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# BRIDGES

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## Understanding the Small Business “Credit Crunch” Perspectives from a Fed Regulator

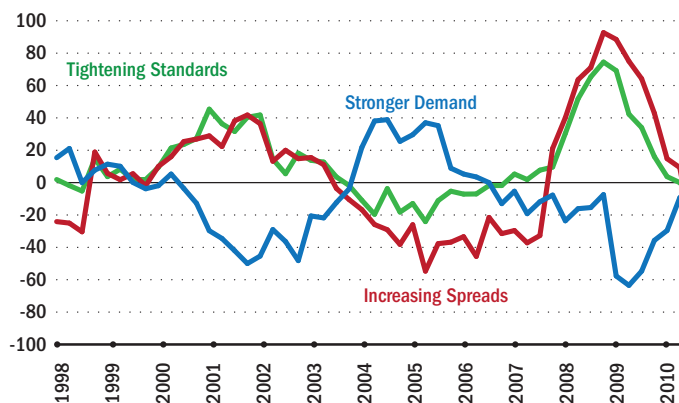
By Julie L. Stackhouse

The financial crisis and recession have challenged many aspects of our economy over the past 18 months, including the fortunes of small businesses. Yet, history tells us that small business activity is essential to creating new jobs in our economy. And the formation and growth of small businesses depends critically on access to credit.

Businesses across the country report that credit conditions remain very difficult. In fact, the data on small loans made by banks show that outstanding loans have dropped from almost \$700 billion in the second quarter of 2008 to approximately \$660 billion in the first quarter of 2010.

To better understand the factors affecting small business

**Federal Reserve Bank Senior Loan Officers Opinion Survey**  
Percent of Respondents Reporting Changes on Small Firms C&I Loan Activity  
Q1 1998 - Q2 2010



Source: FRB and Haver

credit conditions, the Federal Reserve held a series of more than 40 meetings across the country with small businesses, financial institutions, small business trade groups, regulators and small business support

providers—including several in the Eighth Federal Reserve District. The input from those meetings suggests that there are *many factors* affecting small business access to credit, and that no one answer will

provide the solution. What are the factors contributing to the perceived “credit crunch?”

**Key Factor 1: Tightened credit standards and the procyclical effects of credit made available through automated underwriting**

Data from the Federal Reserve’s Senior Loan Officer Survey suggests that standards on traditional bank loans (often called “relationship-based lending”) have tightened overall from where they stood a few years ago. (See chart.) Some bankers suggest that the tightening was long overdue; others suggest that some relaxation may occur as the economy improves. In any event, some borrowers are seeing the impact through additional collateral requirements, a greater focus on cash flow in

*continued on Page 2*

# In this Issue...

By Allen North



Recently I participated in a national event hosted by the Board of Governors as part of the Federal Reserve's efforts to address small business financing needs. The System convened key stakeholders to share their perspectives on the needs of small businesses. Prior to hosting this conference, local events were held throughout the country to identify credit gaps in small business financing, gather information on regional differences in access to credit, and identify best practices that can be replicated in other markets.

The St. Louis Fed's Community Development department conducted four of the local meetings in our district—in Missouri, Arkansas, Tennessee and Kentucky—but the key takeaways from the meetings were similar:

- The economy continues to be an issue for small business. Many business owners have maxed out their credit cards or their credit limit has been reduced, which was a primary source of capital for business owners. With banks cutting credit card limits, owners are finding it harder to get other types of credit.
- Stronger underwriting standards are limiting the supply of loans to small business. Financial institutions have returned to more traditional underwriting standards that are more dependent on equity and cash flow, rather than credit scores.
- The demand for small business support services and assistance from Small Business Development Centers is on the rise. Technical assistance providers report they are currently seeing a different type of client. The business owner who was the traditional bank customer is now seeking the assistance of support service providers and searching for alternative funding sources.
- The U. S. Small Business Administration (SBA) loan programs are good; however, most financial institutions have not taken advantage of the new programs and increased guarantees. Many still have the perception that SBA products require too much preparation, and monitoring and resolution of problem loans is too cumbersome.
- Creating a synergy between financial institutions and support service providers is needed to sustain small business development. A referral system and better communication is needed between the organizations.

Our Community Development team continues to work with stakeholders and community leaders to address these issues locally. This edition of *Bridges* highlights additional efforts to identify issues and solutions for both small businesses and the commercial real estate market.

*Allen North is vice president in the Federal Reserve Bank of St. Louis' Banking Supervision and Regulation Division, with responsibilities for Consumer and Community Affairs.*

## “Credit Crunch”

*continued from Page 1*

analyzing creditworthiness, the requirement for more equity in the proposal or a request for personal guarantees. For some borrowers, these conditions cannot be met.

Tightening credit conditions have been seen not only in relationship-based credit; they are also revealed in the cost-efficient credit generated through automated underwriting systems used by some larger banks. These systems have emerged over the past 15 years and rely on models that are driven primarily by credit scores. Some forms of automated credit are unsecured, such as credit card lines. Other forms are supported by collateral, and frequently, by commercial real estate. Credit generated through automated underwriting mechanisms tends to be procyclical, meaning more credit is available during strong economic times, and less credit is available during periods of economic stress. If a borrower's credit score has declined, or the value of the collateral reduced, then the credit line may be reduced. Some banks using these models have introduced “second look” programs. Those denied credit under the automated system may appeal the decision such that they receive second evaluations.

**Key Factor 2: Weak loan demand on the part of healthy, established businesses**

Credit supply conditions are not the only contributing factor. The demand for credit on the part of healthy, established businesses is also weak. Bankers associated with healthy financial institutions indicate that they have adequate funds, or liquidity, to make loans to creditworthy businesses. However, bankers report that most applicants are seeking to renew existing loans, and there is still little in the way of new money lending for capital investment or business expansion. Businesses cite concern about economic recovery and the direction of government policies.

### **Key Factor 3: Bank health**

While healthy financial institutions generally have adequate funds for lending, those institutions in weaker financial condition face capital constraints, human resource constraints, and concern about regulatory reaction to expanded lending. Presently, 829 of approximately 7,800 financial institutions are on the FDIC's problem bank list. In general, these institutions are experiencing severe asset quality problems. The losses associated with problem assets have impacted capital.<sup>1</sup> To maintain regulatory minimum or even higher required ratios, these institutions may attempt to raise new equity capital. Often, though, investors are unwilling or unable to accept the risk of the investment. Thus, the institution's alternative course of action is to shrink assets, either

through the sale of assets, sale of branches, or lack of renewal of maturing loans.

These institutions typically face human resource constraints, as well. Substantially more employee time is deployed in working with troubled borrowers, making less time available for marketing and extending new credit. In today's environment, many of these same institutions are actively attempting to reduce concentrations in commercial real estate loans. Such risk reduction efforts can detract from the ability to extend new credit.

