RESEARCH PAPER

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Access to Credit: An analysis of the credit climate for small businesses in the Capital Region

Baton Rouge Area Chamber

Since the start of the recession in the third quarter of 2007, small business owners have been considerably affected by the national economic downturn. Thirty-four percent of small business owners nationwide believe the nation's financial problems have significantly affected their business, and another twenty-six percent feel that the problems threaten their business' survival.[1] Issues surrounding access to credit have risen to the surface as a principal challenge for small business owners in the midst of the recession. National, regional, and local surveys indicate that access to credit is an area of top concern for small business owners and that lending standards have become stricter in recent years.

According to national data, outstanding loans to small business dropped from more than $710 billion in the second quarter of 2008 to less than $670 billion in the first quarter of 2010.[2] The percentage of small business owners holding a business loan fell 20 percent last year, and the percentage holding a credit line fell by an equivalent amount.[3] Small business lending is inherently risky, particularly in a struggling economy, but the recovery of small business is critical to the national economic recovery. Small firms employ roughly one-half of all Americans and account for roughly 60 percent of all job creation in the last decade, and the formation and development of small businesses is dependent upon access to credit.

Although it is generally accepted and understood that small businesses have been impacted by the recession, fundamental questions remain about the details of the small business' condition. There has been a lack of data on a national and local level about small businesses, particularly surrounding credit access and the factors that may affect it. In recent months, organizations such as The Federal Reserve System and the National Federation of Independent Business (NFIB) have conducted surveys to try and provide insight about the issues on a national level. Similarly, BRAC conducted a series of focus groups in 2010 to gauge the views of the local credit climate from the perspectives of small business owners, lenders, and regulators and to learn more about what factors are affecting access to credit in our market.

The focus groups identified a series of specific issues and questions surrounding the credit market in the Baton Rouge area. Most of the discussion centered on the impact of tighter regulations, uncertainty in the market, building relationships with regional and national banks, and the processing of SBA loans. Compounded with the inherent risk associated with small business lending, the economic

[1] William, J. Dennis, Jr. "Economic Downturn (2008)." *National Small Business Poll.* NFIB Research Foundation, Washington, DC, 2008, where small businesses are defined as organizations with 250 or fewer employees.

[2] "Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income (Call Report)." The Federal Reserve Board of Governors, March 2010.

[3] Dennis, William J. "Small Business Credit in a Deep Recession." NFIB Research Foundation, Washington, DC, February 2010.

recession has magnified the existing challenges facing small businesses seeking credit, as well as created new hurdles.

Tighter Regulations

The small business perspective of the credit crunch varies greatly depending upon each individual business' current conditions and experiences. While some individuals felt their credit needs were met in recent months and years, others have been forced to turn to personal resources or other nontraditional options. However, small business owners generally agreed that the landscape of the small business credit market has changed significantly since the start of the recession. The small business owners surveyed felt that in recent months, the restrictions in traditional lending settings have significantly tightened and the performance targets a business must meet to qualify for credit have been raised. Subsequently, it has become increasingly challenging to meet these qualifications and fulfill the business' credit needs. Across the nation, small business owners are facing stricter lending standards while at the same time facing declining sales in a recession economy.

Overwhelmingly, lenders surveyed agreed with the sentiment that underwriting regulations have tightened in recent months and some felt that this presented a significant challenge in seeking credit. Many lenders noted that in recent months they had been forced to deny loans that they would have been able to approve a few years ago. Specifically, the increased underwriting regulations have come in the form of heightened personal credit standards, an increased emphasis on cash flow, and greater collateral requirements, all of which were mirrored in The Federal Reserve System national study.[4]

In the Baton Rouge area market, lenders were primarily concerned with the heightened personal credit standards, as it significantly limits a lender's ability to use personal judgment when granting or denying a loan. Lenders noted that an individual can be denied credit simply because his/her credit score has fallen in recent months and felt that the added emphasis placed on credit scores greatly limits their lending flexibility. One lender noted, "Lending is an art, not a science, and a credit score cannot be the only factor used to determine whether or not a loan should be granted."

