' access to credit.[5] Almost 40 percent of the chief financial officers (CFOs) of small businesses who responded to the survey said that credit had become more costly, less available, or both as a result of the financial turmoil. This proportion is up slightly from the March survey when this sentiment was reported by about one-third of responding small business CFOs. This survey also asked respondents to rank their top three concerns for their business, with (changing) options given in the survey. "Credit markets/interest rates" was ranked second to "consumer demand" as the top concern among small business CFOs in both the September 2008 and the March 2008 surveys. This survey also suggested, as did the Senior Loan Officer Survey discussed above, that access to credit is a relatively more serious concern for larger firms. For example, some 38 percent of the Duke/CFO Magazine survey respondents with less than 500 employees indicate that the financial turmoil is adversely impacting their access to credit, but 47 percent of larger firms say this is true. Consumer demand is the top business concern for firms of all sizes.

The effect of the current crisis on household balance sheets is an additional channel through which small business access to credit is being affected. As you know, small business and household finances are, in practice, very closely intertwined. For example, data from the Board's 2007 Survey of Consumer Finances indicated that about 11 percent of households own and actively manage a small business, and of these households, about 18 percent use personal assets to guarantee or collateralize loans for the business.[6] A broadly similar fraction of households that own and actively manage a small business also have made one or more loans to the business. In addition, the most recent Survey of Small Business Finances (SSBF) indicated that about 15 percent of the total value of small business loans in 2003 was collateralized by "personal" real estate (and some 37 percent was collateralized by business real estate assets).[7] Because the condition of household balance sheets can be relevant to the ability of some small businesses to obtain credit, the fact that declining house prices have weakened household balance-sheet positions suggests that the housing market crisis has likely had an adverse impact on the volume and price of credit that small businesses are able to raise over and above the effects of the broader credit market turmoil.

Another indicator of the stress that current conditions have placed on small business credit access is the recent experience of the Small Business Administration's (SBA) 7(a) guaranteed loan program. This program is generally used to provide loans to small businesses when they cannot get conventional loans. Although SBA-guaranteed loans are only a small portion of total small business loans, in recent months the dollar volume of these loans has dropped significantly, and in October 2008 the volume was less than 50 percent of its level 12 months earlier. These declines are the result of a number of factors – lower demand overall for loans due to the weaker economic outlook, tightened credit standards by lenders, and declining creditworthiness among applicants because of their deteriorating financial condition. In addition, market reports indicate that in recent weeks, banks and other

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[5] See Duke University, Fuqua School of Business, and CFO Magazine (2008), Duke/CFO Magazine Global Business Outlook Survey, September, www.cfosurvey.org.

[6] Data collection for the 2007 Survey of Consumer Finances was completed early in 2008 and processing of the data is under way. An article reviewing the highlights of the data is expected to be published in the *Federal Reserve Bulletin* in the first quarter of 2009. Release of the public version of the micro data is expected to follow that publication (see 2007 Survey of Consumer Finances).

[7] See Board of Governors of the Federal Reserve System (2003), Survey of Small Business Finances.

lenders that make SBA loans have not been able to securitize and sell SBA-backed loans to other institutions in the secondary market.

Turning to credit demand, the NFIB survey's results are even more pessimistic than they were in April. For example, the survey's index of small business optimism dropped in October to its lowest level since the monthly surveys began in 1986. This subdued level reflects deterioration in several components of the index, including that the fraction of respondents considering expansion in the next three months and the fraction considering capital expenditures in the next three to six months have fallen to the bottom of their ranges over the past two decades. Weak plans for business expansion will likely reduce demand for loans, which could result in future declines in small business loans even without any tightening of credit supply conditions. As noted earlier, although only 5 percent of small businesses in the NFIB survey ranked financing conditions as their top concern, some 23 percent of firms indicated that sales were their main concern. These results, when combined with the Duke/CFO Magazine survey data, suggest that consumer demand concerns generally provide the most serious challenges facing small businesses.

Policy responses to financial and economic developments and their implications for small business credit access

I would now like to turn to a discussion of the policy actions that the Federal Reserve, the Congress, the Treasury, and other government agencies have taken in recent weeks to address the overall functioning of financial markets and the weakening of economic activity as well as how these policies should assist small businesses going forward.

In response to the escalation in financial market stress that began in late September, policymakers both in the United States and other countries have taken a series of extraordinary actions aimed at restoring market functioning and improving investor confidence. The Federal Reserve has continued to address ongoing problems in interbank funding markets by expanding its existing lending facilities, increasing the quantity of term funds that it auctions to banks, and accommodating greater demand for funds from banks and primary dealers. The Federal Reserve has also implemented several important temporary facilities to alleviate the pressures on money market mutual funds and commercial paper issuers.