Finally, institutions in troubled condition face heightened regulatory review standards. Typically, the financial health of the institution is examined twice each year. Understandably, the institution's board of directors and management become increasingly reluctant to take on additional risk because of the fear of regulatory criticism. To mitigate unfounded concerns, regulators have issued guidance to examiners in the areas of small business lending and commercial real estate loan workouts.

#### **Key Factor 4: Size and limitations of Small Business Administration programs**

Some borrowers unable to qualify for bank credit may qualify for credit under programs sponsored by the Small Business Administration (SBA), and in particular, the loan guarantee programs. These programs are designed to

help small entrepreneurs start or expand their businesses. Loans are originated through bank and nonbank lenders, and the SBA guarantees a specified portion of the loan. Some lenders also use the 504 Fixed Asset Financing Program, while a few use the SBA's Microloan Program. The latter program is made available through nonprofit, microloan intermediaries.

This second "tier" of credit has been important for small businesses in recent months. SBA lending has been stimulated through special funding allocations, an increase in guarantee authority and fee waivers—all of which have helped lenders make loans that otherwise might not have been funded. Not unexpectedly, as temporary supports are discontinued, the volume of new loans also declines.

Banks see opportunity for streamlined and faster SBA loan processing, an SBA guarantee program for loan refinancing that no longer meets bank criteria and packaging assistance for the 7(a) program, similar to what is available for the 504 program. Some banking organizations believe more borrowers would qualify for SBA programs if they had access to technical assistance to aid them in development of such critical documents as business plans and cash-flow analyses.

#### **Key Factor 5: Credit gaps for those not meeting bank or SBA criteria**

For small businesses not meeting the traditional criteria of banks or the SBA, other alternatives are limited. Community Development Financial Institutions (CDFIs), which provide credit and financial services to the most distressed communities, provide one possible loan source to fill this gap. Credit unions have also met some of the need. Other specialty lenders, such as venture capital funds, are typically less accessible to the "Main Street" small business because of the relative sophistication required to draw the interest of these funds. In many cases, these very small and often new businesses have turned to personal unsecured resources, such as family and friends, home equity lines of credit and credit card lines. Employment, housing and credit conditions have reduced these already limited sources.

#### **So, where do we go from here?**

While many conclusions can be drawn from the information gathered at these 40-plus meetings, I would offer a few personal observations:

1. In general, healthy banks have funds to lend and sufficient capital to support new lending. Creditworthy borrowers unable to obtain credit from their current banks may wish to consider other bank alternatives.
2. If the borrower cannot meet bank credit standards, financing through the Small

Business Administration could be considered. Many, but not all, banks are able to facilitate this financing, and sometimes, the borrower will need technical assistance from small business support providers to meet the credit documentation standards. More can be done to encourage banks to engage in small business lending and to form partnerships with small business support groups. Ongoing funding of the SBA and small business support groups will be critical to long-term success.

3. Some borrowers, especially very small businesses, may not qualify for either bank or SBA credit. These borrowers have typically relied on family and friends, credit card lines and home equity lines of credit because of the riskiness of their business operations. Such funding sources have undoubtedly shrunk over the past few years.

This credit gap may be the most difficult to fill, and a public policy decision on stimulus for this sector may be necessary. Sam's Club's program, which is bringing credit to small businesses through the indirect use of an SBA pilot program, is one example of an innovative effort to disperse credit. (See related article on page 6.) However, this program is capped, and any major

*continued on back*

# As Goes Small Business, So Do the Conditions for Commercial Real Estate

By K.C. Conway

It's no secret that since Q4 2007, the U.S. economy has been mired in a "cascading economic recession." The seeds of this recession were a hybrid of over-leveraging and over-building earlier in the decade, which germinated artificial economic demand in the form of expanded homeownership, elevated home prices, inflated commercial real estate (CRE) values, excess commercial construction, and elevated consumer confidence and spending. These new sprouts then branched out with foliage in the form of employment growth and near-record small business formations. Strong sales and readily available credit were the nutrients feeding this plant growth.

So, what happened?

Answering this question will be the basis for academic papers into the next decade. In the interim, elected officials, policymakers and economists are wrestling to develop effective strategies now to arrest job loss, stubbornly elevated unemployment, declining real estate values and the expanding ripples of this recession.

This article is not intended to proffer policy answers; rather it is intended to aid in understanding the linkage between the health of small business and

commercial real estate. One observation that should be clear from the key small business and CRE metrics that follow is that deciding how to address the woes of either small business or commercial real estate in isolation is a bit like trying to answer the question: *Which came first—the chicken or the egg?*

Let's explore this relationship by working the problem backward, from the present-day conditions. An examination of a few metrics establishes the inter-relationship of small business and commercial real estate. We'll call this the "Top 10 Correlations List," if you will, between small business and commercial real estate:

## **...Correlations #10, 9 and 8: Access to credit, government regulation and employee costs (such as health care)**

These are three metrics that tend to have material impacts on both small businesses and commercial real estate. Recognizing that most commercial real estate development—especially residential—is dominated by small companies (those with less than 500 employees), commercial real estate developers and owners alike are small businesses. To the extent that credit is limited, employee costs are high, and government regulations are onerous (at both

a local and national level), commercial real estate and small businesses struggle to grow.

## **...Correlation # 7: "Poor sales"**

According to a 2010 survey by the National Federation of Independent Businesses (NFIB), "poor sales" was the problem identified most (29 percent) as number one by small businesses, followed by taxes (21 percent) and government requirements (15 percent). It follows that if businesses have weak or declining sales, those businesses will not occupy as much CRE space, and why this factor is closely correlated to both small businesses and commercial real estate.

## **...Correlation #6: Office commercial real estate occupancy and business bankruptcies**

Data compiled by office CRE industry trade groups report that approximately 30 percent of all business bankruptcies involve a small service-related business occupying space in an office building or business park. As business bankruptcies have climbed, the national office vacancy rate has climbed to 18 percent.

## **...Correlation #5: Retail commercial real estate occupancy and business bankruptcies**

Data compiled by small business and retail industry trade

groups report that between 40 percent and 45 percent of all business bankruptcies involve space in a retail center. Similar to our last factor, as business bankruptcies have climbed, the national retail vacancy rate has risen to 12 percent—and it exceeds 14 percent in more than half of the nation's 100 most populated MSAs, according to CBRE-Econometric Advisors and International Council of Shopping Centers (ICSC).

