SPEECHES

Start-ups, Job Creation, and Bank Financing

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Key Points

- Federal Reserve Bank of Atlanta President Dennis Lockhart believes start-ups are important generators of jobs for the American economy.
- In order for start-up businesses to grow, especially small businesses that have the capacity to expand and grow quite large, they need access to capital.
- Commercial banks play a significant but not dominant role in start-up financing. Lockhart believes this is prudent, given the need for banks to make loans that can virtually always be repaid and the fact that start-up businesses usually have no proven track record of repayment.
- Most start-up businesses are financed with personal credit cards, loans from friends or family members, home equity lines of credit, venture capital, and angel funding.

Thanks for joining us this morning. We covered a lot of good ground in this conference yesterday. Now it falls to me to kick off the second day.

I welcomed the idea of a conference on "small business and entrepreneurship" because in that title I saw the opportunity for the meeting to address two somewhat distinct but interrelated, or overlapping, claims.

First, in low- and moderate-income communities, small businesses anchor neighborhoods and generate positive social benefits.

Second, it is claimed that small businesses account for a great deal of private sector employment and new jobs.

I've been thinking quite a lot about the jobs crisis the country is experiencing and the role of small business in a solution.

In my time this morning, I'd like to take a close look at the connection between small businesses and job creation, the second of the two claims.

In regard to this connection, we often hear these days that the small business sector doesn't have enough access to capital, and if only the banks would lend more money, jobs would be created. I'd like to look more deeply into this assertion and try to understand the underlying commercial reality.

So this is my general topic this morning: small business, job creation, bank financing. I am a former banker. I hope to add value to this conference by going into some depth on the subject of how banks actually lend to small businesses with a particular focus on business start-ups.

It's axiomatic that almost all start-ups are small businesses. It turns out that research shows that, with regard to job creation, it's *new* businesses that make the most difference in creating jobs, rather than small businesses broadly defined. The Kauffman Foundation supported research that came to this conclusion. So to narrow the focus even further, my specific topic today is start-ups, job creation, and bank financing.

The small business sector

Let me put start-ups, or new business formation, in the full context of the small business sector. The small business sector is extremely heterogeneous. Among the conventional criteria for classifying a business as small are number of employees, revenues, assets, number of establishments, and sometimes legal structure. Unfortunately, no single metric provides a definition that's adequate for all purposes. I'm told a report to Congress in the 1970s cited more than 700 different possible definitions of a small business. The most commonly applied metric is number of employees, with cuts of 500 or fewer and 50 or fewer.

I know many of you in the audience are familiar with this picture, but let me quickly review some high-level information. On an employment basis, the vast majority of business enterprises in the United States are small—even smaller than 50 employees. According to the Census Bureau's 2008 Statistics of U.S. Businesses, there are about 21 million nonemployer businesses in the country. Most are self-employed individuals operating very small unincorporated businesses, which may or may not be the owners' principal source of income. These are important sources of employment for the owners, but clearly are not strong creators of jobs for others. Of the slightly fewer than 6 million businesses that do have paid employees, almost 80 percent have fewer than 10 employees.

For the purpose of talking about start-ups and their impact on job creation, let me suggest a more qualitative categorization. I think we can put new businesses into two buckets: scalable-growth businesses versus inherently small-scale firms. The former have been referred to in a Kauffman Foundation study as "gazelles." The latter have sometimes been called "mom-and-pops." Inherently small-scale firms often populate highly fragmented businesses like restaurants, dry cleaners, boutique retail stores, and beauty salons. Occasionally, one of these inherently small-scale businesses surprises even the owner by growing beyond expectations. And occasionally, the business concept is unique enough to be franchised and thereby grow to substantial scale. Every once in a while a hamburger joint in San Bernadino, Calif., becomes McDonald's. But mostly the businesspeople who launch these small-scale enterprises start with the intention of remaining relatively small.

