



Caught in the Grind

What can spark small business lending?



After graduating from the University of Nebraska in 2008, Adam Rief chose to return home to Bancroft, Neb., and, with the help of his dad, grow his fledgling business designing and manufacturing custom farm equipment.

In two years, Rief's business, Rief Design & Manufacturing, grew to the point that he needed a larger building. But when he applied for a \$90,000 loan from one bank where he'd done business before, he was turned down.

"I was sort of shocked," said Rief, 25. "I guess they felt uncomfortable lending that much money to someone my age with little credit history."

Rief didn't give up. The next day he went to First National Northeast Bank in Oakland, Neb., where a senior loan officer decided to take a chance on the ambitious young entrepreneur. She referred Rief to the Nebraska Enterprise Fund (NEF), based in Oakland, Neb., a micro/small business lender that helped refine his business plan and agreed to guarantee part of the loan. In the year since then, Rief has hired part-time help and sold equipment as far away as Montana.

"There is no way you can grow a company without collateral, and there is no way to get collateral without a loan," Rief said. "Numbers only say so much—having drive should count for something too."

Since the recession, anecdotal accounts of entrepreneurs like Rief struggling to acquire new loans have increased, despite well-publicized government efforts to jump-start the economy with policies designed to boost lending to small businesses.

Jim Wilkinson, an assistant vice president and economist at the Federal Reserve Bank of Kansas City, says data that he and former Bank research associate Jon Christensson examined confirm the ongoing challenges. Their research suggests that two key strategies policymakers implemented to expand the supply of new loans—raising bank capital and reducing problem loans—are largely ineffective and result in only a relatively small fraction of new loans.

"These (government) policies that try to encourage bank lending don't seem to be very effective," he said. "At least our results don't show they are effective in increasing the supply of small business loans."

Still, while Wilkinson says the results are not encouraging, understanding the factors that affect the supply of loans may help policymakers to design programs that more directly support small business lending and, therefore, job growth.

Community development groups say the study reinforces their belief that alternative financing mechanisms, including partnerships

between banks and micro-lenders, like the one that helped Rief, can assist small businesses get a leg up, at least through the recovery.

“I get excited with research like this because I see an opportunity to frame a national dialogue on how we can do things better,” said Leslie Hoffman, vice president of lending for ACCION New Mexico-Arizona-Colorado, a community development finance institution that works with banks to make loans to small businesses.

Good intentions

Wilkinson and Christensson were at first surprised by their findings, which focused on community banks in the Tenth Federal Reserve District, a region that includes Colorado, Kansas, western Missouri, Nebraska, northern New Mexico, Oklahoma and Wyoming. It seemed logical that if capital and problem loans played a role in the decline in bank lending, then increasing capital would induce banks to make new loans, which would generate interest income, leading to more capital, and more loans.

Coming out of the recession, policymakers looked to new businesses to generate jobs. The U.S. economy had lost 9 million jobs, and the Bureau of Labor Statistics estimates that employment fell from a peak of 138 million in January 2008 to a low of 129 million by February 2010. But small businesses were hurting. Lending to all U.S. businesses declined 22 percent from September 2008 to June 2010.

As capital declined and problem loans rose, community banks grew more cautious. Business lending by community banks declined 15.6 percent during the recession and financial crisis. At the same time, bankers reported a weakened demand for loans from qualified small business borrowers. Businesses experiencing sagging sales were more likely to cut back, rather than expand their businesses, Wilkinson said.

Hoping to encourage banks to lend and small businesses to expand, policymakers

implemented several policies, including the Troubled Asset Relief Program (TARP), the FDIC's Legacy Loan Program and the Small Business Lending Fund, to raise the supply of available small business loans.

Bank capital provides a source of funding for new loans and acts as a cushion to absorb unexpected losses, Wilkinson said. Theoretically, increasing capital should correlate well with a greater capacity to make loans; however, the theory didn't pan out when the researchers closely analyzed the data.

“Programs that try to increase capital or reduce problem loans don't seem to translate well into greater lending,” Wilkinson said.