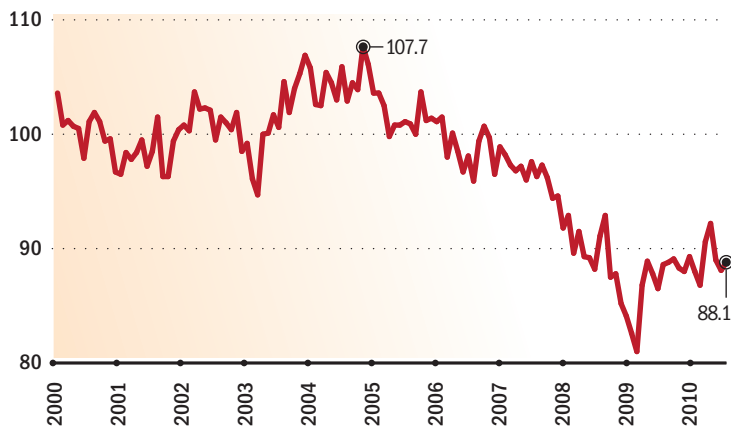
## **...Correlation #4: The small business optimism index and CRE space**

As seen on the accompanying chart, the NFIB Small Business Optimism Index has plummeted from a peak of 107.7 in Q1 2005 to 88.1 at Q2 2010. At the same time, demand for CRE space, measured in the form of net absorption, has been negative.

## **...Correlation #3: Personal bankruptcies and small business sales activity**

As personal bankruptcies rise, fewer consumers have disposable income to spend. A rise in personal bankruptcies is then typically followed by a rise in business bankruptcies. That correlation has held through this recession. Personal and business bankruptcies have been rising in the most populated 180 U.S. MSAs for six consecutive

### Small Business Optimism Index (SA, 1986=100)



Source: National Federation of Independent Business

quarters (according to the U.S. Census Bureau and the Federal Reserve Bank of Atlanta's Commercial Real Estate Market Spotlight).

#### **...Correlation #2: The ratio of small business employment to job growth**

According to the International Council of Shopping Centers (ICSC), 9 percent of non-farm employment in the U.S. is tied to non-anchored retailers in the nation's 104,000 shopping centers.

#### **And...the #1 correlation that demonstrates the interrelationship between small business and commercial real estate: overall job growth**

It is not coincidental that business bankruptcies have increased, and commercial real estate values declined as unemployment has remained elevated at or above 9.5 percent.

While the culmination of

these metrics demonstrates that small business and commercial real estate are indeed interconnected, the virus adversely impacting both small business and CRE is job loss. If employment growth were to re-establish, unemployed consumers would have income again to spend, and employed consumers would have more confidence in the sustainability of their income. This increased confidence would in turn result in increased consumer spending; increased consumer spending would translate to improved sales—the number one issue cited by small business. Improved sales would result in fewer small business bankruptcies, and fewer small business bankruptcies would then eliminate 75 percent of the increase in retail and office vacancy.

The other piece of this puzzle is credit. In the current environment, both small busi-

ness and commercial real estate credit is constrained. Small business credit is recessed largely because of a lack of demand. If businesses are primarily worried about poor sales, they are not inclined to expand or utilize lines of credit. There is also a tiered structure of credit for small business. A material percentage of small business utilized credit cards or equity in their homes to fund inventory and receivables. As those sources of credit have contracted (100 million fewer credit cards at Q2 2010 than at Q1 2009), and home values declined, the second-tier of small businesses without other collateral (plant, building, equipment, inventory, etc.) cannot access credit to survive or grow. The challenge for commercial real estate is different. CRE values have declined 45 percent from their 2007 peak (Moody Commercial Property Index), and are still declining. Banks have elevated CRE concentrations, and the capital markets remain largely closed to CRE, with only \$5.0 billion in estimated C.M.B.S. issuance in 2010 compared with \$234 billion at the peak in 2007. Therefore, the problem with credit to CRE is a concentration of CRE loans in banks and a "refi-gap" created by declining values.

In conclusion, attacking the credit, weak demand and excess supply challenges confronting small business and CRE in isolation will likely prove ineffective. Small busi-

ness and commercial real estate are intertwined in much the same way as the chicken and the egg. Employment is the common thread. Re-establish employment growth, and the tide of demand will rise for both small business and commercial real estate.

*K. C. Conway, MAI, CRE, is a commercial real estate subject matter expert at the Federal Reserve Bank of Atlanta.*

# Growing the Pie: Nontraditional Lenders Aim to Increase Opportunities for Small Businesses

By Amy B. Simpkins

The traditional model of small business lending relies heavily on banks, credit card companies and other intermediary institutions to find and underwrite borrowers based on standardized processes and risk modeling as a primary basis for giving out credit. Analyzing a borrower's creditworthiness is streamlined, so that transaction costs are lowered, and risk is limited.

Many market segments, however, experience either real or perceived barriers to access with traditional lending. Further, relying on standardized underwriting may make credit unaffordable or unattainable if borrowers have weak credit history.

Nontraditional service providers are attempting to respond to what they see as increasing market demand that is not being met by commercial banks and the traditional model of small business lending. Fueled by changes in technology that allow for advances in online loan transactions and payment services, nontraditional financial service providers claim to increase access to credit for small businesses worldwide. Two new business models for small business lending are emerging—one relying



*Sam's Club developed a pilot program to offer loans to qualifying small business members.*

on interpersonal relationships to allocate credit, and another based on unique partnerships between lenders and retailers.

## Peer-to-peer lending

The hallmark of peer-to-peer (P2P) lending is that borrowers and lenders are directly connected and negotiate credit terms favorable to both parties. On Internet-based P2P sites, borrowers share personal and financial information about themselves, and individual lenders decide whether to contribute to borrowers' loan requests. The online format of these products means that anyone who has a computer

and the Internet can apply for, or invest in, P2P loans.

Popular P2P sites include Kiva, MicroPlace, Lending Club, Prosper, Zopa, Loanio and others. According to an interview conducted with Prosper CEO Chris Larsen by staff at the Federal Reserve Bank of San Francisco, P2P was a \$647 million industry in 2009, expected to reach \$5.8 billion by this year.

P2P lending typically falls into one of two categories: consumer lending or international microfinance. Consumer loans, such as those offered by Lending Club and Prosper, can be used as sources of credit

to small and microbusiness owners to finance their operations. Kiva and MicroPlace focus on international microfinance, where investments are directed to low-income entrepreneurs across the globe. Both consumer lending sites and international microfinance sites emphasize the double bottom-line return for such investments, either as an economic driver for our nation's economy or a poverty-alleviation strategy for developing countries.

In both categories, loans are usually underwritten by multiple individual lenders until the loan is fully funded. Once originated, lenders receive a pro rata share of principal and interest payments until the loan reaches maturity or the borrower defaults. Structures of these loans vary greatly across sites, with online platforms typically serving as brokers of the loans or originators of the loans.

