

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Does Small Business Need a Financial Fix?

by Katherine A. Samolyk and Rebecca Wetmore Humes

Although by most conventional economic standards the recent recession is two years past, the health of the economy remains a concern to policymakers. The slow pace of the recovery and the attendant lack of employment growth have led to the perception that a shortage of credit, especially bank lending, is part of the problem. As the story goes, the small business sector, considered a major source of job creation in our economy, is stagnating, largely because of a credit crunch. Shortages of bank credit tend to hit small businesses particularly hard because banks have traditionally been the major source of funding for this sector.

The focus on small business borrowing leads in several directions. On one hand, many debate whether these firms are in any sense constrained in their ability to get credit, or are simply choosing to finance their activities from sources other than conventional lenders. On the other hand, even among policymakers who espouse the credit crunch explanation, there is a lack of consensus as to whether the dearth of small business borrowing reflects an inefficiency inherent in private credit markets or the impact of government policy—be it federal borrowing or financial market regulation. Finally, some argue that sluggish

growth mirrors a lack of demand for funds rather than factors related to the supply of credit.

Without attempting to resolve these issues, policymakers have prescribed a number of remedies for the anemic growth in small business credit in the form of political initiatives. This *Economic Commentary* examines several of these proposed financial fixes. Some aim to spur credit to this sector by promoting activity in the secondary market for small business loans. Others attempt to encourage direct lending by reducing the costs of originating and holding these claims. The initiatives differ not only in the types of financing proposed to increase business credit, but also in the government's role in achieving this end. Some call for direct government intervention, while others recommend a change in regulations to affect the market's allocation of credit. Here, we argue in favor of a deregulatory approach—indeed, an approach that has already been initiated.

■ Funding Small Business

Small businesses are frequently credited with fueling job creation as well as new technology. For example, in 1975 a young entrepreneur, Bill Gates, founded Microsoft Corporation with a boyhood friend. Today this enterprise has

In response to concerns that a credit crunch is impeding growth of the small business sector, policymakers have brought forward several proposals aimed at fueling additional lending. Some advocate direct government intervention, while others aim to change existing regulations to promote the market's allocation of credit. In assessing these proposals, the authors contend that market-oriented initiatives, such as a recent Securities and Exchange Commission ruling, represent the right approach to improving the access of small businesses to credit markets.

grown to be the largest and most influential company in the software industry—a \$2.8 billion behemoth. A 1988 survey by the National Federation of Independent Business (NFIB) states that prior to the recent recession, nearly half of the nation's output was produced by small firms.¹ The importance of the small entrepreneur as a player in the economy underscores current concerns about the ability of this sector to obtain needed funds.

Examining the market for small business finance is not a simple task. The only available data on the balance sheets of smaller firms are found in the Quarterly Financial Report for Manufacturing Corporations.² As the title indicates, this information covers only the manufacturing sector, which accounts for less than 20 percent of our economy's national income. For small firms in the increasingly important service sector, balance sheet data are unfortunately not readily available.

Small businesses have identified commercial banks as their main suppliers of financial services, which include funding for working capital.³ These institutions are the primary source of unsecured lines of credit as well as other types of lending that are often tailored to the particular needs of each enterprise. To the extent that these borrowers are small and specialized, their liabilities are relatively illiquid and hence unmarketable, because it is hard to identify and communicate the associated credit quality to potential investors.

Given that banks are a special conduit of funds to small firms, their capacity to lend translates into the ability of these firms to obtain external funds. Thus, it is not surprising that in the wake of major restructuring in the banking industry, some consider the dearth of small business credit to be symptomatic of a credit crunch.

However, in tandem with problems in the banking sector during the past decade, there has been a proliferation of small business credit from nonbank sources, such as finance companies. To some degree, the surge in credit supplied through these lenders reflects improvements in information technology that have increased their cost effectiveness in supplying credit to smaller firms. In fact, bank holding companies

are joining the trend toward providing business credit by selling asset-backed securities through nonbank subsidiaries in a process known as *securitization*. This trend is commonly viewed as a response to the regulatory costs associated with the provision of the federal safety net, as well as to greater nonbank competition.⁴ To the extent that the loans financing autos, inventories, and the like are being securitized, a de facto secondary market for business credit has emerged. Although it is impossible to tell the degree to which small firms use this source of finance, the documented growth in these credit vehicles suggests that the drop in business lending on banks' balance sheets may, at least in part, reflect increased use of alternative credit sources.

