The Credit Gap: Easing the Squeeze on the Smallest Businesses

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Among the many casualties of the 2007-2008 financial meltdown were small businesses. As the financial system virtually shut down, millions of small business owners across America found themselves unable to get the credit they desperately needed to run their businesses, let alone expand. As a result, thousands of otherwise flourishing firms were forced into bankruptcy or closure, with thousands of American jobs lost.

While this credit freeze has begun to thaw, one critical group of small businesses—firms with fewer than 50 workers—are still at risk of being left behind. These smallest of small businesses provide as much as 30 percent of all private-sector employment.[1] Yet because of their small size, they are much less likely to benefit from government small business loan programs, and they are less likely to win loans from big commercial banks. For this group, the credit crunch is a serious impediment to their success. Many of these businesses relied on personal assets, such as home equity, for financing. But with the crash in home prices, those resources have evaporated. Instead, many smaller businesses rely almost exclusively on risky and expensive credit cards to finance their firms, if they can get credit at all.

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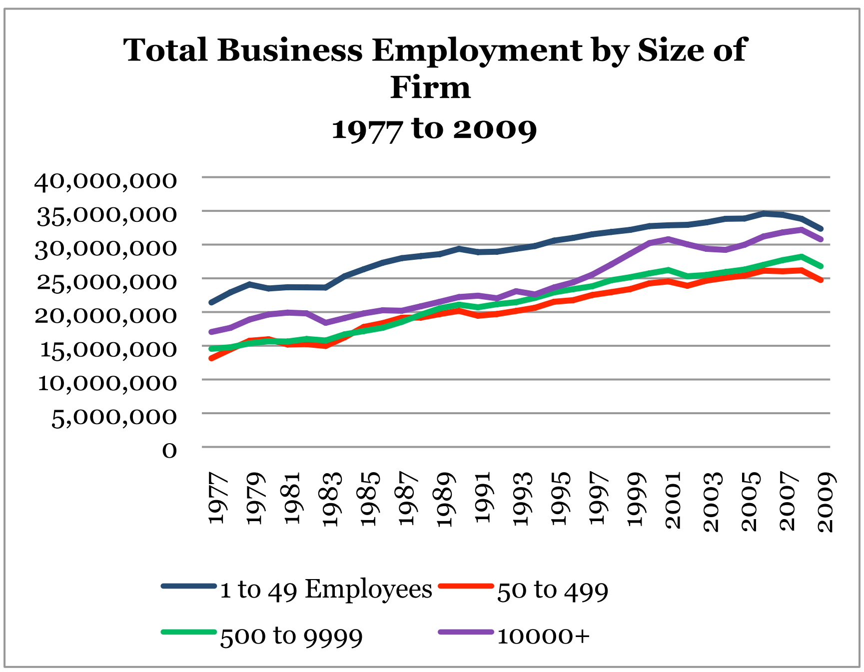
Smaller businesses clearly need more options for getting credit, and credit unions, which already help many small borrowers finance their self-employment and small business ventures with personal loans, lines of credit, and limited business loans, could be an ideal source of credit for these underserved entrepreneurs. However, credit unions are blocked from offering as much help as they could because of an arbitrary and outdated cap on the amount of small business lending that credit unions can do. Bipartisan proposals to increase this limit—such as the ones offered by Senators Mark Udall and Susan Collins and Reps. Ed Royce and Carolyn McCarthy—would help credit unions fill the "credit gap" that these smaller businesses face. It would also be a sensible and cost-effective way to jumpstart the job creation our country urgently needs.

"Smaller" businesses: Small size and big impact

While there is no standard definition of a "small business," the federal Small Business Administration (SBA) and the Bureau of Labor Statistics (BLS) generally define small businesses, for statistical purposes, as companies with fewer than 500 workers. This definition may be useful in broadly distinguishing small businesses from large corporations, but there is enormous diversity among the more than five million businesses with fewer than 500 employees. Certainly, a company of 500 is "small" compared to a publicly-traded corporation employing thousands, but equally vast is the difference between a company of 500 and a company of 50, five or one. These smaller businesses—those with 50 workers or less, including the self-employed—are a unique segment of small businesses and a critical engine of American job growth and innovation. They are also a different lending market than larger small businesses.