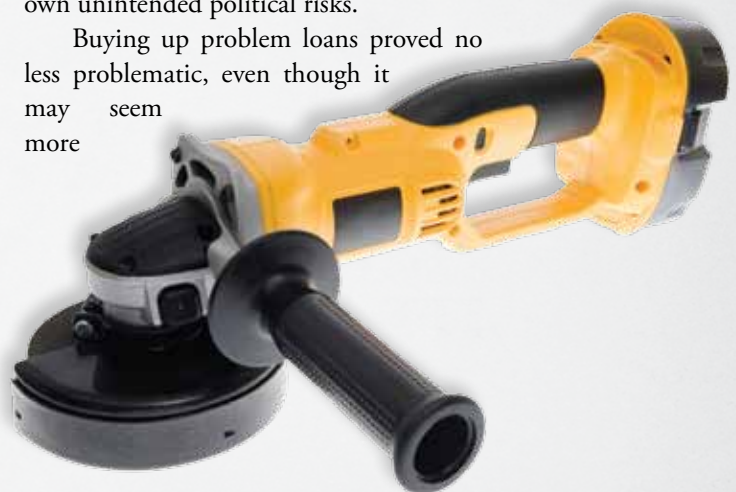
Unintended consequences

Wilkinson and Christensson's research suggests that strategies designed to increase bank capital require large infusions of funding to effect even small changes in lending, making the approach “an inefficient option for increasing small business lending.”

For example, the researchers calculated that, based on conditions in Tenth District community banks at the end of 2010, a one-time capital infusion of \$502 million would raise small business lending over four quarters by only \$59 million. Part of the reason for this wide disparity is that business lending, to begin with, accounts for only 14 percent of community bank lending.

Wilkinson says, in some respects, it might be more effective “to give money directly to small businesses in the form of grants or loans.” Such policies, however, are fraught with their own unintended political risks.

Buying up problem loans proved no less problematic, even though it may seem more



effective because it removes bad assets that weigh down a bank's portfolio. Wilkinson says the strategy is actually more difficult to implement, citing the FDIC's experience as an example.

Although the FDIC was able to find investor groups willing to buy problem assets as part of its Legacy Loan Program, banks were reluctant to put problem assets up for bid. The banks were worried that the bids they received "might be a lot lower than they believed the assets were worth," Wilkinson said.

In addition, selling a problem asset at a loss had the potential to lower the value of many other assets in a bank's portfolio.

"Not only would they have to take losses

Katherine Hunter, a senior vice president at UMB Bank in Kansas City, sees bankers returning to more conservative, traditional underwriting standards that may appear as if they are tightening.

"There are businesses that got loans five years ago that would not have today, under more traditional lending practices," she says.

Now, she says, with regulators looking more closely at small-loan portfolios, "the industry, as a whole, is circling back and scrutinizing some of the lending practices they adopted when the economy was so strong.

"I'm not saying they made bad choices," Hunter said. "But they (lenders) took more modern approaches to lending, and now they

“ There are businesses that got loans five years ago that would not have today, under more traditional lending practices. ”

on the assets they sold, but they might have to mark down other parts of their balance sheet," which might cause examiners to raise their eyebrows, Wilkinson said.

As a result, many banks simply opted out of participating in the government programs.

For example, so few banks have taken advantage of the Small Business Lending Fund that \$26 billion of the original \$30 billion remains. A recent *Wall Street Journal* article states that some of the banks that received funding used it to pay back their TARP loans.

Return to traditional underwriting

Are lenders remaining tight-fisted, as some small businesses claim?

Wilkinson sees a combination of factors. Banks may still be gun-shy, and therefore want to hold on to capital to absorb future losses. And some businesses with shaky cash flow are hanging back, afraid to take on more debt.

"These things feed on each other in a sort of negative reinforcing way," Wilkinson said.

are taking more traditional approaches, and because of that, they are finding it harder to approve loans."

David Long, executive director of Heartland Business Capital, in Overland Park, Kan., describes the change in small business lending another way.

"The lending pie" is simply smaller than it was in 2007, he said. Banks are still competing to attract highly capitalized businesses that have strong projects going, and there is little appetite left for small businesses and startups. "There are no startup loans being made right now," said Long, whose company offers Small Business Administration 504 loans, which provide gap financing to small businesses that might not otherwise qualify for bank loans.

Creating lending relationships

Collateral is a stumbling block for many entrepreneurs. They often rely on their own assets as collateral, including their homes, which may have lost value in the recession. As a result, their credit takes a hit. The businesses

may also have made several late payments on previous loans, contributing to the sense that they are poor credit risks.

