Testimony of Vice Chairman Roger W. Ferguson, Jr.

Small business access to capital

Before the Small Business Committee, U.S. House of Representatives
May 17, 2001

I am pleased to appear before this Committee to discuss the availability of credit to small businesses. Before turning to the latest information on credit market conditions, however, I think it important to highlight the special characteristics of small businesses that make them such an important part of our economy and at the same time create a heterogeneous set of financial needs and credit demands. Much of the information that we have on small business financing comes from surveys, including the Federal Reserve's Survey of Small Business Finances, the latest of which was completed last year.

Importance of Small Businesses

No doubt I am preaching to the choir when I tell this group how important small businesses are in our nation's economy. The statistics collected by the Census and Small Business Administration are indeed remarkable. These data reveal that there were more than 24 million nonfarm business tax returns filed in the United States in 1999. More than 99 percent of these returns were for small businesses, that is, firms with fewer than 500 employees. Roughly half of these were self-employed persons and about a third were part-time. Based on SBA estimates, small businesses employ more than half of the private work force and are responsible for around 50 percent of all sales and private gross domestic product, a share of output that has remained fairly stable over time.

With half of our nation's private, nonfarm output coming from small businesses, obviously our economic well-being depends greatly on this sector. But small businesses do more for us than can be captured in these statistics. Small businesses are a source of new ideas and products. The list of innovations developed by these enterprises in fields such as software, computer technology, aerospace, and pharmaceuticals is quite impressive. The possibility that an idea or new product will eventually transform a small business into a large corporation is a great motivator of change and risk taking. Beyond that, small enterprises make a huge contribution in the form of the support and synergies they provide operating side by side with large businesses. They provide services and inputs to the production process, train workers, and are a primary means of marketing and distributing retail products and services.

An essential feature of a thriving small business sector is the ability of firms to start up, to grow, and to change ownership. Just as essential to the dynamism of our economy is the ability of these firms to downsize when that improves profitability or to exit the markets when their resources are more highly valued elsewhere. There is a tremendous amount of turnover of small firms. In 1999, approximately half a million firms (excluding self-employed for which numbers are not available) closed for one reason or another--perhaps they merged or were acquired by a larger firm, perhaps they failed, or the owner found other reasons to move on. At the same time, more than half a million new businesses were

created.

The continuous entry and exit of firms is a clear sign that resources are responding to shifting demands of consumers and businesses and to changes in the costs of production. The flow of labor and capital from less productive to more productive uses is the cornerstone of a dynamic and healthy economy. A downside of this churning is the greater uncertainty that attaches to the earnings and risk profile of each individual small business. This has significant implications for the financing of small businesses. Indeed, while a number of factors need to be in place for a small business sector to thrive, including a mobile labor force and a sound infrastructure of laws and regulations, perhaps the most important ingredient is access to capital and credit.

The Financing of Small Businesses

The financing needs of small businesses are as varied as the population itself. The life cycle of a small business can take many forms, with very different implications for the types of risks and returns that lenders and investors can expect. For new ventures that have high risk profiles and high expected returns--as do many start-up firms in the tech sector--the initial stages require commitments of equity capital, sometimes from family and friends and sometimes in the form of venture or private equity capital. Further injections of equity are required in the early stages of growth and ultimately some form of "take-out" financing is arranged, such as an initial public offering or a buyout by another firm, that allows the venture capitalist to extract his or her investment.

The past decade has been impressive for the large amount of equity capital that flowed to venture and high-tech enterprises in this country. The National Venture Capital Association estimates that investments in emerging enterprises totaled $214 billion over the past five years, and exceeded $100 billion last year alone. The number of companies funded last year was a record 5,300. About 270 companies that originally were backed by venture capital were purchased by other companies last year. Another 250 were able to go public through initial public offerings (IPOs) of stock, even as the market for publicly traded equity was in the initial stages of its recent decline. The average age of firms going public was about seven years, but many were older, which is indicative of the potentially long-term commitment that investors in venture enterprises must be prepared to make. It is safe to say that the United States has been a role model for countries in Europe and Asia seeking to develop markets for equity financing for small businesses.

But for every new, high-growth firm seeking venture capital, there are hundreds of small businesses in the manufacturing, construction, trade, and service sectors that have quite different financing needs. Some of these firms have established operating histories and marketable assets that make them good candidates for credit from conventional financial institutions. A few are small corporations that have access to bond market financing, though their bonds are likely to be rated below investment grade. The vast majority are small enterprises with few assets to pledge as collateral and with only limited operating experience from which investors can assess operating performance and future earnings streams.