Another problem in examining the funding of small business is that people frequently confuse *venture capital*, which is generally defined as the resources used to start up new businesses, with *working capital*, which refers to the financing used by existing firms as they conduct their current operations and expand the scale of their activities over time. Though the data on sources of venture capital for small business are sparse, another survey by the NFIB finds that the number of new business owners who used either institutionalized venture capital or government programs was negligible.⁵ In fact, while financial institutions do provide some funding for firms' start-ups, most new business owners generally rely on their own resources to set their enterprises in motion.⁶

Nevertheless, the concern with credit availability as a prerequisite for the job growth associated with small businesses underlies the sentiment for government policies to promote lending to this sector. Examining several of these proposed policies will illustrate the issues involved: 1) the viability of making

business loans marketable; 2) the extent to which banks can be encouraged to lend more; and 3) the degree to which regulations constrain small business access to direct credit markets.

■ The Secondary Market Approach

Currently, at least two pieces of congressional legislation seek to promote a *secondary market* for small business loans. This would allow loan originators—such as banks—to package business loans and sell them to other investors rather than fund them with their own debt (for example, deposits). The underlying motive is to increase the marketability of this type of credit and hence the flow of funds to smaller firms, just as home buyers' access to mortgage financing has been enhanced by a strong secondary market for residential mortgage loans.

A plan introduced by Sen. John Kerry (D-MA) and Rep. John LaFalce (D-NY) proposes that government play a role as a financial intermediary for small business loans similar to that of other government-sponsored credit agencies, such as the Federal National Mortgage Association (Fannie Mae). The Small Business Credit Act would create a government-sponsored enterprise (GSE) called the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises (Velda Sue). This enterprise would buy and package loans made to businesses with net worth less than \$18 million and net income less than \$6 million, then issue securities backed by these pools.

The loans pooled by the proposed GSE would be secured by senior mortgages. Velda Sue would purchase only 80 percent of the loan, leaving the remainder with the originator. Finally, the U.S. Treasury would have a proposed obligation to purchase up to \$1.5 billion of

NEW POLICIES AND PROPOSALS AFFECTING SMALL BUSINESS CREDIT

THE SECONDARY MARKET

Small Business Credit Act (Velda Sue)	Would create a government-sponsored enterprise to buy and securitize small business loans.
Small Business Loan Securitization and Secondary Market Enhancement Act	Would reduce regulation, making it easier for the private market to securitize small business credit.

DIRECT LENDING

Small Business Capital Enhancement Act	Would create a government-subsidized loan loss reserve fund for small business loans.
Joint Interagency Policy Statement on Credit Availability	Reduces the regulatory burden on depository institutions provided all statutory requirements are met.

ACCESS TO DEBT AND EQUITY MARKETS

Small Business Incentive Act	Would change regulations to make it less costly for small businesses to issue securities and make it easier for different types of investment pools and business development companies to invest in the securities of small businesses.
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SOURCES: *Congressional Record*, U.S. Senate, February 17, March 2, and March 4, 1993; and *Daily Report for Business Executives*, March 11 and March 31, 1993.

Velda Sue securities. Thus, while the asset-backed securities are not government guaranteed, the Treasury's role is likely to cause market participants to treat them as if they were.

An alternative to direct government sponsorship of business credit securitization is to change the regulations limiting investments in private intermediaries that conduct these activities in order to alter market incentives for the pooling and funding of small business loans. A measure sponsored by Sen.

Alfonse D'Amato (R-NY) takes this approach. The Small Business Loan Securitization and Secondary Market Enhancement Act would make it simpler for private institutions to expand secondary markets on their own.

Under this law, financial institutions that manage pension funds would be allowed to participate in the pooling and packaging of small business loans. Some restrictions in the margin and delivery rules under federal securities laws would be removed, allowing issu-

ers more time to pool small business loans and sell them as securities. The legislation would also reduce costs by permitting issuers to file a single registration statement with the federal government instead of filing in every state, as is currently the case. Banks would not be required to hold "prohibitively excessive" amounts of capital against small business loans that had been sold. In addition, the proposed amendments to federal banking laws and state investment laws would increase

the number of potential investors by allowing depository institutions, insurance companies, and pension funds to hold these securities. Finally, the Secretary of the Treasury would be directed to clarify the tax rules relating to these securities to facilitate their sale.

Encouraging small business loan securitization by deregulation will perhaps increase the volume of secondary market activity already in existence. Some business loans may be difficult to standardize, thus not lending themselves well to sale in a secondary market. Still, if depository institutions can free up some of their on-balance-sheet lending capacity, there may be a corresponding increase in the less marketable forms of small business lending.

