

SPRING 2010  
Volume 1 Number 2

# Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK  
of CLEVELAND



## A Proposal: Using the CRA to Fight Vacancy and Abandonment

### **INSIDE:**

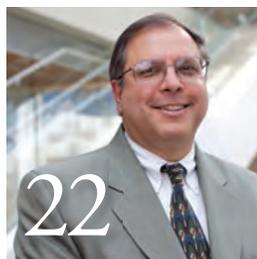
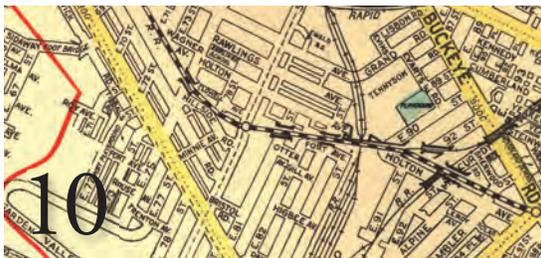
Credit for  
Small Businesses

Systemic Risk

Q&A with  
Economist  
Anil Kashyap

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# Small Businesses: Credit Where Credit Is Due?



Across the country, small-business owners are telling the same story:

First, they need more customers for their products and services.

And second, they need banks to lend them money.

The story of Torbeck Industries, a Harrison, Ohio, manufacturer of safety equipment, has grown all too familiar. During the recession, business at the 35-employee firm has fallen about 50 percent, close to the industry average. In 2009, owner Rich Torbeck approached several banks about obtaining a new loan guaranteed by the Small Business Administration, or SBA. His company had used SBA programs in the past and always made good on its payments.

Only one bank stepped up. But after doing its due diligence analysis, that bank downgraded the firm's collateral by half, which killed the deal. Meanwhile, Torbeck Industries could not pass working-capital tests when it bid on new contracts. In March, the company was forced to turn down a large order because it couldn't finance its cash flow.

"This is a vicious cycle," Torbeck said. "I don't know where it's going to end."

The Federal Reserve has paid a lot of attention to the problem of low demand for products and services. Near-zero interest rates and several emergency programs have been aimed at reviving the overall economy. But the nagging issue of access to credit—especially for small businesses—persists. Why are banks still reluctant to lend?

To find an answer, Federal Reserve Banks across the country recently hosted forums with small-business executives and bankers, asking for their views and hearing from many of them. Helped by that information, researchers are now developing proposals for unblocking the small-business credit channel.

## Credit Tightens

The problems facing small businesses are a big deal for the whole nation. Small businesses have created almost two of every three new jobs over the past 15 years. During that time, they have employed more than half of all workers and created half of GDP. But in the recession, they have suffered intensely, accounting for half of U.S. jobs lost versus 10 percent in the 2001 recession.

Although it is impossible to lump all small businesses in the same bucket, it is fair to say that they share characteristics that make them vulnerable during harsh economic times. They generally cannot tap the public markets for capital, so they turn to commercial banks or personal credit cards, often putting up their own property as collateral.

These factors make small businesses far more vulnerable than others to problems in the real estate markets, which of course have taken their own hit with the recession. As collateral values are written down, many small firms suddenly find themselves in technical violation of loan covenants.

Two major sources of credit for small businesses contracted sharply in 2009: Commercial and industrial loans fell by 20 percent, and commercial real estate loans by 4 percent. In all, bank lending declined by 7.4 percent in 2009—the most since 1942. These declines occurred even though banks' reserves had more than doubled since 2007, aided by the Federal Reserve's response to the financial crisis.

## The View from the Bankers' Side

Bankers see the situation as far more complicated than a mere credit crunch. For starters, they report that loan demand is off, and many companies aren't fully drawing on existing lines of credit. And many of the small firms that are seeking credit seem like risky bets, given their financial condition. They are either losing money, over-extended, or don't have adequate collateral.

With their own capital positions weakened, some bankers admit having to "button down" on lending standards. In sum, they see more risk than reward out there. This mindset is reflected in results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which recently found that banks have significantly tightened credit standards on many loans to small firms over the past few years.

"In 2009, it seemed as if banks pretty much stopped lending," says Marsha Powers, principal of Powers Financial Group, a Pepper Pike, Ohio, firm that helps businesses obtain financing. "I do see some positive activity in this [first] quarter, but they still are being extremely careful in their underwriting. And rightly so."

## The Central Bank's Response

Although poor sales loom as small businesses' biggest problem, there is strong anecdotal evidence that tight credit is also holding back the recovery. The Federal Reserve has tackled the problem from several angles. Besides its efforts to buoy the economy with low interest rates and emergency lending programs, the central bank has joined the nation's other bank regulatory agencies in issuing new guidance for small-business and commercial real estate lending. This guidance encourages bankers to work with their customers during periods of stress. Its goal is to prevent overzealous supervision from creating additional problems for bankers and their customers. At the Federal Reserve Bank of Cleveland, discussions have begun about how banks' perception of regulators' increased stringency may affect access to credit for small businesses.

Another new focus at the Federal Reserve Bank of Cleveland, largely motivated by conversations with small business owners and bankers, is the potential for expanding other government and public programs. For some time, SBA-guaranteed loans have served as a backstop option for small firms in need of credit. In normal times, those loans account for only about 5 percent of outstanding credit to small business. But in times of crisis, that's not

enough to meet the needs of creditworthy small businesses in this country, especially when banks need a taller backstop to safeguard against risk.

SBA programs provide good options for some borrowers in some circumstances, but there can be impediments. A persistent story among businesspeople is that SBA loans are attractive in theory but difficult to secure in practice. Often, the problem is just a matter of paperwork; at other times, it is a matter of borrowers' inability to find a banking partner to underwrite the loan.

Federal Reserve research suggests that as currently structured, SBA lending is too narrowly focused on start-ups, and the scale of lending is too limited to deal with the shortfalls in credit that small businesses are reporting.

The Administration, for its part, has taken steps to address this issue by proposing legislation to allow higher caps on certain kinds of SBA loans and to allow refinancing of certain kinds of owner-occupied commercial real estate. The Administration has also proposed allotting \$30 billion of Troubled Asset Relief Program funds that community banks can use for loans to small businesses. Meanwhile, the SBA has embarked on its own effort to examine product enhancements and streamline the application process.

Even so, it would be a mistake to rely on the SBA as a cure-all for the problem. Researchers at the Cleveland Federal Reserve have met with SBA officials this spring to discuss wider opportunities to further unblock channels for small-business credit. ■

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### What do you think?



Researchers at the Cleveland Fed are collecting public comments as they develop proposals to widen access to credit for small businesses. Future meetings with small-business owners, community development groups, and bankers will be aimed at identifying promising solutions.

We also want to hear from you. What are your ideas for solving the small-business credit crunch? What changes would give bankers more confidence about lending to small businesses? Send your comments to [forefront@clev.frb.org](mailto:forefront@clev.frb.org).

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### President's Speech



Cleveland Fed President Sandra Pianalto described the importance of small businesses and efforts to open up access to credit in her February 25, 2010, speech, "When the Small Stuff is Anything But Small." [www.clevelandfed.org/For\\_the\\_Public/News\\_and\\_Media/Speeches/2010/Pianalto\\_20100225.cfm](http://www.clevelandfed.org/For_the_Public/News_and_Media/Speeches/2010/Pianalto_20100225.cfm)

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