Speeches

The Financial Future of Entrepreneurs

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Good afternoon. I'm delighted to have been invited to speak today at your annual business leaders luncheon. I've heard a story that somebody once asked John Paul Getty -- who made money like scuba divers make air bubbles -- to discuss his business philosophy in a 15-minute speech. And Getty said, "I can do a lot better than that. I can sum up my secret to business success in six words." He then said: "Rise early. Work hard. Strike oil."

I'd be willing to bet that you and I have the first two parts of his advice nailed down. It's the last part we're all still working on. And so, today, short of striking oil, I'd like to talk about the most important thing in the world to small business owners everywhere: money -- where to find it and how to get it. In the real world that all of us inhabit, that's usually known as getting a small business loan. But since I'm a central banker and not a commercial banker, I'm going to talk about some far-reaching issues, like the massive changes to the financial services industry over the past few years.

1. Why Are Small Businesses Important to the Fed? But before I begin talking about financial services restructuring and its relationship to small business lending, I feel the need to answer a very fundamental question often put before me: Why are small businesses important to the Federal Reserve? The main reason has to do with their impact on the economy, since small businesses employ half of the private work force in this nation. And, while that may be reason enough to pay attention to this sector of the economy, let me go beyond sheer numbers.

Types of Work and Creativity
Small businesses are the ones that get many of the nitty-gritty jobs done in our economy. They are often the small service companies that clean our office buildings and repair our cars. They also provide high value-added services, like writing specialized software for very large businesses. And they are often much better at doing these jobs than a big business would be because they are nimble and creative, and they maintain the personal contact that allows them to understand exactly what it is a customer needs.

Entrepreneurs are invariably the ones who dream up the newest ideas for products or services none of us even know we need right now. Somewhere in this room, there might possibly be the next Bill Gates or the next Berry Gordy -- but that's dating myself. Maybe I should say the next Kenny Edmonds (also known as Babyface) or Antonio Reid (aka L.A.), particularly since their LaFace Records is based in Atlanta, where our Reserve Bank is headquartered.

Job Creation
Finally, small businesses are essential to the vibrancy of our economy because they create jobs -- and destroy them -- at a head-spinning rate. I say destroy, because we all know that many small businesses that open their doors are soon out of business for lack of enough capital, or the right idea at the right time, or for a hundred other reasons. One of our Federal Reserve governors, Larry Lindsey, discussed job creation recently at a small business conference that the Richmond Federal Reserve Bank sponsored. Research suggests, he said, that for every job created on net, roughly 10 new jobs were created, and nine jobs were lost. These numbers describe an economy that is remaking itself nearly twice a decade, thanks in large part to the willingness of many entrepreneurs to simply take a chance and to do things differently.

Overall, this nation has gained far more jobs than it has lost over the course of the past three decades. This situation stands in stark contrast to other nations in Europe, for instance, where countries have a much more rigid labor market structure than we do here. For example, while our private sector has been increasing employment by nearly 2 million during the last quarter century, the European private sector has barely created any net new jobs over the same period. Of course, our stable economy is partly responsible for this situation as is the entrepreneurial climate we have in this country.

Economic Intelligence from Small Business
So, we all know how important small business is to the U.S. economy, but why then is it important to me in my job? Because as a central banker, my views on monetary policy are shaped by the many sources of economic intelligence I receive. The unique perspective of small businesses in the Southeast helps to keep me better informed about the forces at work in our economy at large.

You may know that I represent the Southeast during monetary policy discussions of the Federal Open Market Committee (FOMC). This committee, which is part of the Federal Reserve System, meets every six to eight weeks to take a formal reading on the economy and monetary policy. In fact, we just had a meeting last week. At these meetings, which involve extensive discussions and debate, 12 of the 19 participants at the FOMC table are the regional Fed presidents. The other seven are Chairman Alan Greenspan and the other governors from the Board of Governors in Washington. The 12 presidents rotate their vote annually with five voting at each meeting, and I will be a voting member next year. But we all have a voice at every meeting, and I can assure you that all the governors and presidents listen carefully to each others' views. It is truly a deliberative process by which we hopefully reach the very best policy decision for the country as a whole.

In fulfilling that responsibility, each Reserve Bank president has his or her own staff of economists, who monitor the regional economy and also develop their own forecasts of the national economy. In addition, we regional Fed presidents rely on grass-roots information from people like you. Business people and bankers who serve on our board of directors meet with us each month and make formal reports on what they are seeing in the economy. I also often meet with other groups of business leaders around the Southeast, including our Advisory Council on Small Business, Agriculture, and Labor. As you get to know me better, I hope you will feel comfortable to call or come see me from time to time to tell me what's going on in your industry.