■ Encouraging Direct Lending

An alternative to the secondary market approach is a policy that would promote direct lending to small business by reducing the cost to lenders. Again, there are two possible paths to achieve this end: direct government intervention and deregulation. A bill introduced by Sen. Donald Riegle (D-MI) is one example of government subsidization of direct lending to small businesses. The Small Business Capital Enhancement Act would establish a state-administered program in which the borrower, lender, and state and federal governments would pay premiums into a loan loss reserve fund that would compensate the lender in the event of borrower default.⁷ Participating lenders would include banks, savings and loans, and credit unions with proven lending experience and financial and managerial capacity. Supporters believe that this bill will increase lending to small businesses by lowering the risk to banks and other lenders.

In the event of default, the lender could recover losses up to the total of the premiums associated with that loan. If a

loss exceeded this amount, the lender could still draw on contributions associated with any other loans it had made under the program. Each lender's claim on this fund would be limited to the premiums associated with its loans, so that it would be required to absorb any additional losses. Thus, while the program is not an outright government loan guarantee program (the stated liability is limited to the fund contribution), the government's ante in the fund is clearly a subsidy.

Notwithstanding concerns about the federal budget deficit, the issue of subsidizing small business loans should be addressed. If the private sector is unwilling to make these loans without government support (because they are unprofitable or too risky), perhaps they should not be made. Alternatively, if this credit is not being extended because of the costs associated with government policies, a more fruitful approach may be to address regulatory burdens. Several proposals specifically target bank costs of lending.

The new administration and the four financial regulatory agencies recently released a policy initiative aimed at reducing regulatory burdens *without* any legislation. The Joint Interagency Policy Statement on Credit Availability represents a collaborative effort between the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision. The plan was still broad in focus when it was released on March 10, but the specifics of any change will be announced as they are finalized. Here, we concentrate on two parts of the plan that target small business lending.

One area would eliminate barriers to loans for small and medium-sized businesses by reducing documentation and

encouraging the use of lenders' judgment and borrowers' reputations. On March 30, it was announced that strong, adequately capitalized banks will be allowed to make and carry a basket of loans with few documentation requirements.⁸ The maximum amount of each loan qualifying for this program is \$900,000, or 3 percent of the lending institution's portfolio, and the total of such loans is limited to an amount equal to 20 percent of the institution's capital. Banks and thrifts will be encouraged to make these loans "based on their own best judgment as to the creditworthiness of the loans and the necessary documentation," thus allowing for so-called *character loans*. The loans will be evaluated on the basis of performance and are exempt from examiner criticism of banks' documentation.

The implications of this policy for small business credit availability hinge on two factors. The first is whether the documentation of credit quality represents a relatively large share of the cost associated with lending to smaller firms. In addition, banks must be willing to reduce documentation. They may not be prepared to do so, as documentation costs seem to be viewed as necessary in evaluating credit risk.

Although the specifics have not yet been announced, another area of the policy initiative that could encourage small business borrowing is one that would reduce the appraisal burdens associated with real estate. Property is often used as collateral by small businesses that have few other tangible assets. However, the high costs of appraisals may make these loans unprofitable. The new policy would change requirements so that these appraisals would not need to be conducted by licensed or certified appraisers when real estate is offered as additional collateral. The agencies also seek

to limit the frequency of required appraisals to only those needed for safety and soundness. In addition, the agencies hope to prevent loans from being foreclosed on when the collateral value has dropped even though the borrower has proven to be capable of servicing the debt. Easing foreclosure rules on real estate lending would benefit small businesses by making their main source of collateral more attractive. Nonetheless, all of these changes come with the stipulation that *all statutory requirements must be met*. So, the strict requirements for appraisals outlined in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) may blunt the impact of this new policy initiative.

■ Access to Debt and Equity Markets

The policy prescriptions outlined above aim to encourage lending to small business by financial intermediaries. Alternatively, in an attempt to increase the access of small business to financing in direct credit markets, Sen. Christopher Dodd (D-CT) has introduced a bill, the Small Business Incentive Act, that would amend the Securities Act of 1933 and the Investment Company Act of 1940. Public offerings of securities up to \$10 million could be exempted by the Securities and Exchange Commission (SEC) from registration and disclosure provisions. The current exemptive authority is only \$5 million. By lowering the costs of issuing small amounts of securities, more small firms would have access to the market. This bill would also make it easier for different types of investment pools and business development companies to invest in the securities of small businesses by amending the Investment Company Act of 1940, which governs mutual funds and other entities that deal in securities of other businesses.

■ Does Small Business Need a Financial Fix?