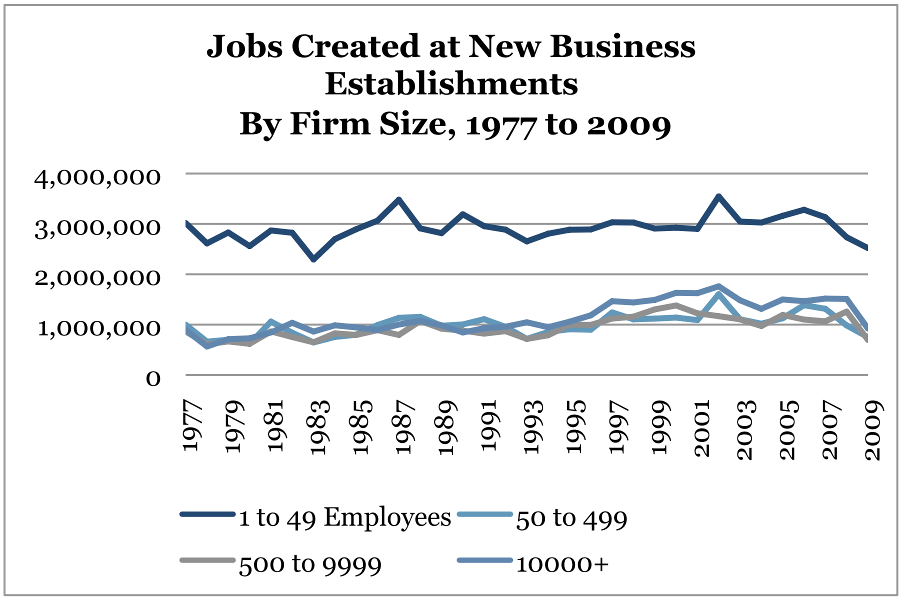
- **Smaller businesses and self-employed are a potent engine of job growth.**

Businesses with fewer than 50 employees account for about 30 percent of private sector employment. They accounted for 34.6 million jobs in 2006 according to the Census Bureau's Longitudinal Business Database. As the chart below shows, businesses with fewer than 50 workers have consistently provided more jobs than any other category of business by firm size, including the very biggest companies in America.



Source: Longitudinal Business Database of the Census Bureau's Center for Economic Studies.[2]

Smaller businesses maintain their overall leading role in job creation despite facing more difficulties and more market turmoil than the larger businesses. In a typical year, 500,000 to 600,000 new smaller businesses are born. These new firms create between 2.5 million to 3.5 million new jobs. As the next chart shows, businesses with fewer than 50 employees also account for 40 to 50 percent of the jobs created by new businesses each year. They are also the quickest to add jobs in the recoveries following recessions (see, for example, the spikes in smaller business job growth in the early 1980s and after 2001).



Source: Longitudinal Business Database of the Census Bureau's Center for Economic Studies.[3]

- **Smaller businesses are a growing group.**

Smaller businesses—including the self-employed—are likely to become an even more important segment of small businesses because of a recent wave of new micro-entrepreneurs. Two recent developments in particular may be contributing (and could further contribute) to the surge in smaller businesses: (1) the increase in self-employment; and (2) the passage of health care reform.