Recognizing the importance of small businesses, we endeavor to understand the sources and uses of credit by different sizes of firms. To this end, the Federal Reserve has undertaken three national surveys of small businesses, the first in 1987, the second in 1993, and the third completed last year. A detailed description of the latest survey, along with preliminary results, was published in the April 2001 *Federal Reserve Bulletin*. This morning I will

highlight a few preliminary findings and note that the data have just become available for what promises to be interesting analytic work.

The Survey of Small Business Finances

The survey sampled 3,600 small businesses that were representative of more than 5 million nonfarm, nonfinancial enterprises that operate for profit. It gathered information on a large number of items, including each firm's use of credit; characteristics such as the number of employees, industry, and age of the firm; and its income and balance sheet data as of year-end 1998. We expect these data to be used by researchers at the Board and elsewhere to address a wide range of issues. The earlier surveys have been used, for example, to shed light on the relationship between a business and its bank or primary lender and to study how financing choice varies with location, age, size, or other characteristics of firms. The latest survey can be used to update these studies and to assess how small businesses may have altered their use of credit and financial services in response to technological and competitive changes in the financial environment.

The preliminary survey results we've glimpsed so far are interesting as much for their consistency with previous surveys as for the changes they reveal. For example, despite the large amount of structural change and consolidation in the financial service sector and the improving accessibility of capital markets to many smaller firms, commercial banks continued to be the dominant provider of financial services to small businesses in 1998. Of the 55 percent of small businesses that obtained credit from market sources or institutions, nearly three-fourths had some sort of credit arrangement, such as a line of credit, a loan, or a lease, with a commercial bank. Finance companies served about 13 percent of small business borrowers, and leasing companies served about 7 percent. The survey results also confirmed the growing use of business credit cards by small businesses. About one-third of all small businesses--and more than 50 percent of firms with 20 or more employees--had business credit cards in 1998.

We included questions on the survey about the problems small businesses considered to be most pressing. Small businesses in 1998 expressed concern about the quality, cost, and availability of labor and about increased competition from larger, international, and Internet firms. Of note, financing was not high on their list of concerns.

It is not surprising that small firms were feeling the pressures of tight labor markets and increased competition: 1998 marked the seventh year of a robust expansion. Bolstered by a technology-led acceleration in productivity, real GDP growth averaged 4-1/4 percent in the latter half of the 1990s, and the unemployment rate had dropped to 4 percent by the end of the decade. Aggregate indicators of credit availability were quite positive in the mid to late 1990s: Banks were generally easing credit terms, and business loans grew robustly at both large and small banks. The surge in equity markets provided a welcome environment for firms going public for the first time, and firms carrying below-investment-grade bond ratings were able to issue bonds at historically narrow spreads over Treasuries. While disruptions in global markets in 1998 raised risk premiums on junk bonds and bank loans and threatened a seizing up in financial markets, ultimately they did not derail the flow of credit, especially to smaller businesses.

Recent Trends in Small Business Financing

Since the 1998 survey, the economic and financial environment has again changed, and this time in ways that are less conducive to risk-taking and leverage. It became increasingly

apparent over the course of last year that the pace of economic growth was slowing. Credit markets firmed, including bank lending, partly in response to concerns that a slowing economy would result in some deterioration in the financial well-being of businesses and their creditors. As corporate profits fell and businesses revised down their outlook for sales and earnings growth, investors became less certain about the returns they should expect on investments.

By late last year, equity markets looked considerably less attractive as a source of financing, especially to firms hoping to go public for the first time. The volume of IPOs dropped dramatically in the fourth quarter and remained sparse in the early months of this year, though it has not dried up entirely. As prospects for takeout financing through an IPO became problematic, private equity investors became more cautious about committing capital to earlier stages of financing. While venture capital investments exceeded $100 billion last year, the pace of investment has slowed in recent quarters and there are reports that some young firms are finding it hard to get second- and third-stage financing for venture capital projects.

