Everybody agrees that small businesses aren't borrowing as much as they did before the recession. Nobody, it seems, agrees why.

Is it:
A. Less demand by small firms themselves?
B. Lack of enthusiasm by banks to lend to small businesses of any stripe (but especially those deficient of collateral)?
C. Lending standards on steroids?
D. Consolidation in the banking industry?

The answer, a new report from the Cleveland Fed suggests, is E: All of the above.

"It's not just demand. It's not just supply. There are multiple issues here," says Ann Marie Wiersch, a policy analyst with the Cleveland Fed who co-authored "Why Small Business Lending Isn't What It Used to Be" with Scott Shane, a Case Western University economist.

In some ways, it's a chicken-and-egg paradox. Small business growth is down since the recession, which translates into muted demand for loans. But at the same time, growth might be lower because small firms can't get the credit they need to expand.

From the banks' perspective, it's just a fact that lending to small businesses isn't as profitable as lending to large ones. The loan values are smaller, for starters. Also, small business loans tend to be very heterogeneous (one is not like the other) and cannot go through automated approval processes, which are cheaper for the banks to administer. Because of their dissimilarities, small business loans are also difficult to securitize. Meanwhile, credit standards are stiffer in the wake of the financial crisis, thanks in part to stepped-up scrutiny by supervisors. And a 15-year trend of consolidation in the banking industry has dwindled the number of community banks, which historically have made small business lending their bread and butter. Gone are the days of the loan by handshake with your friendly neighborhood banker.

Small businesses employ roughly half of the private sector labor force. And that's the reason it's so important to carefully identify the real sources of the small business credit crunch—money thrown at the wrong problems won't help small businesses get the credit they need, and the whole economy could suffer right along with them.

For example: It's clear from the data and anecdotal evidence that banks have sufficient capital right now and more than enough cash sitting on the sidelines that could be deployed to activities such as small business lending. So at this moment, policies that aim to strengthen banks' capacity for lending won't help the problem. Instead, perhaps efforts should be aimed at addressing the widely diverse credit needs small businesses, or ways to make these businesses more profitable.

—Forefront Staff

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