From 2000 to 2008, the number of self-employed Americans grew by 12 percent. The Bureau of Labor Statistics estimates that there are more than 15 million Americans who are now self-employed, including 9.4 million who aren't currently captured in small business data because they are "unincorporated" (i.e. they haven't created a separate legal entity for their small business)[4] and another 1.4 million Americans who work at a wage or salary job but are self-employed as a second job.[5]

Much of the growth in self-employment from 2000 to 2008 has been due to gains in self-employment among Hispanics and older workers. According to the SBA, Hispanic self-employment more than doubled between 2000 and 2008, and Hispanics now make up 10.2 percent of self-employed workers.[6]

Older self-employed workers are an even larger group. Between 2000 and 2008, the share of self-employed workers between the ages of 55 and 64 grew from 16.2 percent to 22.2 percent.[7] The SBA predicts that trend will continue as more members of the baby boomer generation work to supplement their retirements. Self-employment also has increased in business, professional, and other services as advances in technology have created opportunities for small business and self-employed contractors.

The passage of health reform could further fuel the trend in self-employment. Proponents of health reform have argued that one of the signal achievements of the Affordable Care Act is its potential to largely eliminate the problem of "job lock"—that is, the phenomenon of workers staying in a job just for the insurance. When the law goes fully into effect in 2014, every self-employed American and small business owner in America should have access to more affordable health coverage through the health insurance "exchanges" that the law creates.

Between 2000 and 2008, the share of self-employed workers between the ages of 55 and 64 grew from 16.2 percent to 22.2 percent.

This could potentially free up thousands of Americans to pursue small business or self-employment opportunities. As notable MIT health economist Jonathan Gruber argues, "a system that provides universal access to health insurance coverage … is far more likely to promote entrepreneurship than one in which would-be innovators remain tied to corporate cubicles for fear of losing their family's access to affordable health care."[8] In an essay for *Washington Monthly*, Gruber cites studies finding that better access to affordable health care could increase the ranks of the self-employed by 2 percent or more.[9]

Sand in the gears: The continuing credit crunch for smaller businesses

But despite the tremendous potential for job growth and innovation that smaller businesses and self-employed workers can bring to the American economy, these smaller firms are facing a major threshold obstacle to their own growth and success: lack of access to credit.

During the financial crisis, according to the Federal Reserve, banks raised their requirements for collateral, cash flow, and credit scores to such an extent that even some small businesses with perfect payment histories were denied new loans and were required to pay additional cash payments to keep their existing loans. For example, in May 2009, Advanta, then the fifth largest small business credit card issuer, stopped all new purchases on its 2.5 million small business credit cards before it was eventually shut down by regulators and put into federal receivership.[10]

As a result of developments such as these, some small businesses that were current in their payments were forced into bankruptcy or closure when their credit limits were dropped. The Federal Reserve also found that some large banks eliminated all new business loans below $200,000, deciding they were not worth the trouble of assessing the credit risk.[11] Even without additional borrowing, businesses faced higher fees and rates because their debt ratios and credit ratings were negatively affected by cuts in their credit limits. [12]

While things are looking much brighter today, small business lending is still far from having fully recovered. In a recently released study, the Financial Services Roundtable reported that financial institutions had loaned $607 billion to small businesses in the first half of 2011.[13] However, this figure is still 15 percent below the $711 billion in small business loans made in the first half of 2008.

Moreover, according to the monthly Thomson Reuters/PayNet Small Business Lending Index (SBLI), the volume of new small business loans is still only three-fourths of its 2007 peak, despite having risen gradually through 2010 and 2011.[14]

For smaller businesses, the environment is even tougher.

- **Smaller businesses face bigger obstacles to getting commercial credit.**

Larger small businesses have an easier time getting credit, which means that as the small business lending environment improves, these larger firms will be the ones to benefit the first and the most. Smaller businesses, however, face bigger hurdles to getting credit that are unlikely to go away even if the economy improves.

The Federal Reserve's 2003 Survey of Small Business Finances (SSBF) found that larger small businesses were more likely than smaller ones to have credit lines, capital leases, motor vehicle loans, mortgages, and equipment loans. The larger firms were more likely to apply for new credit and were more likely to be approved. These credit transactions enable the larger small businesses to build up what the Federal Reserve called "relationship financing" with lenders. The lender is able to accumulate information about a business, its owners, its financial history, and its outlook that would not be apparent to other lenders or credit raters.[15]

Smaller firms, on the other hand, are more difficult for lenders to assess. Many do not have established credit histories apart from the owners' personal credit. They may not have accumulated enough assets to serve as collateral. Many are new or expanding businesses whose future cash flow is difficult to predict, and they are in a more volatile environment.

