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The Impact of Environmental Liability on Access to Capital for Small Business

by Public Policy Associates, Lansing, MI 48933-2408, contract no. SBA-8144-OA-94

Purpose

In recent years, anecdotal evidence has suggested that the liability provisions of various federal and state environmental statutes are reducing (and in some cases eliminating) access to much-needed loans for small businesses. This study examined the actual extent to which environmental liability has posed a barrier to obtaining capital for these firms. In particular, it analyzed the impact of factors such as environmental risk, firm size, industry and profitability on loan outcomes.

Scope and Methodology

Research methods included a literature review and interviews with key experts in the areas of banking, small business, insurance, and environmental law and regulation. A detailed questionnaire was developed and was administered to 1,322 small firms nationwide. Univariate analysis and linear probability modeling were used to analyze collected information. A risk index also was developed, using the logit regression model to capture differences among firms in exposure to environmental risk factors.

Highlights

This report provides evidence that environmental liability has indeed posed a barrier to obtaining capital for at least some small businesses throughout the nation. The survey indicated that more than one out of every 10 small businesses (or about 575,000 small firms with employees nationwide) that had applied for a loan reported such an effect. However, the results do not support the assertion that this environmental liability capital access barrier has fallen disproportionately upon the smallest businesses. For the entire sample, firm size played a minor role in determining both perceptions of an environmental liability problem and the effect of increased environmental risk on loan outcomes. Firms within certain industries (such as manufacturers, wholesalers, transportation/communication firms, and business service firms) were more susceptible to environmental liability problems.

Perhaps the most significant finding relates to the impact of environmental risk on lending. First, it appears that increased levels of environmental risk had only a limited negative impact on the loan outcomes examined. While environmental risk generally increased the probability that firms would be rejected by at least one lender, it did not have significant impact on firms' abilities to obtain the full amount they sought or to complete their intended investment project. It is to be noted that it is not known that the borrowing costs may be higher for them.

Second, although risk is not strongly related to loan outcomes, it is related to firms' decisions about seeking loans. The results show that among firms not seeking loans, higher risk firms were more likely to report that environmental liability concerns played a role in their decisions.

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Other findings include:

- Manufacturers did seem to suffer more negative loan outcomes when environmental risk increased. In particular, environmental risk had statistically significant negative effects on their ability to obtain the full amount they sought from banks and to complete planned projects for which loan funds were to be used.
- Just over one in five of the firms reporting that environmental liability posed a barrier to capital, said that lenders had rejected loans because of environmental factors. Among this group, nearly 65 percent were completely denied funds by all lenders approached.
- Firms that have perceived an environmental liability barrier may have adjusted their financing strategies to improve their ability to obtain capital. Firms reporting that environmental liability posed a barrier to capital also reported greater use of non-bank sources of financing such as vendor credit, venture capital/investment company funds, and leasing arrangements.
- A number of secondary factors influence the effect of increased risk on loan outcomes. For example, a previous borrowing relationship with the lender was found to ease the impact of environmental risk on firms' abilities to obtain capital. In contrast, firms seeking loans in order to comply with environmental regulations (for example, to purchase pollution abatement equipment) faced a more difficult time overcoming environmental risk.
- Firms using business real estate as collateral were less likely to obtain positive outcomes.
- Firms reporting that environmental liability posed a barrier to obtaining capital said the number one channel through which environmental liability worked to restrict capital access was compliance costs. Almost half of these firms reported that compliance costs were a barrier, with almost one in five stating that they completely blocked access to capital. More than 22 percent cited the costs of bank-imposed environmental inspections, while 21.3 percent reported that banks had directly denied them loans because of the lenders' perceptions of the firms' environmental risk.
- Almost one-third of the firms affected by environmental liability said that federal regulations were primarily responsible for their capital-related problems, compared with only 14 percent citing state regulations as the more serious problem. State hazardous waste laws were deemed to be the most significant specific source of problems.
- The percentage of firms that perceived an environmental liability barrier varied greatly by region. At least 15 percent of the firms within SBA Regions I, III, V, and IX reported a problem. In the six other regions, not more than 4 percent of firms reported a liability-related barrier.

Conclusion

The report concluded with recommendations for a number of policy changes and other strategies to minimize the barrier that environmental liability poses on access to capital. The recommendations include the following:(1) develop networking programs for lenders and small businesses to help both groups better understand the actual significance of various environmental risks to lending decisions, and to determine what can be done to work through these risks. (2) Enhance the marketability of environmentally impaired property by amending liability standards of federal and state environmental laws to exempt non-culpable new purchasers from liability; (3) Establish state and/or federal environmental loan-guarantee programs; and (4) Replace the current joint and several liability standard with a proportional liability standard to ensure that firms pay only their fair share of the cleanup bill.

Ordering Information

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