Economic Factors Affecting Small Business Lending and Loan Guarantees

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Summary

A slowdown in the U.S. economy is likely to reduce the demand for loans by small businesses because the slowdown would reduce the number of profitable projects, and the decrease in loans to small businesses could reduce the demand for Small Business Administration (SBA) loan guarantees. Increases in mortgage delinquencies and defaults that started in 2007 and continue into 2008 are making lenders more cautious about the risks of all kinds of loans, including business loans. This could increase the demand for Small Business Administration guarantees. The ultimate impact of these factors, which work in opposite directions, cannot, however, be predicted with any confidence.

This report lists some sources of information about the condition of the small business loan market. It will be updated as developments warrant.

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The Demand and Supply for Business Loans

Most economic and financial analysts view the market for business loans in the U.S. economy in a traditional supply and demand framework that takes into consideration the alternate ways to finance a business and various ways for those controlling capital to invest. A business—large or small—with a project it thinks will meet its profit requirements, considers internal and external funding sources. Many times, these businesses weigh borrowing money (debt) against selling an ownership stake. Those with money to invest—the current owners, friends of the current owners, banks, pension funds, hedge funds, trusts, mutual funds, etc.—examine the financial returns and risks on a loan, compare what one company offers against the offers of other firms, and examine alternatives to business loans such as consumer loans or government bonds. This report analyzes the factors influencing the decision to finance for businesses in general and for small businesses in particular.

Demand for Capital

A business undertakes the projects expected to most increase its value. It does this by proceeding with the projects that have the greatest risk-adjusted rate of return. A risky project should be anticipated on average to produce a greater yield than a riskless investment, such as U.S. Treasury bonds, to compensate for the probability of a loss (or less than expected profit). When there are a large number of projects that are expected to be profitable after adjusting for risk, a company will desire to borrow more money than when it finds fewer projects that are profitable after adjusting for risk.

As the economy fluctuates, the supply and demand for loans changes. When the economy is growing rapidly, a typical company will find many more projects that would be profitable than when the economy is growing slowly or even shrinking. Changes in specific business sectors increase or decrease the supply and demand for capital in those business sectors.

All economic sectors (consumers, businesses, and government) at times compete with each other to borrow for various purposes. Businesses borrow long term to finance plant and equipment and short term to obtain working capital to meet payrolls or finance inventory. Business borrowing is sensitive to interest rates, other loan terms (such as the life of the loan, any collateral, and any other restrictions), and the economic outlook. Interest rates matter because the cost of borrowing can be critical in determining whether a project will be profitable. The economic outlook is more important for long-term borrowing because of its impact on a project's profitability. Frequently, these two factors work together. An increase in interest rates and a deteriorating economic outlook can impact some sectors, such as new home construction, more than others, such as fast food. Other factors influencing business demand are the cost of investment goods, the durability of the goods, and tax treatment of investments.

A business's alternatives to finance a project may depend in part on its size. Banks, other corporations, individuals, and governments make loans. Many of these lenders have minimum and maximum size loans that they will make. Some loans could be too small for a large lender to process and service. Some lenders have application or processing fees that could make borrowing small amounts uneconomical. These concerns are one reason that the Small Business Administration (SBA) created the microloan program. Large loans could exceed the financial capacity or legal limits on lending.

Firms can sell bonds to the public (in some cases by private placement). The advantage to those who purchase bonds is that, unlike many business loans, they can be sold in the secondary market. For some companies there is a ready, liquid market for bonds. The disadvantage of bonds is that they have high fixed costs; as a result, bond issues typically are for tens of millions of dollars. This size makes it uneconomical for small businesses to issue bonds.

Consumers and governments compete with businesses to borrow money. Consumers frequently borrow to purchase homes and consumer durables such as cars and large home appliances.[1] Consumers also borrow to meet short term needs or shortfalls in income. In general, household income is the largest determinant of consumer borrowing. Other factors that influence the demand for consumer loans include fluctuations in income, seasonal factors, interest rates, and expectations about the future.

Governments (federal, state, local, and foreign) borrow to allow spending to exceed revenues. The federal government is relatively insensitive to changes in interest rates. State and local governments, especially those required to balance their budgets, can be sensitive to interest rates. Foreign governments are sensitive to the inflation, interest, and exchange rates.