There is tremendous "churn" in the smaller business market, even if net job growth is positive. Around 15 to 20 percent of smaller business jobs turn over each year. [16] In 2006, for example, when net employment at smaller firms grew by more than 1 million jobs—from 33.5 million to 34.6 million—this was the result of 7.2 million new jobs created and 6.1 million jobs lost.[17] Three-fourths of businesses with fewer than 50 workers are in the service, retail, or construction industries—sectors that rise and fall with changes in demand from consumers and other businesses.[18]

This job turnover shows the intensity of competition in many small business markets. Moreover, smaller businesses also generally need smaller loans, which means the return for banks may not be worth committing the time and effort to assess all the uncertainties that come with a younger, smaller business.

In the Federal Reserve's 2003 Survey of Small Business Finances, 18 percent of business owners—including 26 percent of owners of firms less than five years old—said that they had not applied for needed credit within the past three years because they expected to be turned down.[19]

- **Smaller businesses are less likely to benefit from federal small business lending programs.**

To the extent that smaller businesses do get small business credit, much of it is based on credit cards, which are riskier and more expensive for small business owners.

Nearly one in five small business owners say they haven't applied for needed credit within the past three years because they expect to be turned down.

The Federal Reserve Banks of Philadelphia and St. Louis have both reported that the majority of smaller loans to businesses are credit cards and that commercial banks have been shifting small businesses from traditional loans to credit cards since the mid 1990s.[20] This trend was accelerated during the economic downturn when banks sharply reduced conventional loans and featured business credit cards as the alternative. The Nilson Report, a monthly industry report, listed 38 banks that have issued $123.5 billion in small business credit cards. The top six banks had a total of 9.4 million small business credit card accounts, with 13.9 million cards, and $110.5 billion in credit.[21] JPMorgan Chase by itself accounted for 4.7 million small business credit cards totaling $33 billion in credit. [22]

According to quarterly data published by the Federal Deposit Insurance Corporation (FDIC), the number of "unsecured" small business loans (such as credit card loans) jumped during 2008 (though it has since declined by 22 percent), at the same time that small business loans secured by commercial real estate (e.g. a storefront) dropped sharply. The most likely explanation is that businesses that were cut off from conventional loans took on credit card debt in 2008 before lenders started tightening the credit card market as well. As the following chart shows, secured loans made up just 7 percent of small business loans under $1 million in 2011 (compared to 10 percent in 2007).

Number of Small Business Loans (under $1 million) as of June 30 FDIC Report, 2007 to 2011

Loan Category	6/30/2007	6/30/2008	6/30/2009	6/30/2010	6/30/2011
Secured Loans	2.46 million	1.84 million	1.80 million	1.73 million	1.50 million
Unsecured Loans	22.1 million	25.4 million	21.4 million	20.7 million	19.8 million

For smaller businesses, especially those that rely on "microloans" of $100,000 or less, the share of secured lending is even smaller. For the first half of 2011, real-estate secured loans accounted for just 2 percent of total microloan volume.

Nonfarm Business Loans of $1 Million or Less as of June 30, 2011[23]

Business Loan Category	# of Loans ≤$1million	$ Amount ≤$1million	Avg. Loan	# of Loans ≤$100,000	$ Amount ≤$100,000
Secured Loans	1.5 million	$324 billion	$215,322	469,000	$20 billion
Unsecured Loans	19.8 million	$283 billion	$14,277	18.9 million	$120 billion

Compared to more traditional loans, credit card lending is more expensive and risky. In addition to charging higher interest rates and potentially dropping credit limits without warning, small business credit card issuers also commonly mingle the credit of businesses with the personal credit of the owners. This means any change in the businesses' credit will affect the owners' personal credit, and vice versa. The Credit Card Accountability Responsibility and Disclosure Act (Credit CARD Act), enacted in 2009, provides some protections for personal credit cards against unreasonable fee and rate increases among other provisions, but the act specifically excludes business credit cards from those protections.