General Uncertainty among Small Business Owners

From the small business perspective, there are a number of additional changes that have impacted a small business owner's ability to access credit. There is a general sense of uncertainty among small business owners, especially new or

[4] "Addressing the Financing Needs of Small Business: *Summary of Key Themes from the Federal Reserve System's Small Business Meeting Series*." Board of Governors of the Federal Reserve System. July 21,2010.

first-time business owners about how to successfully attain the credit they need from a financial institution. Although they know where they should be seeking credit, small business owners stated that they did not necessarily know how to approach lending organizations. Furthermore, for some small business owners, there is a lack of understanding as to how to best position their businesses to receive credit. For example, while many first-time business owners knew that in order to receive a loan they must present a business plan to potential lenders, they did not necessarily know how to write a strong business plan or where to turn for assistance.

While a lack of knowledge among small business owners or first-time business owners about the lending process is not necessarily surprising or linked to the recession, there is a small percentage of small business owners nationwide who are "discouraged borrowers:" individuals not seeking credit because they do not think they will be able to receive it. According to the NFIB, 45 percent of small business owners did not attempt to borrow money in 2009. Eleven percent of those individuals are considered "discouraged borrowers," and this sentiment was mirrored in regional discussions. Many regional small business owners expressed that they felt as though traditional lenders, such as banks, were not interested in working with small businesses or lending money to them. A number of small business owners surveyed have given up on seeking credit from traditional lending organizations.

Local Banks vs. National Banks

In local discussions, many small business owners felt that it was simpler to work with local banks, and preferred local or regional banks to larger, national banks. Small business owners found it more difficult to work with national banks when seeking credit because these organizations often do not have authority in-house to approve loans. Small business owners felt that they were typically more successful in receiving credit from local banks than from national banks.

In general, national data supports the notion that larger, national banks may not meet the credit needs of small business customers as well as small banks. For example, while half of the small business customers of smaller commercial banks had all of their credit needs met in 2009, fewer than 30 percent of small business customers of large commercial banks did so.[5] While the lenders surveyed did not collectively suggest that it was more difficult to receive a loan or a line of credit from a larger bank, they did indicate that larger banks are often subject to greater scrutiny from regulators.

[5] See note 3 above.

SBA Loans

There is much confusion and little confidence surrounding the U.S. Small Business Administration's (SBA) Guaranteed Loan Programs among small business owners, both regionally and nationally. While the primary program, the 7(a) Loan Program, offers guaranteed loans and is available for use by both financial institutions as well as non-traditional lenders, small business owners did not feel that lenders were knowledgeable about whether or not a small business owner should pursue an SBA loan. Small business owners, as well as some lenders, exhibited some frustration with the SBA loan program. Both parties felt that the process of applying for an SBA loan was so cumbersome and confusing that it was nearly impossible to navigate successfully.

Furthermore, some lenders felt that the process for managing SBA loans in many financial institutions discourages the utilization of the loan programs. Many financial institutions have specific loan officers that are dedicated to processing SBA loans. If a lender recommends a small business owner for an SBA loan program, the loan will be processed by the dedicated SBA loan officer, forcing the original lender to forfeit the account. Some financial institutions believe that this system decreases a lender's willingness to recommend an individual for an SBA loan.

Overall, SBA lending represented only four percent of the total lending activities in the U.S. in 2009. The underutilization of this program is an area of concern for many local small business owners, and many felt that lenders in the region were less likely to work with them to pursue an SBA loan.

Recommendations

There are a number of actions that small business owners and financial institutions could take to help improve the current conditions of the credit market in Baton Rouge.

For small business owners:

Be Prepared & Use Your Resources

Small business owners should be well prepared before approaching a lender to ask for credit. Lenders advise that small business owners should be familiar with the qualities that lenders are looking for, as well as understand the importance of good, clear financial records to lenders. Lenders strongly recommend that small businesses have their financials done by a Certified Public Accountant in order to improve their chances of receiving a loan.

Furthermore, small business owners should reach out to Small Business Development Centers (SBDC) or other business consulting resources to take advantage of the various resources and assistance available for both new and existing businesses. A SBDC can assist small business owners with writing a strong business plan, preparing for meetings with potential lenders, receiving financing, and managing the business' finances. A listing of business assistance providers can be found on BRAC's website at www.brac.org.