2. What's the State of Small Business Lending Now?
As a backdrop to talking about developments in the financial services industry, I'd like to answer the more immediate question of, What's the state of small business lending now?

Overall, it's in good shape. According to a recent national survey by the National Federation of Independent Businesses, only 7 percent of small business respondents said that lack of access to credit or the cost of credit is a primary problem -- and 40 percent said it isn't a problem at all. That puts credit concerns 64th on a list of 75 small business concerns. The Number 1 problem they cited is the cost of health insurance, while other high-ranking problems have to do with high taxes, red tape, and the low quality of labor.

The fact is that small businesses now have access to more credit and to more sources of credit than in the past. How do we know? We study banking loan statistics. The Federal Reserve monitors the status of business lending by the banking sector on a regular basis through our bank call reports, and the data show healthy increases in small business lending. For instance, banks that report small business loans showed an increase of nearly 13 percent from June 1995 to June 1996. This followed a 13 percent increase from '94 to '95, and an 11 percent increase from '93 to '94.

The Federal Reserve also conducts surveys to determine how small business gets access to the financial sector and how it uses the financial sector. We completed the second extensive survey on this topic two years ago. Results show that, overall, banks provided more than 60 percent of the dollar volume of credit (excluding trade credit and credit card credit) in both 1987 and 1993. However, the percentage of firms that got credit from banks dropped significantly from 44 percent to 37 percent over those same five years. Savings and loans also lost nearly half of their 7.4 percent share of the small business credit market. And who picked up this business lost by banks and thrifts? Primarily, finance companies, leasing companies, and brokerage firms. That tells me that small business owners are finding more sources of credit.

Now, it's probably a safe bet that some of you small business owners here today would tell me that things aren't quite as good as all those statistics imply -- that although you may be able to get a loan, the rates are higher than you'd like. In fact, bankers are saying something similar.

When I talk to bankers in the Southeast, they tell me that rate spreads for small business loans are greater than for large customers not just for the usual reason that the risks and costs are higher for small firm lending -- but also because banks' pricing of small business loans has become more accurate in terms of factoring in the risks and costs. Senior loan officers throughout the nation made this same point in the Fed's survey that was just released four days ago [Nov. 19]. I think this pricing issue is a new twist that small business owners must pay attention to, and I will have a little more to say about it in a moment.

So, looking at the aggregate, small businesses's access to credit has been growing, thanks in part to new sources of credit. If things are good now, I think the future is looking even better. I believe that structural changes in the financial services industry -- brought on by the increasing use of technology -- will continue to make it easier for worthy small businesses to find the money they need to grow, and that's what I'd like to talk about next.

3. Why Is the Future Brighter?
Why do I think the future is even brighter for small business lending? It all comes down to competition. Thanks to technology that is allowing both banks and non-banks to rapidly create new products and services, both entities are fighting harder to keep their old customers and to find new ones. It reminds me of the time, beginning in the late 1970s, when the state of Florida was transforming its banking system and allowing banks from outside the state to open up branches. These changes brought new competition to bear on the marketplace. One orange grower summed up the effects of this competition perfectly by saying, "All I know is, suddenly I had bankers who were willing to talk with me who weren't before."

Now, thanks to interstate banking, we're starting to have this same kind of competition on a national scale. For example, it has been good for consumers who benefit from lower credit-card rates. And, I believe that small business owners will be the next group to benefit from this competition to find new sources of business.

Parallels Between Consumers and Small Business
Because of the increased competition within the financial services industry, consumers like you and me are getting more attention from our bankers. (Have you had a note or phone call from your personal banker lately?) The securitization of credit cards and mortgages has contributed to the development of national markets. Therefore, we almost literally have bankers beating on people's doors to try to get them to sign up for one of their lines of business.

I see some strong parallels between how bank deregulation has increased access to credit for consumers and how it might do the same for small businesses. In addition, financial service companies now have to look harder to see where they can make a profit, particularly as their margins have decreased in personal and mortgage lending. Small business lending becomes a more attractive alternative when it's just about the only profitable thing left. So, bankers are seeking to economize and to streamline their credit evaluation process for small businesses. This should come as no surprise. And it goes without saying that anything that can help to make the loan process more uniform -- rather than having to gather information about each business loan on a case-by-case basis -- would certainly save costs.