In contrast, the entrepreneurs behind scalable-growth businesses hope their companies will become large. They may expect that success will bring the opportunity to go public or sell to a larger company.

Within the category of small business start-ups, scalable start-ups and scaling young businesses are drivers of job creation. What makes them scalable is that these new firms address large potential markets, offer products and services with positive-scale economies, or have a business model that's replicable. Of course, many intended scalable-growth businesses fizzle out and fail. The DeLorean Motor Company—intended to rival GM—quickly disappeared (and then found its name recently resurrected).

Business births and deaths

As I hope what I've just said points out, there is a tremendous churn of new business formation, failure, and disappearance. In a dynamic economy like that in the United States, businesses start and cease operations all the time for any number of reasons.

Data from the U.S. Census Bureau show that the rate of establishment formation, and I'll use this as a proxy for business formation, averaged about 12 percent a year over the period 1992 to 2005. Exit rates averaged about two percentage points lower during this period, so the total number of establishments grew over time. A closer look at business mortality shows that about 20 percent of establishments failed in their first year. About half failed within the first five years.

The data here are not perfect, but I think they are reliably suggestive of an economy that is constantly and vigorously creating new businesses and jobs while at the same time destroying other businesses and jobs. It's the balance of these that makes for positive or discouraging labor market conditions. Without a continuous flow of new business formation, the U.S. economy would be always shedding jobs. And many of the jobs created by business start-ups are impermanent because of the high failure rate.

We know that the rate of business failures grew sharply during the last recession. More troubling, though, is that the rate of new business formation fell sharply during the recession and seems to have been slow to recover. According to data from the Bureau of Labor Statistics, the number of new establishments decreased from a peak of about 870,000 a year in 2006 to 700,000 in 2009, and was 720,000 in 2010.

So, in broad strokes, here's the picture: virtually all start-ups start small. Whether they're so-called "mom-and-pops" or "gazelles," they create some jobs at inception. Inherently small enterprises either fail or sustain operations, but tend to level off in terms of employment. The growth businesses ramp up creating initial employment. They may fail in time, or they may grow to what is still small scale and level off, or they may break out and grow to large scale.

A 2010 Kauffman Foundation study shows that just 1 percent of employer businesses—those growing the fastest—generate roughly 40 percent of new jobs in a given year. Three-quarters of those businesses are less than five years old.

Role of banks in start-up financing

The takeaway point is this: if we want to grow jobs, one place we should look is to start-ups and young businesses, especially scalable-growth businesses that often set out to commercialize innovation. Scalable start-ups need capital. So what is the role of banks in providing start-ups with this needed capital?

Commercial banks play a significant, but not dominant, role in start-up financing. The information is a little dated, but according to the U.S. Census Bureau's 2007 Survey of Business Owners, 19 percent of employer firms said that a business loan from a bank was a source of start-up or acquisition capital, 11 percent cited using credit cards, and 8 percent used home equity loans.

Despite the not insignificant role of banks, it turns out that the most commonly used source of start-up financial capital was personal savings—used by 62 percent of respondent firms.

In April of this year my colleague Federal Reserve Governor Elizabeth Duke spoke on small business credit availability. In her talk, she cited the Federal Reserve's 2010 Survey of Consumer Finances, which—despite its name—had some information on sources of funding to start, acquire, or expand closely held businesses. Referencing this survey, she pointed out that the most frequently used source of start-up finance was personal savings and assets.

When a bank does make a loan specifically to finance a start-up, the bank—regardless of its size—rarely backs the business per se, or the entrepreneur based on his or her good standing, without recourse to a so-called "second way out." Banks usually require an independent source of repayment, which typically means collateral unrelated to the business that can be readily liquidated, or a guarantor of independent means.

The most prevalent form of hard collateral is real property. Start-up entrepreneurs often hear, "If you'll put up your house, we'll lend to your new business." Real estate related to the business—to the extent the entrepreneur needs such and actually owns it—can be problematic as collateral because its value may be a function of the business cash flow it helps generate. In such a case, the banker's primary source of repayment and second way out are not independent of each other.