For a comprehensive explanation of P2P lending, read the working paper on this subject created by the Center for Community Development Investments at the Federal Reserve Bank of San Francisco ([www.frbsf.org/publications/community/wpapers/2009/wp2009-06.pdf](http://www.frbsf.org/publications/community/wpapers/2009/wp2009-06.pdf)).

## Retailers in the game

As the economy begins to

recover, small businesses have started to look for sources of credit to fund expansion. Unfortunately for the smallest businesses—five employees or less and revenues less than \$500,000—credit is often unavailable through traditional lending models used by commercial banks. Sam's Club, a division of Wal-Mart Inc., recognized that most of its customers fall into this category. In light of growing demand, Sam's began examining alternatives that would increase credit availability for its small business members.

The result is a pilot program to offer loans of up to \$25,000 to qualifying Sam's Club small business members. These loans are offered through a partnership with Superior Financial Group (Superior), a nonbank Small Business Lending Company (SBLC) authorized by the Small Business Administration (SBA). The program will primarily rely on the Community Express program to originate loans targeting minority-owned, women-owned and veteran-owned small businesses, as well as micro-entrepreneurs.

Superior's offering of the SBA Community Express product is similar to an unsecured credit card. Superior has developed an online application, which is user-friendly and provides information and tools to educate applicants on different types of loans, overall creditworthiness, and how to improve their chances of

loan approval. Normally, the application can be approved in minutes, and the borrower is contacted within days to set up loan closing. While the applications are prequalified through an automated underwriting process, some discretion is applied during the review process.

Superior Financial Group reports that approximately 45 percent of applications have been approved for an average loan amount of \$9,500. The pilot status of these programs is important because that statute limits the total number of loans made under all SBA pilot programs. For example, if 70,000 SBA loans were made nationally this year, no more than 7,000 pilot program loans (including Community Express, Export Express and Patriot Express) can be made this year. In order to ensure that the SBA does not exceed this statutory limitation, each lender originating loans in the pilot programs cannot close more than 200 loans a month.

Representatives from Sam's Club and Superior Financial Group report that demand for these loans is far exceeding expectations. Where initially 100 applications were expected a month, in July 2010 alone more than 2,500 applications had been received.

### **The impact of nontraditional lending**

Nontraditional lending to small businesses has implications for a host of diverse stake-

holders—federal state and local policymakers, financial regulators, community development groups, consumer advocates, and financial institutions alike.

Policymakers and regulators must ensure that alternative products and services do not include high fees and other predatory practices. Borrowers and investors need to be fully aware of the risks involved with such products and pay careful attention to disclosure statements and prospectus information. Some things to note may be whether FDIC insurance applies or which, if any, industry or bank guarantees may or may not be applicable.

In particular, when considering P2P sites, borrowers applying for consumer loans need to be mindful of the cost of credit, just as with any other form of unsecured debt. Ian Galloway, investment associate with the Federal Reserve Bank of San Francisco, explains. "This (P2P lending) expands consumer credit access but it can be an expensive option, with interest rates as high as 36 percent in some cases."

Allen North, vice president in the Banking Supervision and Regulation Division at the Federal Reserve Bank of St. Louis, notes that, "demand for small dollar credit is evident." But "the risk-return tradeoff may be one reason why more banks and other SBA lenders do not participate significantly in programs or partnerships like that of Sam's and Superior." But he offers that if expan-

sion of programs like this is deemed a desirable policy option, more intermediaries like Superior need to be at the table. "This would reduce the risk of administration of the program should one intermediary become unable to continue participating for any reason."

At the same time changes the nontraditional market occur, the Federal Reserve is actively engaged in efforts to ensure that traditional financial institutions are able to meet the credit needs of small businesses in a responsible way that add to the range of borrowing opportunities available to business owners. (See articles on pages 1-3 summarizing key findings from the Federal Reserve's local small business meetings and national capstone event held earlier this year). Overall, the evolution of this market indicates there is continuing need for industry-based solutions that model new ways to match supply and demand. Whether through traditional or nontraditional lenders, innovation appears to be the new norm for small business lending.

*Amy B. Simpkins is assistant manager at the Little Rock Branch of the Federal Reserve Bank of St. Louis.*

## Reader Poll

**Which of the following items do you believe could have the most impact for ensuring access to financing creditworthy small businesses?**

- Encouraging private-sector innovation: Broader usage of “second look,” “loan-for-hire,” and other innovative credit programs on behalf of financial institutions.
- Undertaking regulatory solutions: Greater Community Reinvestment Act (CRA) consideration for community development loans, program-related investments, or grants that increase access to lending capital, loan-loss reserves, loan packaging and technical assistance.
- Enhancing public-sector support: Increasing support for federal program solutions, such as via the SBA, the CDFI Fund, the New Markets Tax Credit program, etc.

Take the poll at [www.stlouisfed.org/community\\_development/](http://www.stlouisfed.org/community_development/). Results are not scientific and are for informational purposes only.

The previous poll focused on restructuring and retooling for the future, and asked: **What practices are you pursuing to maintain sustainability or build capacity?**

**Based on 26 responses:**

- 27 percent said collaborating with other organizations
- 4 percent said merging with another organization
- 8 percent said reducing the number of services or programs offered to our clients
- 4 percent said reducing expenditures, downsizing, furloughs
- 25 percent said looking for new funding sources
- 9 percent said tightening lending standards
- 15 percent said pursuing innovative, new business models
- 8 percent said using technology and/or social media

## Have you HEARD

### Summaries Available for Second Policy Dialogue

Eight videoconference sites and more than 500 people convened Aug. 26 to hear from national experts on the topic of Addressing the Achievement Gap and Fostering Community Leadership, the second in a series of public policy dialogues in the St. Louis Fed's 2010 Exploring Innovation lineup. Donna Ford, Ph.D., a professor of Education and Human Development at Vanderbilt University; Jean Horstman, president and CEO of Boston-based Interise; and Douglas Scarboro, director of the Office of Talent and Human Capital and educational liaison for the City of Memphis, presented both current perspectives

and remedies for change for closing the “achievement gulf” in educational arenas, as well as those in business, municipalities and society. An online video of the conference, as well as summaries of the sessions, will soon be available on the St. Louis Fed's Exploring Innovation site at [www.exploringinnovation.org](http://www.exploringinnovation.org).

### St. Louis Fed, Fannie Mae Offer Foreclosure Resources

The St. Louis Fed will soon update its web-based Foreclosure Resource Center, which contains valuable information for consumers and communities. The site, located at [stlouisfed.org/foreclosure](http://stlouisfed.org/foreclosure), will offer information on the recent loan modification and scam alert news

conference held at the St. Louis Fed, along with the six facts to know about loan modification scams. Also on the site will be up-to-the-minute news, regulatory policies and speeches regarding foreclosure and mortgage topics. An updated foreclosure mitigation toolkit for communities has already been added.