The Emergency Economic Stabilization Act (EESA), enacted by Congress in early October, provides critically important new tools to address financial market problems. The Troubled Asset Relief Program (TARP), authorized by the legislation, allows the Treasury to provide capital to financial institutions across a wide spectrum of sizes and to purchase or guarantee troubled mortgage-related and possibly other assets held by banks and other financial institutions. The EESA also temporarily raises the limit on the deposit insurance coverage provided by the Federal Deposit Insurance Corporation (FDIC) from $100,000 to $250,000 per depositor and temporarily fully covers non-interest-bearing transactions accounts, such as payroll accounts. As you know, this latter action was aimed particularly at helping small businesses.

In response to weakening macroeconomic activity and the increased downside risks to economic growth and employment implied by the recent escalation in financial market stress (along with diminished upside risks to inflation), the Federal Open Market Committee (FOMC), in a coordinated effort with other central banks, lowered the target federal funds rate 50 basis points to 1-1/2 percent on October 8. This cut was followed by a further 50 basis point easing to 1 percent at the October FOMC meeting.

Additionally, on November 12, the federal banking agencies released an interagency statement aimed at ensuring that all banking organizations fulfill their fundamental role in the

economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers.[8]

These actions should have a wide range of positive effects across the entire economy, including small businesses. Policymakers' actions over the last two months in interbank funding markets, commercial paper markets, and the money market mutual fund industry should help restore market functioning and allow short-term funding to be directed to where the economy most needs it. Likewise, the activities permitted as part of the EESA legislation should help rebuild confidence in the financial system, increase the liquidity of financial markets, and improve the ability of a broad range of financial institutions to raise capital from private sources. The expansion in the coverage of deposit insurance provided by the FDIC should also bolster public confidence and provide additional liquidity to FDIC-insured institutions. The FOMC's cumulative 1 percentage point reduction in the federal funds rate in October, combined with previous reductions between September 2007 and May 2008, should lower lending costs and stimulate economic activity in coming quarters. And, the agencies' recent guidance should encourage lending to creditworthy borrowers.

The benefits to small businesses from some of the above-described policy actions will be largely indirect, but nevertheless real. For example, although small businesses do not themselves issue nonfinancial commercial paper, they nonetheless benefit when large nonfinancial firms can issue commercial paper in well-functioning markets and thus do not have to tap backup lines of credit at banks. Similarly, improving interbank funding markets and restoring public confidence in banks and other financial institutions benefits small businesses – again, indirectly – by lowering intermediaries' and thereby small businesses' borrowing costs and increasing the volume of loans that banks can extend. The temporary increase in FDIC deposit insurance coverage should reinforce these effects by further strengthening public confidence and providing additional liquidity to FDIC-insured institutions.

Importantly, some of these policy actions will also directly benefit small businesses. For example, the higher deposit insurance coverage limits confer direct benefits by greatly reducing the volume of exposed small business deposits as well as by decreasing the number of small businesses with exposed bank deposits. Data from the 2003 SSBF indicate that under the $100,000 deposit insurance ceiling, an estimated $178 billion of small business deposits were uninsured, and 8.7 percent of small businesses had some deposit exposure. With the increased ceiling of $250,000 and the full insurance of non-interest-bearing transactions accounts, the 2003 SSBF data suggest that total small business deposit exposure fell to $37 billion and that less than 1 percent of small businesses have any deposit exposure. Among firms with fewer than 10 employees – which represent over 80 percent of all small businesses – the broader deposit insurance coverage reduces total deposit exposure from an estimated $22.1 billion to $1.6 billion and leaves only 0.3 percent of these businesses with any deposit exposure.

The recent reductions in the federal funds rate should directly benefit small businesses. Lower policy rates should result in small businesses facing lower borrowing costs, especially because rates on small business loans tend to be tied to the prime interest rate, which generally moves closely with the federal funds rate.[9] In addition, stronger economic activity resulting from lower interest rates should result in small businesses enjoying increased demand for their products and services.

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[8] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers", joint press release, November 12.

[9] The Survey of Terms of Bank Lending indicated that 40 percent of the dollar volume and two-thirds of the number of C&I loans originated over the past year have been tied to the prime rate.

Of course, the magnitude of the effects of recent policies are highly uncertain, given the current climate of extreme financial stress as well as the nonconventional nature of a number of these policy actions. Thus, the Federal Reserve will continue to monitor closely how the effects of recent policy actions are affecting small business conditions and economic activity more broadly.

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, credit supply conditions to small businesses have tightened substantially since last April. Although credit appears to be generally available, such availability usually comes with tougher standards and at a higher cost. However, while credit concerns are real, the weakened state of the economy and the resulting drop in demand for their products and services appear to be the more serious challenge for small businesses in the current environment.

How small businesses' access to credit will evolve will likely be strongly influenced by the success of recent policies undertaken by the Federal Reserve, the Congress, and other policy institutions aimed at improving the functioning of financial institutions and markets, rebuilding confidence in the financial system, and stimulating economic activity. Given the current financial and economic environment, the sizes of the effects of recent policies on both the economy and small businesses are highly uncertain. For these reasons, the Federal Reserve will continue to monitor evolving financial market and economic conditions and their effects on small business access to credit as part of its broader efforts to restore the health of the U.S. financial system and our economy.