Supply of Capital

The same sectors—individuals, companies, or governments—that borrow also lend funds. Sometimes, this is done to take advantage of differences in interest rates, and in other cases timing differences are important. In general, the motivation to save depends on current interest rates, current and expected future inflation, and the timing of future income and expenditures. Sometimes, financial intermediaries like banks borrow money for the purpose of lending to others. For example, one business model used by banks is to offer the Federal Deposit Insurance Corporation's guarantee to collect inexpensive, relatively small deposits that are then combined into much larger loans.[2]

Businesses lend money to other businesses for a variety of purposes, including to finance the purchase of goods and services from the first firm. Profitable companies may accumulate funds for possible future investment. For example, as of December 31, 2007, Microsoft had $21 billion in cash, cash equivalents, and short-term investments.[3] Microsoft proposes to use some of its retained earnings to purchase Yahoo for an estimated $44.6 billion.[4]

Consumers supply money for lending through deposits in banks and other financial intermediaries. In addition to traditional deposits such as checking accounts, savings accounts, and certificates of deposit, consumers have specialized vehicles like Individual Retirement Accounts (IRAs) and Section 529 college savings accounts.[5]

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[1] See Sangkyun Park, "The Determinants of Consumer Installment Credit," *Federal Reserve Bank of St. Louis Review*, (November/December 1993), pp. 23-38.

[2] Many large banks in the United States and other countries also invest on their own accounts. In this case they are not acting as financial intermediaries.

[3] U.S. Securities and Exchange Commission, Microsoft Corporation, Form 10-Q for the Quarter Ending December 31, 2007. Available at http://edgar.sec.gov/Archives/edgar/data/789019/000119312508011476/d10q.htm.

[4] Michael S. Malone, "Microsoft's Yahoo Gambit," *Wall Street Journal*, February 5, 2008, p. A17.

[5] CRS Report RL33482, *Saving Incentives: What May Work, What May Not*, by Thomas L. Hungerford.

Governments use financial intermediaries to lend either short or long term. For example, tax revenues might be put into a certificate of deposit for several months before they are used to pay salaries or other expenses. Foreign governments put their money in other countries for a variety of reasons, including the desire to hold reserves in "stronger" currencies and greater security. Over the last few years, many governments have created sovereign wealth funds (SWFs) to invest internationally.[6]

Debt and Equity

An alternative to borrowing to finance projects is to find investors to purchase ownership shares or equity. The SBA's Small Business Investment Company (SBIC) program is designed to stimulate private equity investments and long-term loans to small businesses.[7]

There are numerous differences between debt and equity. Those who hold debt are contractually entitled to specified interest payments for a specified time period. The principal is repaid according to the loan agreement. If a company fails to make its payments, lenders can force it into bankruptcy and seize the company's assets to pay off the loan. Sometimes lenders require collateral to secure the debt. A company might set aside money in a sinking fund that is pledged to pay the interest and/or principal. Lenders to small businesses sometimes require an SBA 7(a) or 504 guarantee to reduce the loan's risk to a level that is acceptable.[8] The SBA seeks, but does not require, to have the business owners pledge real estate or other assets as collateral.[9] The SBA requires holders of at least 20% of the ownership of a company to personally guarantee the loan.

Holders of common stock (usually just called stockholders) have no claim on a specific amount of money. They are entitled to a share of profits (usually called dividends), but management may decide to retain the profits so that the firm can take advantage of a good opportunity. Microsoft's offer to purchase Yahoo is a case in point. Microsoft will use some of its retained earnings and borrow the rest. Shareholders unhappy with this decision have little recourse unless they can convince the board of directors to change its policy.

Some companies issue preferred stock, which combines some characteristics of debt and equity. Preferred stock promises to pay a certain dividend; it has a lower claim on company revenues than bonds, but a higher claim than common stock. Preferred stockholders cannot force a firm into bankruptcy for failure to pay dividends, but common stockholders cannot receive a dividend unless the preferred stockholders are paid.

Lastly, in the United States, business interest payments are tax deductible. Corporate profits (from which dividends are paid) are subject to corporate income taxes.

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[6] CRS Report RL34336, *Sovereign Wealth Funds: Background and Policy Issues for Congress*, by Martin A. Weiss.