In August, Fannie Mae launched a new web site, [KnowYourOptions.com](http://KnowYourOptions.com). This site offers detailed consumer information via videos, testimonials and step-by-step recipes for keeping homes out of foreclosure.

## CALENDAR

### OCTOBER

**5**

**FedFocus: Financial Coaching: a New Approach to Building Prosperity for Low-Income Workers—Louisville, Ky.**

Sponsor: Federal Reserve Bank of St. Louis, Louisville Branch  
[www.stlouisfed.org/community\\_development](http://www.stlouisfed.org/community_development)

**13**

**FedFocus: Findings from the FDIC's Small-Dollar Loan Pilot Program—Louisville, Ky.**

Sponsor: Federal Reserve Bank of St. Louis, Louisville Branch  
[www.stlouisfed.org/community\\_development](http://www.stlouisfed.org/community_development)

**26**

**Keys to Building Business Through Microenterprise—Bowling Green, Ky.**

Sponsor: Partners for Entrepreneurial Advancement in Kentucky  
[www.peakky.org](http://www.peakky.org)

### NOVEMBER

**3**

**FedFocus: Asset Building Coalition Strategies—Louisville, Ky.**

Sponsor: Federal Reserve Bank of St. Louis, Louisville Branch  
[www.stlouisfed.org/community\\_development](http://www.stlouisfed.org/community_development)

**3**

**Perception is Everything: Cultural Differences in a Local Diverse Business Environment—Louisville, Ky.**

Sponsors: Hispanic Latino Business Council, Tri-State Minority Supplier Development Council (TSMSDC) and the Louisville Branch of the Federal Reserve Bank of St. Louis  
[HLBC@greaterlouisville.com](mailto:HLBC@greaterlouisville.com)

**10**

**Public Policy Dialogue: Tapping New Sources and Exploring New Models for Community Development Finance—St. Louis, Little Rock, Louisville and Memphis**

Sponsor: Federal Reserve Bank of St. Louis  
[www.stlouisfed.org/community\\_development](http://www.stlouisfed.org/community_development)

**16-17**

**NCIF Annual Development Banking Conference—Chicago, Ill.**

Sponsor: Federal Reserve Bank of Chicago  
[www.ncif.org](http://www.ncif.org)

### DECEMBER

**14**

**FedFocus: Small Business Lending in Commercial Banks: An analysis of Recent Trends—Little Rock, Ark.**

Sponsor: Federal Reserve Bank of St. Louis, Little Rock Branch  
[www.stlouisfed.org/community\\_development](http://www.stlouisfed.org/community_development)



# Attention Bridges Readers!

Are you on our e-mail list to receive meeting invitations and other notifications that are often sent exclusively via electronic mail? If you're not sure, check these recent e-mail notices, which were distributed from the Fed's community development offices during the past couple of months.



**Exploring Innovation**  
Addressing the Achievement Gap  
and Fostering Community Leadership  
Aug. 26, 2010  
A part of the "New Voices: Fresh Issues" public policy dialogue series

The achievement gap is at the root of America's workforce competitiveness challenges. These challenges are widening and spreading. Time, community leadership, and innovation are essential to address these issues and support development.

The Federal Reserve Bank of St. Louis is adding to offering new emerging issues. Each month the site will introduce you to a new Featured Innovator, highlighting promising practices in the field of community development that have real, positive impact on the communities they serve.

**10,000-Hour Challenge Nears the One-Third Mark and Introduces the Featured Innovator for July!**

The Federal Reserve Bank of St. Louis' 10,000-Hour Challenge, which promotes innovation in community development, has reached close to one-third of its total, clocking in at 2,865 hours as of June 25, 2010.

The Challenge, kicked off in late April during the Bank's Exploring Innovation in Community Development week, shares innovative community development strategies through a designated section on the St. Louis Fed's web site: [www.stlouisfed.org/10kChallenge](http://www.stlouisfed.org/10kChallenge).

Each month the site will introduce you to a new Featured Innovator, highlighting promising practices in the field of community development that have real, positive impact on the communities they serve.

**This Month's Featured Innovator:**

The Featured Innovator for July is the Cornerstone Community Loan Fund's Renter Equity program. Based in Cincinnati, Ohio, the Renter Equity program provides a pathway to building needed equity for residents in affordable rental housing. St. Anthony Village, located in Cincinnati's Over-the-Rhine neighborhood, is Cornerstone's demonstration project for Renter Equity and the first of its kind in the U.S. To read about the group's community development achievements and view a video about St. Anthony Village, click here.

**Take the Challenge!**

Through the Challenge, the Fed is seeking to discover what can be accomplished when the community development profession collectively devotes 10,000 hours to innovation. It was inspired by Malcolm Gladwell's 2008 book, *Outliers*, which asserts it takes 10,000 hours of practice to become an expert at a skill, task or activity.

It is not too late for you to take the Challenge and possibly be selected as next month's Featured Innovator! To participate, community development professionals nationwide are invited to submit stories of their innovative projects here.

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**INNOVATION IS:**  
people working together to develop and implement new, feasible ideas that create value. Innovation is the act of introducing something new to create change that is valued by the community. Value creation is essential to innovation.  
Click to watch a video about this month's Featured Innovator: Cornerstone Community Loan Fund.

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[Joann.Harris@stls.frb.org](mailto:Joann.Harris@stls.frb.org)

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# SPANNING THE REGION



THE REGION SERVED BY THE FEDERAL RESERVE BANK OF ST. LOUIS ENCOMPASSES ALL OF ARKANSAS AND PARTS OF ILLINOIS, INDIANA, KENTUCKY, MISSISSIPPI, MISSOURI AND TENNESSEE.

## **MEDI Loan Programs Assist Kentucky Business Owners**

The Minority Economic Development Initiative (MEDI) was established more than 20 years ago in Hopkinsville, Ky., to create and support an environment where all minorities can participate in economic opportunities. MEDI assists small business owners with business planning, financial packaging, feasibility assessments, pre- and post-technical counseling, procurement and certification assistance and much more. After 20 years of service, MEDI has now become MEDI of Western Kentucky, Inc., a 501(c)(3) organization covering four Area Development Districts. In February 2009, MEDI, in partnership with Christian County government, re-established its microloan fund for new or existing businesses.

Loans are provided to low and high-risk clients based on a sliding scale. Loans range from \$2,500 to \$10,000. The first microloan was for the expansion of the Hopkinsville Child Development Center from an in-home daycare to a licensed commercial daycare. The development center is the first bilingual based facility in the region. It focuses on a dual

language program through cultural activities, games, songs and books whereby children develop oral language skills in both English and Spanish.