- **Lack of access to credit means lost opportunities and jobs.**

Lack of access to credit hurts smaller businesses in two significant ways: (1) they may be unable to get the resources to launch a new business or self-employment venture; or (2) for those self-financed businesses that do succeed, they may still be unable to get the resources necessary to grow beyond the capacity of the owner's personal assets and credit.

Starting a new business is a daunting task, and businesses that are financed with the owners' personal assets and personal credit have a relatively short window in which to succeed. They have to generate a positive cash flow from the business before they run out of personal resources and max out personal credit. Businesses that require significant equipment purchases, inventories, or other up-front investments require more personal resources and are more difficult to launch. Moreover, the intensity of the competition in the smaller business market makes it vital for small business owners to have access to small loans so they can adapt, modernize, and expand to keep pace with their competitors.

Better access to credit would help increase the odds that a small business can achieve liftoff. In the absence of these opportunities, the nation's economy would be denied a potential chance for creating new jobs.

Credit unions: An option for easing the squeeze on smaller businesses

Creating better access to credit for smaller businesses could help ensure that we leave no opportunities on the table for getting our economy moving again.

While there are any number of policy options for expanding credit to smaller businesses, the easiest and most obvious option is to expand the lending capability of some of the lenders who are already the most likely to be working with smaller businesses as their customers—that is, credit unions.

Sen. Mark Udall (D-Colo.) has proposed a bill to allow credit unions to increase their business lending to a maximum of 27.5 percent of their total assets—a proposal that credit unions say could result in $13 billion additional small business lending in the first year.[24]

Raising the cap on small business lending by credit unions could result in $13 billion in additional small business lending in the first year.

This proposal would amend the current law, under which credit unions are prohibited from having more than 12.25 percent of their total assets in business loans. This limit was put into place in 1998 as part of federal legislation enacted in response to a Supreme Court ruling that would have tightened the limitations on membership in credit unions.[25] The current lending cap was not considered a major provision of the legislation at the time and is now an arbitrary limit on the ability of credit unions to help smaller businesses make the leap toward growth.

Raising the cap could substantially benefit smaller business owners and in turn the economy at large. It would enable credit unions to extend more credit to their existing members who are small business owners interested in expansion or who are just starting out a new venture, while the current low cap may block these opportunities for growth.

Moreover, credit unions are uniquely suited to the needs of smaller businesses. First, credit unions are already specialists in the smaller loans

that smaller businesses need. According to credit union data, the average size of a small business credit union loan is about $200,000.[26]
Second, because "relationship financing" is a traditional strength of credit unions, they will be well-equipped to assess the risks of the smaller businesses who apply, especially since smaller business owners are almost certainly customers already. While some argue that the existence of some sort of a lending cap is necessary to distinguish credit unions' unique non-profit status from that of commercial banks, raising the limit to at least the level proposed by Sen. Udall would in no way compromise credit unions' mission.

Conclusion

Small businesses employ half of all private sector workers and are responsible for almost two-thirds of the private sector jobs created in the past 20 years. They lead the innovation of new technologies, products, services, and business strategies. Small business markets are dynamic with new businesses constantly entering, many existing businesses profiting and growing, others struggling, and some that do not survive.

This fierce competition for survival is what fuels innovation. Better access to credit can help ensure that good ideas also have a good shot at getting off the ground.

While there is inherent risk in extending credit to new ventures or to the expansion of small companies, there is even greater risk to the overall economy if credit is unavailable to those businesses that create new jobs. The challenge for lenders and for government regulators and guarantors is to responsibly manage the risk of small business lending, not to avoid it altogether.

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