[7] See CRS Report RL33243, *Small Business Administration: A Primer on Programs*, by N. Eric Weiss for additional information on SBICs. The SBA's website on the SBIC program is at http://www.sba.gov/aboutsba/sbaprograms/inv/index.html.

[8] The SBA can guarantee 75%-85% of a certain private sector loans to small businesses under Sections 7(a) and 504 of the Small Business Act as amended (15 U.S.C. 636); see CRS Report RL33243, *Small Business Administration: A Primer on Programs*, by N. Eric Weiss for additional information.

[9] 13 C.F.R. 120.150 and 120.160. In some SBA programs collateral is not optional.

How Do Small and Large Businesses Differ?

For many purposes, the Small Business Administration defines a small business as one with 500 or fewer employees. Small businesses by their nature have fewer employees than large firms. They have fewer assets, less equipment, and undertake smaller projects. As a result, a representative small business needs to raise less money than a large business in the same industry. On the one hand, small businesses are unable to take advantage of economies of scale in raising capital such as bonds. For example, a small business borrowing $10,000, may pay a higher interest rate than a large business borrowing $10 million. On the other hand, large businesses may find only a few lenders who can accommodate their financing needs, whereas small businesses may borrow from one of many lenders.

Those who are concerned about the availability of credit to small businesses frequently suggest a number of reasons that small businesses may pay a higher interest rate or face more requirements to get a loan than an equally creditworthy, larger business.[10] These include the following:

- Small businesses are thought to be more affected by swings in the economy and consequently are riskier.
- Small businesses have a higher failure rate than comparable larger businesses and consequently are riskier.
- Potential lenders have a harder time assessing how creditworthy a small business is. There are great differences between small businesses in the same industry and many reasons for borrowing money. This variation makes it difficult to develop general standards that can be applied to small businesses.
- There is limited reliable financial information on many small businesses. Many small businesses are young, have a short credit history, and have not been through a difficult economy. Most small businesses are privately owned and do not publish current, detailed financial information. Many small businesses use staff instead of independent accountants to create financial reports.
- Small businesses have less collateral than large organizations to pledge for a loan than a large business. This can lead to borrowers (and the Small Business Administration) requiring owners to use personally owned real estate as collateral.

Financial institutions, such as commercial banks, that have ongoing relationships with a small business are considered by many to have an advantage in lending because of their experience working with the small business. The history between a small business and the bank that serves it gives the bank information on the owners, managers, markets, and potential of the loan applicant that is not available to other lenders. This can lead to better lending decisions and may facilitate monitoring the business's financial health, which reduces the risk to the lender.

[10] Testimony of Federal Reserve Governor Frederic S. Mishkin before U.S. Congress, House Committee on Small Business, *Availability of Credit to Small Businesses*, 110th Cong., 1st sess., November 7, 2007. Available at http://www.federalreserve.gov/newsevents/testimony/mishkin20071107a.htm.

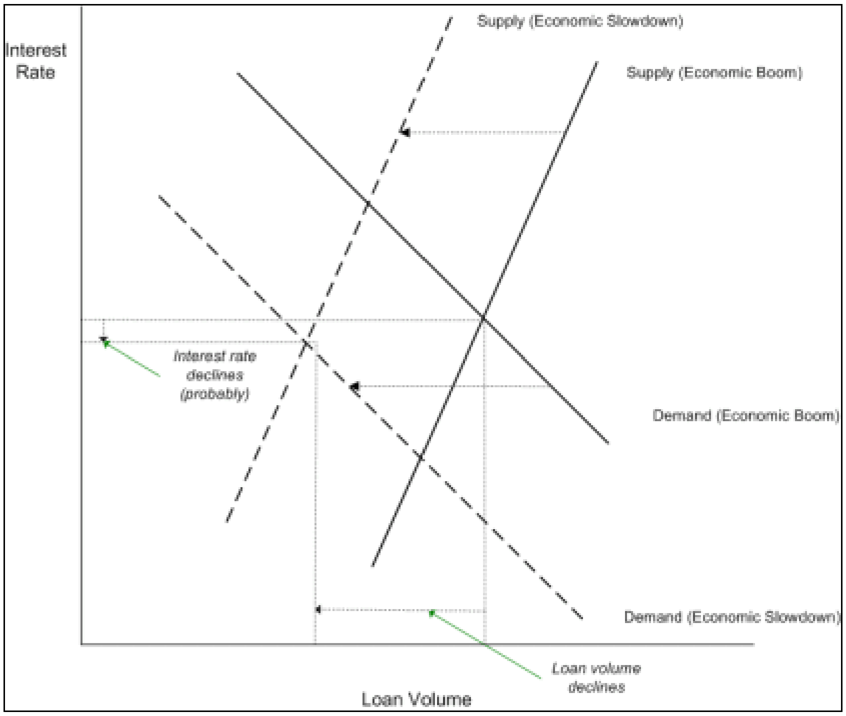
Likely Impact of An Economic Slowdown on Small Business Borrowing