Hopkinsville's Minority Economic Development Initiative is dedicated to serving all small business owners through education, training and financing. To find out more about MEDI, visit [www.medi.hopkinsville.com](http://www.medi.hopkinsville.com) or call 270-885-8885.

## **Montrose, Ark., Takes a Strategic Approach to Growing Businesses Though Access to Microcredit**

Mayor Larry Coulter knows that financing small businesses in rural Arkansas is not easy. But he also knows growing locally owned businesses is critical to a successful economic development strategy for a rural community like Montrose, Ark., with a population of only 492. That is why he has developed a step-by-step strategy to encourage entrepreneurship that includes regional collaboration, increased access to technical assistance and access to microcredit.

Working with the surrounding Delta communities of Portland, Parkdale and Wilmot, Coulter has formed the Mon-

trose Regional Commerce Project aimed at supporting existing microenterprises and growing new entrepreneurs. The project has established a resource center—a modified business incubator that includes training facilities, operating and meeting space, and technical capabilities such as Internet access. A broad scope of technical assistance and training is available through the resource center, from Internet marketing and bookkeeping to business analysis.

The hope is that through increased technical assistance and training, businesses will be positioned better to apply for and secure microcredit through SBA and USDA Microloan Programs. So far, this strategy appears to be working with one loan closed using the SBA Microloan Program in neighboring Hamburg, Ark., to expand a photography business, and five others from the region already in the pipeline. In addition, an outreach strategy is under way to educate local lending institutions on the importance of microcredit to the region's businesses.

Information about business development in Montrose, including subscription to its newsletter, is available by e-mailing [att.mrcp@yahoo.com](mailto:att.mrcp@yahoo.com).

To learn more about technical assistance available to small businesses in rural Arkansas, visit [www.altconsulting.org](http://www.altconsulting.org) or [www.sba.gov/localresources/district/ar/index.html](http://www.sba.gov/localresources/district/ar/index.html). To learn more about federal microloan programs visit [www.sba.gov](http://www.sba.gov) and [www.rurdev.usda.gov](http://www.rurdev.usda.gov).

## **Minority Business Microloan Program Available in Mississippi**

The Minority and Small Business Development Division (MSBDD) of the Mississippi Development Authority (MDA) is offering the Minority Business Microloan program with the goals of job creation and assistance to certified minority and women-owned businesses in Mississippi. The loan funds can be used for inventory purchase, working capital, machinery or equipment. It cannot be used as gap financing or along with any other type of financing.

The Minority Business Microloan is made for a maximum of seven years in amounts that range from \$2,000 to \$35,000. The interest rate is 4 percent above the Federal Reserve discount rate. Those applying must be creditworthy and able to repay the loan. Also, they must not be in default of any previous loan from the state or federal government. The

# BRIDGES

*Bridges* is a publication of the Community Development Office of the Federal Reserve Bank of St. Louis. It is intended to inform bankers, community development organizations, representatives of state and local government agencies and others in the Eighth District about current issues and initiatives in community and economic development. The Eighth District includes the state of Arkansas and parts of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee.

**Glenda Wilson**  
Assistant Vice President  
and Managing Editor  
314-444-8317

**Yvonne Sparks**  
Senior Manager  
314-444-8650

**Amy B. Simpkins**  
**Jeanne C. Marra**  
Special edition editors

## Community Development staff

St. Louis: Matthew Ashby  
314-444-8891  
Daniel P. Davis  
314-444-8308  
Jean Morisseau-Kuni  
314-444-8646

Memphis: Kathy Moore Cowan  
901-579-4103  
Teresa Cheeks Wilson  
901-579-4101

Little Rock: Lyn Haralson  
501-324-8240  
Amy Simpkins  
501-324-8268

Louisville: Lisa Locke  
502-568-9292  
Faith Weekly  
502-568-9216

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industries that can apply are manufacturers, warehouses and distribution centers, and retail.

The mission of the Minority and Small Business Development Division is to enhance economic development by providing technical and financial assistance to minority, women-owned and small businesses so they can compete more successfully for government and commercial contracts.

For additional information, contact MDA's Financial Resources Division at [financial@mississippi.org](mailto:financial@mississippi.org) or 601-359-3552. For assistance on becoming a certified minority- or women-owned business, contact MDA's Minority and Small Business Development Division at [minority@mississippi.org](mailto:minority@mississippi.org) or 601-359-3448.

## Operation Bootstrap Spreads Seed Grant Funding in Southern Illinois

Entering into its third year of existence, Operation Bootstrap has extended \$177,000 of seed grant funding through a micro-finance program established for budding entrepreneurs who seek to launch their businesses within the southern 16 counties of Illinois. The program, facilitated by the Southern Illinois University Entrepreneur-

ship Center in Carbondale, Ill., and funded through support provided by the Delta Regional Authority, seeks to engage new ventures through a training program where participants develop skills necessary to launch and sustain the operations and activities of their new businesses. Each entrepreneur successfully completing the training program is eligible to apply to receive up to \$3,500 in grant funding to invest into the development of their enterprises.

Operation Bootstrap has graduated 133 participants from the program, 55 of whom have received seed grant funding. "The impact our graduates are having upon the region is significant," notes Robyn Laur Russell, director of the Southern Illinois University Entrepreneurship Center. "The seed grant funding provided by Operation Bootstrap not only enables individuals to turn their own business plans into reality, it also creates an investment in the local economy of southern Illinois, and we are beginning to see job creation in several of our cities as a result of the program."

For more information about Operation Bootstrap, visit its web site at [www.operationbootstrap.biz](http://www.operationbootstrap.biz).

## Kentucky License Plate Contest to Benefit Small Businesses

To emphasize the important role that Kentucky's small and microbusinesses have, the Kentucky Commission on Small Business Advocacy and Partners for Entrepreneurial Advancement in Kentucky Inc. (PEAK), a statewide, non-profit 501(c)(3) organization dedicated to microenterprise development, are coordinating a specialty small business license plate competition. Recognized as an innovative community development idea in the St. Louis Fed's 10,000-Hour Challenge, the competition, which runs through Nov. 10, is open to any small Kentucky-based business with 50 or fewer employees. Proceeds collected from those purchasing a small business specialty license plate will be used to fund small business and entrepreneur development programs in Kentucky. For more information, go to [www.peakky.org/licenseplate.aspx](http://www.peakky.org/licenseplate.aspx).



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### “Credit Crunch”

*continued from Page 3*

expansion would require additional funding.

Small businesses face constraints on their access to credit. The Fed's outreach sessions have made it clear the issue is complex and multifaceted. Consequently, it will take innovative approaches and must be attacked from many angles. The entrepreneurial spirit, which is indicative of most small businesspersons, is going to be critical for those entities to come up with solutions—whether private or public, for profit or

nonprofit, or a consortium of parties working in concert—to provide credit.