With all of the aforementioned proposals on the table, it might seem impertinent to question whether small business truly needs a financial fix of *any* kind. The multifaceted pursuit of remedying the perceived lack of small business credit may in fact be a case of legislative overkill. Indeed, we recommend a second opinion in light of recent regulatory changes by the SEC.

In particular, Rule 3a-7 of the Investment Company Act of 1940, which the SEC passed last fall, targets small business lending by expanding the options for asset securitization. The provisions of this rule will allow lenders, including banks, to package a broader range of assets, including small business loans. Because banks can earn fee income for servicing the loans being sold, acting as a trustee for investors as well as providing credit enhancements, they will benefit from the expansion of the breadth of asset securitization.⁹

Beyond representing a potential profit opportunity for the banking sector, the SEC action is intended to promote business credit availability. The means to this end involve making this class of loans more marketable to both originators and investors. For example, securities backed by general-purpose loans to smaller firms can now be sold on public markets, allowing them to be securitized in a manner similar to that used for residential mortgages. By increasing both the liquidity and the profitability of these loans, this policy encourages bank lending to this sector. This remedy is attractive in that it facilitates small business lending via asset-backed securities markets that are proliferating *because* they are profitable. As noted by SEC Chairman Richard Breeden, "The rules should have a direct and quite immediate benefit to the capital markets in per-

mitting greater flexibility with instruments that have proven their value to the financial markets."¹⁰


At the other extreme, government-sponsored attempts to promote lending would represent a move to encourage lending in an area the market has deemed unprofitable. Proponents of direct government intervention (in the form of Velda Sue or the loan loss reserve program of the Small Business Capital Enhancement Act) argue that such intervention is needed because the private sector is not in a position to absorb the risks involved in small business lending. However, credit markets have become *more* efficient in recent years, so if the private sector is not extending certain types of credit, it is because these products have not become profitable enough relative to the associated risks or regulatory costs.

The merit of current proposals to reduce regulatory burdens is uncertain. The Clinton plan seems well-intended, yet the impact of some of its elements may be blunted by vagaries of interpretation as well as statutory regulations. Proposed legislation aimed at expanding small business access to securities markets would allow the market to make the ultimate allocative decisions and may have merit. Yet, the recent SEC changes have diminished the urgency of a quick fix. These policies should thus be evaluated on their probable long-term effects rather than on more immediate sentiments for spurring small business lending.


Perhaps the most prudent action regarding small business credit availability would consider the effect of the SEC ruling before prescribing future regulatory changes.

■ Footnotes

1. See William J. Dennis, Jr., William C. Dunkelberg, and Jeffrey S. Van Hulle. *Small Business and Banks: The United States*. National Federation of Independent Business Foundation, 1988.
2. This report, published by the U.S. Department of Commerce, Bureau of the Census, gives data by asset size categories of less than \$5 million, \$5-10 million, \$10-25 million, \$25-50 million, \$50-100 million, \$100-250 million, \$250 million to \$1 billion, and greater than \$1 billion.
3. See Gregory E. Elliehausen and John D. Wolken. "Banking Markets and the Use of Financial Services By Small and Medium-Sized Businesses." *Federal Reserve Bulletin*, vol. 76, no. 10 (October 1990), pp. 801-17.
4. See Charles T. Carlstrom and Katherine A. Samolyk. "Securitization: More than Just a Regulatory Artifact." Federal Reserve Bank of Cleveland. *Economic Commentary*, May 1, 1992.
5. See Arnold C. Cooper, William C. Dunkelberg, Carolyn Y. Woo, and William J. Dennis, Jr.. *New Business in America: The Firms and Their Owners*. National Federation of Independent Business Foundation, 1990.
6. While entrepreneurs may draw on an existing source of credit (such as a second mortgage) to start a business, banks generally do not lend solely on the basis of the prospective profitability of the new enterprise.
7. The bill authorizes \$50 million of federal funds to cover the federal government's part in the program. The borrower would pay a share (from 1.5 to 3.5 percent) of the loan amount to the loss reserve fund. The lender would pay the same amount. The lender could also negotiate with the borrower as to how much of its contribution would be paid by the borrower as part of the loan. The total borrower-lender contribution would be matched by the state. The federal government would then reimburse the state for half of its advance to the loss reserve fund.
8. Banks must earn one of the top two supervisory risk ratings and qualify as adequately capitalized institutions according to guidelines set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Insider loans and delinquent loans cannot be included with these loans.
9. Banks are expressly forbidden from serving as a trustee of these assets if they also provide credit enhancement in support of these instruments.
10. See "SEC Eases Securitization Rules: Banks Gain Options." *American Banker*, November 20, 1992, p. 1.



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