In the capital markets, the default rate on high-yield bonds climbed markedly last year to its highest level since 1991, boosting lender concerns about the ability of weaker firms to service their debt in this environment. Yields on junk bonds rose appreciably relative to those on better-rated debt. In consequence, the issuance of junk bonds dropped sharply in the fourth quarter. Although the capital markets continue this year to exhibit considerable selectivity, the flow of credit through bond markets has been strong over all. Gross bond offerings by nonfinancial firms totaled nearly $160 billion in the first four months of this year. And, although they are paying higher risk premiums, non-investment-grade companies still are able to raise funds: Junk bond offerings have accounted for about 25 percent of the gross issuance this year.

As you are aware, the Federal Reserve conducts surveys of senior lending officers at large banks around the country. These surveys ask about banks' credit terms and standards, about loan demand, and other issues that may be topical. During the market turmoil in late 1998, banks began taking a harder look at the loans that they make to large and middle-market businesses. While financial markets settled down subsequent to 1998, banks appear to have maintained a more vigilant posture. Last year, in an environment of rising delinquency rates on loans and indications of declining credit quality, the net percentage of banks who reported some firming in their lending standards for large and medium borrowers rose steadily in each of our surveys.

Anecdotal reports suggest that banks were particularly concerned about concentrations of risk in sectors such as telecommunications, where returns have dropped sharply, and in manufacturing and other sectors highly dependent on energy and petroleum-based inputs. Banks also reported firming standards and terms on loans to small businesses, but to a lesser degree than for large firms. Normally, we expect small businesses to bear the first pulse of credit tightening. But the downgradings and unexpected shocks affecting large, investment-grade corporations have led creditors to rethink the relative risks of lending to large and small firms.

Banks have continued to tighten standards and terms on loans and credit lines this year. In our May survey, just over one-half of domestic banks reported tightening their standards on C&I loans to large and middle-market firms over the past three months, and 36 percent

tightened standards to small firms over the same period. Most of the banks that had tightened continued to cite a more uncertain economic environment, a worsening of industry-specific problems, and a reduced tolerance for risk.

In their latest reports, bank loan officers also indicated that the demand for business credit has waned of late, largely owing to reductions in planned investments and diminished financing for mergers. Just as lenders are treading more cautiously as the economy slows, so too are borrowers. Caution is apparent even among small businesses. Importantly, the small business surveys conducted by the National Federation of Independent Business (NFIB) in the first quarter revealed that only 13 percent of their surveyed members thought the current period was a good time to expand, roughly half the percentage of a year earlier. The small businesses who thought it was a bad time to expand cited unfavorable economic prospects and a poor outlook for sales. Of note, very few--only 3 percent in the April NFIB survey--mentioned financing costs as a reason that the current period was not a good time to expand.

Indeed, the recent NFIB surveys suggest that most of the respondents have not found financing conditions to be particularly onerous to date, despite the more cautious posture of financial institutions and higher risk spreads. For creditworthy businesses, large and small, the cost of borrowing has declined with the easing in monetary policy and the associated decline in lending rates since the fall. The prime lending rate has fallen 2 percentage points since the end of last year, and the average interest rate paid by respondents on the April NFIB survey was down almost 1 percentage point over the same period, to its lowest level in nearly a year.

While we may take comfort from the lack of angst expressed by small borrowers in the NFIB surveys, I expect that many risky small businesses have found credit a bit harder or more expensive to obtain. On the other hand, there are few signs of the types of financial headwinds that prevailed in 1990 and played havoc with the ability of many creditworthy small and medium firms to renew credit lines and roll over loans. In contrast to that period, our financial institutions have had a long stretch of solid earnings growth during which to build capital and liquidity positions. In addition, although loan portfolios have recently begun to deteriorate, delinquency rates of business and real estate loans remain well below those of the earlier period. Commercial real estate markets, in particular, have not gone through the boom-and-bust excesses of the late 1980s and early 1990s.

Summary

In sum, we have seen greater caution being exercised by both borrowers and lenders in credit markets recently. Such tightening might be expected in an economy that has slowed after several years of rapid expansion and debt growth. Much of the firming to date has been selective and directed toward companies perceived to face an uncertain future in the new economic environment and to leveraged companies that are vulnerable to a period of slowing sales and profits. Overall, however, credit flows have been well maintained, and lending institutions are in much better financial health than a decade or so ago. Importantly, reports from small businesses are relatively upbeat with regard to the availability of credit. Although risky borrowers face close scrutiny, banks apparently have continued to accommodate the needs of their creditworthy business customers, while bank lending rates, on average, have moved lower.

▲ Return to top

Last update: May 17, 2001, 10:00 AM