Maria Meyers, director of the University of Missouri-Kansas City Innovation Center, believes perception is partly to blame. She says the general perception in the market is that banks aren't lending, so small businesses don't ask.

"We need to bring the two groups together to make the connection," she said.

Small Business Development Centers (SBDCs), located at both four-year and community colleges, increasingly act as liaisons between fledgling businesses needing technical support and lenders looking for high-quality applicants. They can help small businesses hone loan applications, address credit issues and then link businesses with receptive lenders and providers of gap financing, such as the SBA.

Other organizations that assist small businesses navigate the passage from startup to successful loan applicant include SCORE and U.S. SourceLink, a national association of

small business development coalitions.

"To get a bank loan right now, you have to be prepared," Meyers said. "And you need a trusted referral. It's all about referrals."

Hoffman, of ACCION, said bankers also are becoming more aware of the option to refer a potential client to a business development organization for help before deciding to deny a loan application.

"We work with a lot of bankers who are working hard to support their customers," Hoffman said. "They provide us with critical support through operating grants and lending capital. But just as importantly, they serve as a voice for us in the community by providing referrals to our organization."

One measure of success for those relationships, Hoffman said, is "half of our lending volume this year has been to startups."

The uncertain road forward

Adam Rief is an example of the trend Hoffman describes—he never would have

ADAM RIEF FOUND DIFFICULTY IN PROCURING A BANK LOAN for his growing small business, Rief Design & Manufacturing, in Bancroft, Neb. Major banks have little appetite today for small business and startup loans; however, Rief found support through an enterprise fund that helps small business owners find financial assistance.



PHOTO BY BOB GREENSPAN

gotten a loan if First National Northeast Bank Vice President Marlene Anderson hadn't made the extra effort to refer him to the Nebraska Enterprise Fund.

"She's the reason we got the loan—100 percent," he said. "I had no idea there was anything out there like this." Though Rief had enough collateral for part of the loan, he didn't have enough for all of it. Nebraska Enterprise Fund was able to guarantee a smaller portion of the loan using a CD it held on deposit at First National and pledged as security for Rief's loan. Northeast Economic Development, Inc. from Norfolk, Neb., an NEF program partner and borrower, participated in the loan package also.

Rief Design & Manufacturing now has clients in Iowa, Kansas, Montana, Nebraska, North Dakota, South Dakota, Wisconsin and Wyoming. Rief has custom-designed and produced more than two dozen farm implements, which he says result from sketches he makes on paper and then refines on his computer.

Anderson said both the bank and Rief benefitted.

"It gave the bank additional collateral and allowed Adam to expand his business." She said the bank saw Rief as a young go-getter who could contribute to the community's economic lifeblood. "So we went the extra mile to see if we could help him."

Glennis McClure, program manager for the Nebraska Enterprise Fund, says the fund has experienced growing demand for its services from small businesses. But many are short on credit and collateral, which is why banks are pulling back.

"We are reaching out to banks a lot more with our CD Guarantee," she said. The loan-enhancement program is catching on with banks: "Anymore it seems very natural that a bank seeks a guarantee."

Alternative lending partnerships, micro-lending enterprises and gap financing have surely provided new options since the recession.

Still, for now, bank lending remains the most significant resource for new small business loans. And the positive news is that bankers such as Hunter are optimistic that the tide is turning.

"While some financial institutions are still working their way through, I'm a believer that banks are jumping back in," she said. "The spigot is being opened back up."

With signs that banks are beginning to look for new and expanded opportunities to lend to small businesses, Wilkinson thinks there is a pressing need for ongoing research on ways to design sustainable programs and policies to support an increase in small business lending and job growth, but no single approach or policy has yet been shown to work the best.

"We wanted to put our research into what is hopefully an expanding base of knowledge about small business lending," he said.

"It's one piece of the puzzle. The better we understand it, the better the programs and policies we are able to design."



BY PAUL WENSKE, TEN CONTRIBUTING WRITER

FURTHER RESOURCES

"CAN THE SUPPLY OF SMALL BUSINESS LOANS BE INCREASED?"

By Jim Wilkinson and Jon Christensson
KansascityFed.org/publications/research/er

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.