*Julie L. Stackhouse is senior vice president over Banking Supervision, Credit and the Center for Online Learning at the Federal Reserve Bank of St. Louis.*

#### ENDNOTE

- 1 When a bank experiences severe asset quality problems, regulators may require higher levels of capital to absorb the additional risk on the balance sheet.

On July 12, 2010, the Board of Governors of the Federal Reserve

System, hosted a forum entitled *Addressing the Financing Needs of Small Businesses* in Washington, D.C., which served as a capstone to the 40-plus meetings held throughout the country earlier in the year. Transcripts, as well as video and audio clips, from the capstone event are now available on the Federal Reserve Board's web site at [www.federalreserve.gov/events/conferences/2010/sbc/default.htm](http://www.federalreserve.gov/events/conferences/2010/sbc/default.htm). The session is also available on the Board's YouTube channel at [www.youtube.com/FedReserveBoard#p/a](http://www.youtube.com/FedReserveBoard#p/a).

### Only Online

In addition to the print version, each issue of *Bridges* offers articles that are exclusively online. These articles expand on topics in the current issue. Online articles for the fall issue of *Bridges* are:

**New Quarterly Data Provide Timely Analysis of Banks' Lending to Small Businesses – What are the Trends?**

**Trends in SBA Lending; Product Reviews by Eighth District Bankers**



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<https://www.stlouisfed.org/publications/bridges/fall-2010/new-quarterly-data-provide-timely-analysis-of-banks-lending-to-small-businesses--what-are-the-trends>

## New Quarterly Data Provide Timely Analysis of Banks' Lending to Small Businesses - What are the Trends?

James Fuchs , Amy Chivetta

In the wake of the financial crisis, a significant amount of attention has shifted toward the health of U.S. small businesses, and more specifically, on their ability to access credit. This is understandable considering that, according to the Small Business Administration (SBA), more than 99 percent of all employers in the U.S. are small businesses (defined as businesses with 500 or fewer employees) and they employ more than half of all private sector employees.[1]

This concern is bolstered by the fact that small business credit has indeed tightened at the nation's commercial banks, as the total volume of outstanding small loans to businesses as of June 30, 2010, was nearly 6 percent lower than the volume reported as of June 30, 2009 (falling from \$616.0 billion in 2009 to \$579.1 billion in 2010). This is only the second year-over-year decline in small loans in the last decade; the first was from 2008 to 2009, when the decline was 2.2 percent.

Prior to 2010, small-dollar business loan information was only available on an annual basis. The amounts are now being collected on a quarterly basis, allowing bank supervisors, policymakers and economists to track not only annual trends in small loans to businesses but also potential seasonal fluctuations.

In response to the unprecedented change in small business credit, policymakers and lawmakers have discussed the need to create incentives to encourage community banks—generally those with less than \$1 billion in total assets—to make small business loans. But while this line of thinking acknowledges the important role that the nation's community banks play in making small business credit available, it overlooks some of the trends that have taken place over the past decade—namely, *the majority of small business credit extended by banks now comes from the nation's largest banking institutions—those with more than \$50 billion in total assets.*

### Who's making small loans to businesses?

In the past decade, small loans to businesses have accounted for a decreasing share of community bank loan portfolios. In 1999, for example, these loans accounted for, on average, at least 25 percent of a community bank's loan portfolio; as of June 30, 2010, this ratio was closer to just 20 percent. On the other hand, while commercial banks with more than \$50 billion in total assets have, on average, about 5 percent of their loan portfolios concentrated in small business loans, the actual *amount* of small business lending by these banks has increased significantly.

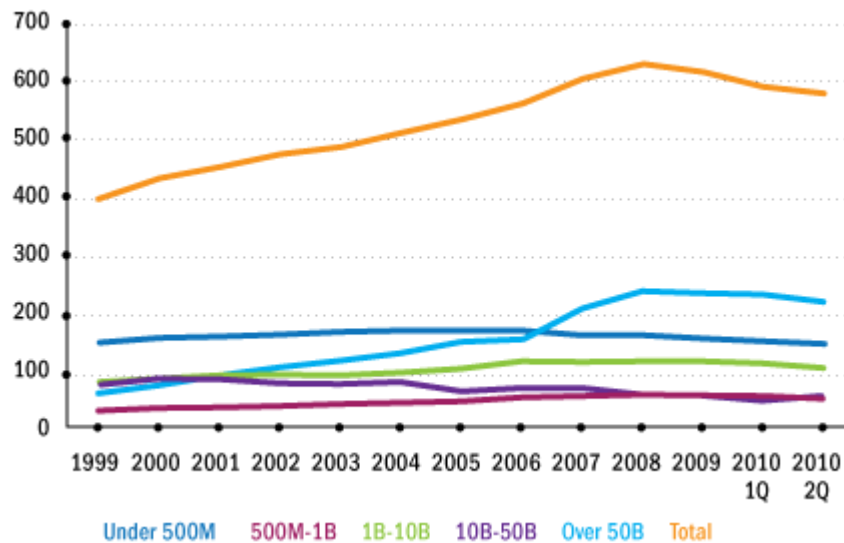
The figure shows the changes in the amount of small business loans made by commercial banks over the past decade. In 1999, community banks extended nearly 40 percent of all of commercial bank small

business credit. In just 10 years, this paradigm has shifted, and the majority of small business credit is now extended by banks with more than \$50 billion in assets.

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## Small-Dollar Business Lending By Different Size Classes of Banks (in billions of dollars)

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An analysis of banking data as of June 30, 2010, shows that the 6,129 community banks (those with less than \$1 billion in total assets) in the U.S. extended \$198.2 billion (35 percent of the total) in small business credit. The 32 banks with more than \$50 billion in assets, on the other hand, extended \$218.4 billion (38 percent of the total) in small business credit. Adding the amount of small business credit extended by commercial banks with between \$10 billion and \$50 billion in assets shows that nearly half of all small business credit extended by U.S. commercial banks comes from 81 institutions with more than \$10 billion in total assets.

This analysis has limitations, however. For example, banks do not specifically report small business loans, but rather small loans—loans of \$1 million or less—to businesses in their quarterly filings. This means that inevitably some small-dollar loans that are made and reported are not necessarily loans to small businesses.

Despite this limitation, the trends do seem to suggest that small-dollar lending to businesses has been decreasing significantly over the past two years, and that over the past decade, there has been a notable shift in activity from community banks to the nation's largest banks.

## What kinds of small loans to businesses are being extended?

Another interesting observation is that more than 85 percent of the small-dollar loans reported in the FFIEC's Consolidated Reports of Condition and Income (Call Reports) are for amounts less than \$100,000, and more than 50 percent of these small loans are made by the largest banks. While not conclusive, this suggests that large bank share of small-dollar business lending has increased by extending credit through business credit cards. This is consistent with changes in the early to mid 1990s, when credit-scoring models used for personal credit cards and secured credit lines were extended to include business credit cards.

