Reversing the decline in small business lending

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July 25, 2014

Of course small business lending is risky. The annual failure rate for firms with fewer than five employees averages around 20 percent — 1 in 5. That's true even during a boom.

And younger firms, which are more likely to be minority owned, fail at even higher rates.

While small business lending often declines during a recession, recent regulatory changes may well result in a permanent decline in bank lending to small business. The impact will be felt across all small businesses, but the effect is likely to be greatest for minority-owned small businesses, as statistically these owners often have less personal wealth and weaker credit histories.

Of course, banks are only one conduit for small business and minority lending. Peer-to-peer, crowd-funding and direct capital market financing are poised to play a greater role and potentially offset part of the decline in bank finance.

A useful proxy for bank lending to small business is the volume of loans made sized under $1 million. This flow peaked at about $16 billion in the second quarter of 2006, declining to about $10 billion in third quarter of 2009, around the trough of the current economic cycle. After a long, slow and bumpy climb, small business bank lending had recovered almost all its decline by the first quarter of 2014.

This recovery, however, masks the fact that as a percent of total bank lending, small business lending continues to decline. Estimates from the Federal Reserve Bank of Cleveland show small business lending falling from more than 50 percent of non-farm, nonresidential bank lending in 1995 to less than 30 percent today. This trend has been a steady one, showing little sign of reverse. And these numbers are not adjusted for inflation, which shows small business lending has a long way to go before regaining its previous real peak.

The future of small business lending will have a disproportionate impact on minorities. Although white owners continue to own the majority of small businesses, growth in business ownership has been considerably larger among minority owners. The U.S. Census Bureau reports that

during the economic expansion from 2002 to 2007, the number of businesses owned by minorities increased 45 percent, led by African-American owners, who experienced a 60 percent increase in businesses owned. White-owned firms increased only about 13 percent during this period. While minority-owned firms now account for more than 20 percent of businesses, they remain relatively small, employing only around 5 percent of the nation's employees.

The vast majority of small businesses are seeded with the personal or family savings of the founder. While the scale may differ, the reliance of savings differs little across ethnic groups. Reliance on home equity and credit cards, important sources of start-up capital, also display only minor differences across race, with minorities being slightly more dependent on credit cards and whites more often tapping home equity. As inflation and record-low interest rates reduced the returns to savings, this decline may explain some of the dramatic fall in new business creations. The long-run trend decline in savings has been accompanied by a similar decline in entry rates among small businesses.

Various business surveys have also shown a decline in credit quality across small businesses. Yet these figures only explain the recent cyclical trends and not the long-term decline in small business lending as a share of bank lending.

One significant driver has been the spread of risk-based bank capital rules. Beginning with its implementation in 1992, Basel I placed higher capital charges on business loans relative to most other bank assets. Under the Basel rules, banks are required to hold minimum capital against an asset based upon the regulatory risk weight. Risk weights are essentially the relative cost, in terms of capital, of holding different assets.

For sovereign debt this risk weight is zero, meaning that no capital is required. For small business this risk weight is currently 100 percent — so to maintain an 8 percent capital ratio, a bank would be required to hold 8 cents in equity for every dollar of small business lending. For highly rated corporate securities or mortgage-backed securities, the weight is 20 percent. Since Basel I, banks have faced a much higher relative cost to lend to small business. Not surprisingly, banks have reduced such lending relative to favored asset classes.

If the impact of Basel I on bank lending to small business had not been bad enough, the proposed Basel III rules would provide further disincentive for banks. First, the newly required liquidity requirements will mandate that banks have a minimum amount of so-called liquid assets, which will not include small business loans. Higher risk weights for small business are continued under Basel III. Despite playing little role in the recent financial crisis, small business lending will bear the brunt of regulatory reforms.

Section 1071 of the Dodd-Frank Act also creates new data collection requirements for bank small business lending. While intended to increase small business lending to minorities, the requirements of Section 1071 are just as likely to result in a reduction in small business lending. Section 1071 compliance will likely be based on lending ratios, not volumes. Therefore, to hit the “correct ratios” banks are likely to reduce small business lending to white-owned business. Even without a decrease, increased compliance costs will be passed along to small business borrowers.

Banks will continue to play an important role in small business lending. Fortunately, initial concerns as to the impact of increasing bank consolidation on small business lending have proved misplaced. Larger banks have been as willing (or unwilling) to engage in small business lending as small banks.

However, non-bank lending is becoming an increasingly important source of capital. In fact, non-bank finance companies currently comprise about 15 percent of small business lending and are better positioned for growth in this market than commercial banks. One prominent peer-to-peer lender, Lending Club, has seen its small lending business double every year since 2007, having made more than 16,000 small business loans. While only one player in a small market, the attractive yields offered by peer-to-peer lenders — coupled with a more flexible regulatory environment — offer considerable potential for small business lending. Peer-to-peer has also offered a valuable source of loans for borrowers with less than stellar credit. As commercial banks remain constrained, the future of small business lending may well see its largest growth occur outside the traditional banking sector.

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