Other sources of financing

Banks have pulled back their direct lending to finance business start-ups in recent years. For example, the Atlanta Fed's poll of small business credit conditions in the Southeast found that businesses less than six years old were much less likely to have used a loan from a bank when they started their businesses than were older firms, and more likely to have relied on personal savings.

Beyond personal savings, owners of new and young businesses rely on their personal credit to start up. Sources of personal bank credit for starting a business include home equity loans and credit cards. So the fall in residential real estate values since 2007 is a plausible explanation for some of the drop-off in new business formation during and since the recession. Budding entrepreneurs have less equity in their homes to back a home equity line of credit. Both credit limits and outstanding balances on home equity lines of credit have continued to decline since 2007. According to CoreLogic, at the end of June this year, almost 23 percent of residential properties with a mortgage were in a negative equity position, and in some locations that percentage was much higher.

Personal credit card revolving debt has also been a source of start-up and early-stage financing. Personal credit cards are a form of unsecured credit and are granted on the basis of assessments of repayment risk factors such as personal credit history and income. Again, the bank is not backing the business idea per se. According to the New York Fed's *Quarterly Report on Household Debt and Credit*, both the number of credit card accounts and account limits have increased modestly in 2011, but they remain well below pre-recession levels as credit card delinquency remains elevated.

Some banks—but a minority—have specialized asset-based lending (ABL) units that enable them to use the business assets—receivables, inventory, and equipment—as collateral. But because ABL is a specialized lending business requiring significant infrastructure and systems investment, many banks are not geared up to do this kind of lending. ABL requires detailed and frequent monitoring of collateral positions and specialized expertise. Such lending techniques have historically been the province of nonbank finance companies that fund themselves in wholesale markets and are not depositories like banks and credit unions. The wholesale funding model of finance companies came under severe stress during the financial crisis and its aftermath.

The economics of the ABL business require substantial scale to absorb the cost of intense collateral monitoring. Many community banks cannot afford the investment in ABL infrastructure and specialized lending personnel. In any event, business asset-based loans and lines of credit are rarely available to raw start-ups that are not yet proven or established businesses. This is because predictable and reliable cash flow is always the preferred and happy way that loans get repaid.

My point here is that banks are not natural financial backers of a new business idea based on the perceived merits of the idea or the assets generated by the business in the early period of operation. This has been the reality for quite some time. The data showing the incidence of failure among start-ups reinforce this point, I think. The more reasonable domain of banks is loans of moderate risk to more established businesses that can demonstrate a track record. Because banks make loans using mostly depositors' money, they have to be right in their credit decisions virtually all the time.

So how then are we to get capital to start-ups and early-stage enterprises in the interest of job creation? What parties are appropriate and geared up to take the risk financing start-ups?

As I've already mentioned, personal savings and money from friends and family have been very important sources of start-up financing.

In addition, high-potential start-ups can also look to venture capital firms and angel financing. Business incubators are increasingly playing the role of organizers and coordinators of angel networks. A recent development has been the use of social media to mobilize start-up investment, aggregating smaller dollar investments.

More start-up activity needed

Taken together, this is not a wholly satisfying answer. Capital formation for scalable start-ups and early-stage businesses—including debt capital—is both a free market and public policy challenge. The volume of activity is immense, the targets of investment are small, the risk of loss is high, and the market—so to speak—is atomized, decentralized, and not highly organized.

We know the start-up sector is important, and it is sputtering. We need more activity in this area of the economy. It is tempting to look at the commercial banking sector as a fix. I think that is too narrow a view. My purpose today was simply to lay out the commercial reality of this challenge, as I see it. I think a practical grasp of commercial reality—including the role of banks—is a necessary starting point for generating ideas that will be helpful.

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