An economic slowdown or a recession could have several impacts on small business borrowing.

- As lenders become more risk averse, they could decline to make loans that they would have made in more prosperous times. SBA loan guarantees might offset this caution and help small businesses to expand.
- An economic slowdown could reduce the risk-adjusted profitable opportunities for small businesses to invest, reducing small businesses' demand for loans.
- Small businesses might become more risk averse and decide not to undertake projects with risk and profit characteristics that previously would have been undertaken.
- The decline in house prices since 2007 is likely to have reduced the collateral value of any real estate owned by a small business and of the business owner's home. The SBA seeks, but in general does not require, collateral for its guarantees.

Figure 1, below, illustrates the supply and demand for capital during times of economic prosperity and slowdown. The supply curve, which shows the amount of capital (measured on the horizontal axis) that is available in the economy at the interest rates (measured on the vertical axis), shifts to the left indicating that less capital is available at the same interest rate. The demand curve, which shows the volume of loans (also measured on the horizontal axis) that business would take out at various interest rates (also measured on the vertical axis), shifts to the left illustrating that fewer business loans are desired at the same interest rate. Economists refer to the interest rate where the supply and demand for business loans is equal as the equilibrium interest rate.

Figure 1. Supply and Demand for Business Loans



The graph shows the interest rate declining, but this depends on the steepness of the supply and demand curves and the amount that each shifts. If the supply curve shifts more to the left than is drawn, or if the demand curve shifts less to the left than is drawn, interest rates could rise. In this case, although supply and demand have both decreased, supply declined more than demand. In both cases, however, loan volume falls.

Monitoring Small Business Borrowing

Only limited information on small business borrowing is available. The Federal Reserve conducts a Survey of Small Business Finances and makes a report to Congress every five years; the most recent survey was completed in 2003, and the next is being conducted in 2008. The report using the 2003 survey was released in 2006.[11]

Another source is the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which is conducted quarterly, in January, April, July, and October.[12] It asks those surveyed about changes in lending terms to small businesses (those with annual sales of $50 million or less). It also asks about the demand for small business loans. Given that the Federal Reserve does not use the SBA's industry based definition of "small," the results are more

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[11] Traci L. Mach and John D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Businesses," *Federal Reserve Bulletin*, October 2006, pp. A167-A195. Available at http://www.federalreserve.gov/pubs/bulletin/2006/smallbusiness/smallbusiness.pdf.

[12] Board of Governors, Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices. Available at http://www.federalreserve.gov/boarddocs/SnLoanSurvey/.

indicative than an exact measure of what is happening to small business lending as viewed by the SBA.

The Federal Reserve conducts a quarterly Survey of Business Lending on loans made by various types of banks to businesses.[13] Some of the information is broken down by the size of the loan ($3,000 to $99,000; $100,000 to $999,999; $1,000,000 to $9,999,000; and $10,000,000 and more). The survey is released in the last month of the quarter (March, June, September, and December).

The SBA's Office of Advocacy publishes annual reports on small business lending. The most recent is for 2006.[14] Upon request, the SBA may be able to provide information on the volume of loan guarantees.

Conclusion

Precise economic forecasts are frequently difficult to make. Forecasting the impact of an economic slowdown or recession on the demand for SBA guarantees on loans to small businesses is particularly difficult for two reasons. First, the impact on SBA guarantees of declining small business investment may or may not be offset by an increase in lenders seeking to avoid risk. Second, there is only limited information on which to base such a forecast.

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[13] Board of Governors, Federal Reserve, Survey of Terms of Business Lending. Available at http://www.federalreserve.gov/releases/e2/.

[14] Available under various titles at http://www.sba.gov/advo/research/lending.html and http://www.sba.gov/advo/research/banking.html.