Credit Scoring
Right now, the financial services industry is on the cusp of developing a new system of providing financing to small businesses that incorporates credit scoring. In fact, some of the biggest banks in this nation have already instituted credit scoring systems and have begun to go after small business loans aggressively.

Credit scoring is a statistical procedure that allows a financial institution to evaluate default risk based on the relationship between observed loan performance and specific characteristics of the loan and the borrower. In order to develop a credit score card for businesses, lenders must have a large amount of historical information on the performance of loans with similar characteristics. Because business borrowers are such a diverse group, it will take time to develop these databases. So to help in this effort, lenders are adopting more standardized loan terms and application forms.

I should point out here that not every small business loan can be standardized so that it can be securitized. That's why regional banks and your local community banks will continue to play their important role in small business lending.

Now, I know that credit scoring still has its share of glitches, but the intellectual and technological investments that are being made will help to evaluate these loans. And when that happens, I believe that small business loans will go the same route as mortgages, credit card receivables, and the like, being funded in the national credit market. Just as the securitization of credit cards has helped consumers, a national small-business-loan market could help make credit more readily available for small businesses in general.

4. How Can Credit Scoring Help Both Small Businesses and Bankers?

If you're a small business person, you may be thinking, "I can see how credit scoring makes a lender's job easier, but can it really help me?" Let me tell you why I think credit scoring can help both small businesses and bankers. With new technologies and greater availability of information, banks and other lenders are becoming more adept at doing just what I mentioned earlier: efficiently evaluating loan risks. That means that, in the long run, lenders should be able to lower the costs of small business lending.

By using credit scoring and by moving toward more standardized small business loans, financial services companies should be able to "securitize" small business loans. Both bankers and small business owners will reap the benefit of increased liquidity thanks to securitization, because more liquid small business lending will provide banks and other lenders with additional sources of funding. That should translate into more loans for more small business owners. Another benefit of this new technology-based system is that it should help lenders to make more timely decisions on loans with fewer delays.

Demographics

And I don't think that the benefits of the restructuring of the financial services industry will stop there for small businesses. Why? Because I believe that, thanks to the changing demographics in the United States, banks will have to start figuring out ways to make money on the liability side of their ledger, rather than depending primarily on the asset side. When that happens, we're going to see some other radical changes in the industry, and, on balance, they should all be positive for small businesses.

Here's how I think financial institutions have to be thinking about their future: It all comes down to the baby boomers and the major shift we're going to see as they reach that point in their lives when their kids are out of college, for example. In addition, as an age group, the boomers are going to start to inherit large sums of money from their parents' generation. Those items are on the plus side of the ledger.

On the minus side, though, is the fact that this large group of people is concerned about how much of a cushion it's going to get from Social Security when it's time to retire. The upshot is that these folks are not about to drive to their nearest bank and buy some CDs to secure their retirement years. They're going to want financial advice and brokerage services, and I believe banks will find ways to provide these services -- at a profit, of course. Many large institutions have already started to offer new services -- such as sweep accounts, tailored investment programs, and improved lock box services -- to fill more small businesses' needs.

I can see a good fit between small businesses and the expertise that already exists within financial institutions. First, small business owners will want this same kind of financial advice and brokerage service to diversify their asset holdings. Second, and closely related, small business owners have always had problems with succession planning. Almost by definition, in a small business, when the owner wants to retire, there simply aren't as many people to choose from who have the experience to lead the company. It would seem that estate planning could be a very good fit with the needs of small business owners, who need good advice on how to cash out of their business and how to plan for the time when they are no longer with the company.

Small Business Owners' Responsibility

Ultimately, though, nobody in the financial services industry can help entrepreneurs or small business owners who cannot help themselves. What I mean by this, particularly for small business owners, is that you must devote the time to putting together the right kinds of materials so that bankers and other lenders can adequately assess the risk of making you a loan. Unequivocally, that means nobody who either wants to go into business, or expand an existing business, should even think of visiting the local financial institution without both a balance sheet and a business plan in hand.

This advice may seem simplistic to many of you, but you might be surprised to know that many people seem to think that lenders are like Hollywood movie producers who agree to produce movies based on a high concept described in one or two sentences by a hotshot screenwriter. Lenders are not Hollywood producers. They cannot give out money based solely on a high-concept idea. They need to see numbers. With the advent of credit scoring and securitization, numbers are becoming even more important.

Conclusion

To sum up, then, technology and deregulation are drastically changing the financial services industry. You personally may not be seeing changes yet, but you're going to see them over the next five years. And I promise you, they will make a significant difference for small business owners.

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