## Small business' impact on the economy

Despite changes in the ways in which commercial banks are extending small business credit, there is still a question as to how to jumpstart small business lending in a still weak but recovering economy. In a July 12 speech during the Federal Reserve's small business capstone event, "Addressing the Financing Needs of Small Businesses," Fed Chairman Ben Bernanke cited three main reasons for declining small business lending: a weaker demand from small businesses for loans, a worsening in small business financial conditions during the economic downturn and a restriction in credit availability to small businesses.[2] However, acknowledging the importance of the small business sector he also stated that, "Making credit accessible to sound small businesses is crucial to our economic recovery and so should be front and center among our current policy issues."

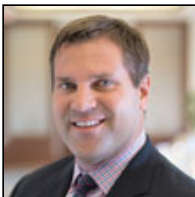
While small loans to businesses on commercial bank balance sheets have indeed declined by more than 8 percent over the past two years, it's important to note that many small businesses, especially "Main Street" start-ups, might not meet longstanding minimum creditworthiness standards that have been required by banks. Instead, many start-up businesses, which have historically relied on personal lines of credit, via credit cards, loans from friends or family members, and home equity lines of credit, have seen their resources impacted as well. These businesses have also experienced growing problems accessing credit due to decreased credit card lines, declining house prices or the impact of the recession on the entrepreneur's personal network.

Until economic and business conditions improve, policymakers will continue to evaluate small business lending to determine if, and to what extent, the government should step in to try to catalyze small business lending in the near-term and potentially develop an appropriate mechanism to back-stop the risk inherent in small business, given the current environment of diminishing borrower creditworthiness.

### Endnotes

1. [www.sba.gov/sites/default/files/sbfaq.pdf](http://www.sba.gov/sites/default/files/sbfaq.pdf) [back to article]
2. <http://www.federalreserve.gov/newsevents/speech/bernanke20100712a.htm> [back to article]

### ABOUT THE AUTHOR



#### James Fuchs

James Fuchs is a vice president at the Federal Reserve Bank of St. Louis. He joined the St. Louis Fed in 2009.



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<https://www.stlouisfed.org/publications/bridges/fall-2010/trends-in-sba-lending-product-reviews-by-eighth-district-bankers>

# Trends in SBA Lending: Product Reviews by Eighth District Bankers

Daniel Davis

In July 2010, the Community Development staff of the St. Louis Fed conducted telephone interviews to survey financial institutions of various sizes across the Eighth Federal Reserve District about their experiences with lending products initiated by the Small Business Administration (SBA). The results of this informal survey demonstrated that in this difficult environment for lending to businesses, the SBA is providing critical access to credit. Following are some of the specific results of that survey.

## State of SBA Lending

For much of the Eighth District, SBA loan originations have been steady. Most of the surveyed institutions reported that there have been no significant decreases or increases in the number of SBA loans in the last couple of years, and none are anticipated through 2010. The institutions noted that SBA loans are most often used for expansion and refinancing, although some markets are seeing a demand for loans from start-up entrepreneurs. Some banks viewed the economic downturn as an opportunity to market SBA loans. The survey acknowledged that two major changes in SBA guidelines were key factors in helping Eighth District financial institutions maintain healthy loan volumes. The major changes included: 1) SBA borrower fees being temporarily eliminated and 2) the SBA guaranteeing up to 90 percent of loan amounts. Financial institutions indicated that these changes ensured that the SBA loans were a good deal for both banks and borrowers alike.

SBA loan demand varies according to the type, size and age of the business seeking the loan, as well as by region within the Eighth District. Areas exist where demand for new loans has been low, largely due to the economic market of communities within those areas. In some markets, business owners are unwilling to take on additional debt through loans due to conditions presented by an unstable economy. Institutions in Kentucky, however, note that SBA lending in their state has outpaced the rest of the nation. As of May 2010, Kentucky surpassed its 2009 SBA lending totals, with lending increased by a whopping 217 percent. The survey indicated that the upswing in Kentucky's SBA lending is a result of a greater number of banks taking advantage of the guarantees offered through SBA's loan programs.

## Review of SBA Products

**7(a) Loan Program:** Survey findings indicate that banks across the Eighth District use the SBA Express loans within the 7(a) loan program. SBA Express loans require minimal work to originate and feature low documentation requirements. Bankers noted and appreciated the streamlined process of the SBA Express loans. Financial institutions specified that the SBA Express loans are a good match between the needs of the lenders and smaller businesses requiring small-dollar loans. The Rural Advantage and Community



Express loans, also a part of the 7(a) loan program, are not highly used by the financial institutions that were surveyed.

**504 Loan Program:** Financial institutions utilizing the 504 loan program explained that the loan program works well in their markets and that that the program has created an effective product for borrowers. Institutions value the partnerships with local community development corporations (CDCs) to originate these loans. The 504 program has significant volume in debt refinance of commercial real estate (CRE), often allowing permanent construction financing of CRE that otherwise would not be possible without the SBA. The survey revealed that the stress in commercial real estate can be mitigated with the 504 loan program, as some bankers explained that long-term fixed rate financing, which is critical for economic development, would not be possible without it. In some areas of the Eighth District, few 504 loans are completed on a regular basis due to what is perceived by bankers as an intensive application process. Several small banks specifically indicated that they do not have the staff support to dedicate to the completion and monitoring of 504 loans.

**Microloan Program:** Financial institutions across the Eighth District are reportedly using the SBA's microloans of up to \$35,000 to appropriately boost working capital for small businesses. No challenges or issues with the microloan process were identified by financial institutions.

**America's Recovery Capital Program:** Bankers lauded the intent of this program, which allows for loans up to \$35,000 with a 100 percent guarantee for small businesses that have taken a major hit due to the economy (for example, those that have noted a 20 percent reduction in sales or a reduction in employees). Financial institutions tend to underuse the program, according to the survey, and would value a more streamlined process for the loans.

## Recommendations for Enhancements

While the Fed's survey indicated that District bankers are generally satisfied with SBA lending products and services, it also identified the following opportunities for improving future opportunities for lenders and borrowers alike: 1) automate billing statements, reports and accounts for borrowers; 2) hold frequent education and training sessions for community bankers on SBA products and services; 3) assign lenders to regional SBA processing offices, which would help the SBA processors and commercial bankers to build working relationships; and 4) when possible, streamline the lending process.

### ABOUT THE AUTHOR



#### **Daniel Davis**

Daniel Paul Davis is vice president of community development and community affairs officer at the St. Louis Fed.