November 12, 2009

Small businesses, small banks, big problems?

In a speech on Tuesday, Federal Reserve Bank of Atlanta President Dennis Lockhart drew some connections between the current commercial real estate (CRE) problems and the prospects for a small business-led recovery.

The starting point was an observation made in an earlier macroblog post that identified the important role small businesses have traditionally played in job creation in the economy and how they had been disproportionately negatively affected in this recession.

What are the connections between CRE and small business? An obvious direct link running from small businesses to CRE is that small businesses are an important source of demand for many types of commercial space. A link from CRE to small businesses is that CRE problems in banks could potentially affect credit availability for small businesses.

CRE pressures
The problems currently facing the CRE industry have been building for some time for both property owners and the holders of CRE debt:

- The income generated by nonresidential/nonowner-occupied CRE has generally been falling as vacancy rates on commercial space rose, and capitalization rates–the ratio of income to valuation–have climbed sharply.
- The decline in CRE valuations has created a significant amount of "rollover risk" when CRE loans and mortgages mature and need to be refinanced (about $340 billion in CRE debt is estimated to mature in 2010 and 2011). At the same time, delinquency rates on CRE loans have been increasing sharply, especially for CRE lending for residential construction and development purposes.

This recent Cleveland Fed report captures some of the dimensions of the banking systems exposure to CRE, as does this *Wall Street Journal* piece from March.

Small business lending
Banks have already responded to the generally weakened economic conditions and reduced creditworthiness of borrowers by raising credit standards for all types of lending, including commercial loans, credit cards, and home equity. But there is a risk that additional bank problems, such as the realization of substantial CRE losses, could further constrain bank lending right at the time when credit is needed to support economic growth.

President Lockhart draws the connection between further bank problems and the prospects for small business-led recovery by observing that small businesses depend significantly on the banking sector as a source of financing. (A 2003 Federal Reserve survey of financial services used by small business showed over 50 percent of small businesses had a credit line or bank loan. In addition about half of small businesses use a personal or business credit card.)

The dependence of small businesses on banks is particularly problematic if the banks facing the most severe CRE problems also are a significant source of loans to small businesses.

It turns out that much of the CRE exposure is concentrated among the set of 6,880 or so smaller banking institutions (banks with total assets under $10 billion). Based on the June 2009 Bank Call Report data, these banks represented 20 percent of total commercial bank assets in the United States but hold almost half of the CRE loans.

It seems reasonable to assume that the banks with high exposure to CRE (say, those with CRE exposure as measured by a CRE loan book that is more than three times their tier one capital) are likely to take a conservative approach toward additional loan growth. The bad news is that the banks with the highest CRE exposure also account for about 40 percent of all commercial loans under $1 million–the types of loans most likely used by small businesses.

It is important to recognize that this analysis does not automatically imply small businesses will not be able to get needed funding when demand increases. For instance, even if banks with high CRE exposure are unable to expand lending as demand increases, it is possible that other banks that are less constrained will be able to step in to provide the needed financing. Also, small businesses depend a lot on other sources of financing, such as credit cards, and the large card issuers tend to have low CRE exposure.

Today, the number one challenge for small businesses remains poor sales rather than access to credit. But tomorrow, it will be important that small businesses also have access to funding if they are going to play their traditional role as an engine of growth.

By John Robertson, a vice president in the Atlanta Fed's research department

November 12, 2009 in Banking, Financial System, Labor Markets | Permalink