Build Relationships

Overwhelmingly, lenders recommended that small business owners take the time to build relationships with their lender. Lenders indicated that small business owners will likely be more successful in receiving credit if they are always honest with their lenders about their financial situations, throughout stable times and challenging times. Small business owners can earn credibility by being honest, as well as by maintaining a relationship with their lender throughout the year.

Lenders, particularly from local financial institutions, indicate that continuity in a banking relationship is very important to them. It is valuable for small business owners to keep a close relationship with their lender on a regular basis, whether or not they need to ask for money at that time. When a lender is consistently updated on the status of a small business, it builds their confidence in the integrity of the owner and the quality of the business and better positions the business to receive credit in the future. Specifically, lenders recommend meeting quarterly with your banker to review the business' current financials. Furthermore, both small business owners and lenders alike recommended maintaining relationships with multiple banks or financial institutions at one time. It is important that small business owners have multiple options for financing, and having relationships with multiple financial institutions may increase the likelihood that all of the small business' credit needs will be met in the long term. However, in order to maintain a transparent and honest relationship, small business owners should make each lender aware of other financial relationships that the small business owner maintains.

For lenders and regulators:

Increase Communication

Because lenders felt that it was difficult to comprehend and manage the heightened expectations imposed by regulators, it is important that there is an increased dialogue between the two groups. It is essential that lenders gain a solid understanding of each new regulation that is imposed, and due to the frequency of new regulations, many feel that this task is nearly impossible to complete without increased assistance. The need for increased communication between financial institutions and regulators was mirrored in the study completed by the Federal Reserve, which recommends that regulators use real-world examples to help lenders better understand new regulations.

Manage Perceptions

In order to successfully reach the greatest number of small business clients, larger banks should be aware of the perception maintained by many small business owners. The perceived notion that larger banks are difficult to work with and that it is more difficult to receive credit there could potentially be affected by strategic marketing and customer relations. By targeting small business clients and working to address their perceived concerns, more successful lending relationships may be built.

Greater Utilization of SBA Loan Programs

Financial institutions should work with small business owners to ensure that those who are a good fit for an SBA loan know that is the type of loan they should pursue. In many financial institutions, there is little incentive for lenders to pursue SBA loans – apart from the cumbersome process; the current system used by many financial institutions to process SBA loans discourages lenders from recommending them. Financial institutions should develop a new model to process SBA loans that does not require lenders to forfeit an account if he/she recommends an SBA loan.

Because of the confusing and lengthy nature of processing an SBA loan, it is important that financial institutions have at least one person on staff with a solid, complete understanding of the SBA loan application process. It is clear that lenders do not sufficiently understand the SBA process. It would be beneficial for the SBA to offer more thorough training to loan officers. As changes are made or as the process evolves, additional training should be offered, at least yearly. Policy initiatives should push for the SBA to simplify its processes, as this was an issue raised nationwide.[6]

Increase Use of “Second Look” Programs

Although small business owners and lenders have limited influence over regulators’ decisions, there are alternative ways lenders can assist small business owners in meeting their credit needs. Regulators emphasized the success of “second look” programs, in which traditional lenders connect clients with alternative sources of small business capital. Through a “second look” program, if a traditional lender cannot meet their clients’ credit needs but recognizes potential in the business, a nontraditional lender, such as SEEDCO Financial or ACCION Texas-Louisiana, may be able to make a loan. Alternative

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[6] See note 4 above.

lenders often have greater flexibility with regulations and may be able to approve riskier loans. The financial institution and nontraditional lender partner together and serve the greatest number of businesses in the community and ensure that more credit needs are being met, even in the midst of tightened regulations.

Development of “second look” programs among traditional lenders would not only increase the amount of capital received by small business, but would also connect small businesses with new resources in the community. “Second look” programs may help alleviate some of the credit crunch felt since the start of the recession.

Conclusion

Although the recession has created many unique challenges that have impacted small business lending, there are many opportunities for both small business owners and lenders to positively affect the Baton Rouge area credit market. Small business owners are critical to ensuring the recovery of the U.S. economy and providing stable job growth in our future. As small business owners, lenders, and regulators work together to address the existing issues in the market, they will help ease the credit crunch and will assist in our economic recovery.