Economic Factors Affecting Small Business Lending and Loan Guarantees

Updated January 8, 2013

Congressional Research Service
https://crsreports.congress.gov
RL34400

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

Small businesses (usually defined as companies with 500 or fewer employees) are an important part of the nation's economy. At various times during the business cycle, concern is voiced about the difficulties that small businesses have obtaining loans. There can be many reasons for periodic declines in small business lending over the business cycle: loan standards change, the quality of projects to be financed changes, and small businesses' demand for loans fluctuates with anticipated customer demand.

Congress created the Small Business Administration (SBA) to assist small businesses in many ways, including by guaranteeing loans made by the private sector. This guarantee reduces a lender's potential loss on a small business loan and should make lenders look more favorably on small business loan requests. Nevertheless, there are several reasons why the volume of small business loans varies over time despite the availability of the SBA's guarantee.

The business cycle's impact on the volume of SBA guarantees is not clear. When the economy is growing, demand for SBA loan guarantees can increase as small business expands to take advantage of opportunities or small businesses might reduce their demand because they can obtain loans without the SBA's guarantee. In an expanding ecomomy, lenders are more willing to make loans on more favorable terms.

In slowdowns, concern over potential losses leads lenders to tighten all loan standards, perhaps affecting small businesses disproportionately. The demand for SBA loan guarantees can increase as small businesses are unable to obtain loans without the government's backing or interest in SBA loan guarantees can fall because there are fewer reasons to borrow. Even with an SBA guarantee, small business owners frequently pledge their personal residences as collateral for business loans. During the 2007-2009 recession, the widespread decline in home prices reduced owners' abilities to provide such credit enhancement. The ultimate impact of these factors on SBA loan volume, which work in opposite directions, cannot, however, be predicted with confidence.

This report analyzes reasons used to justify government intervention in small business lending and discusses how making the proper analysis of problems improves the policy outcome. For program information on SBA loan guarantees, see CRS Report R41146, *Small Business Administration 7(a) Loan Guaranty Program*, by Robert Jay Dilger and CRS Report R41184, *Small Business Administration 504/CDC Loan Guaranty Program*, by Robert Jay Dilger. This report also identifies some sources of information about the condition of the small business loan market.

This report will be updated as developments warrant.

Contents

The Demand and Supply for Business Loans 1
Demand for Loans 1
Supply of Loans 2
Debt and Equity 3
How Do Small and Large Businesses Differ? 4
Likely Impact of Economic Fluctuations on Small Business Borrowing 5
Monitoring Small Business Borrowing 6
Policy Analysis 7
Conclusion 8

Figures

Figure 1. Supply and Demand for Business Loans 6

Contacts

Author Information 8

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 alternative 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 (equity) stake. Those with money to lend—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 borrow for businesses in general and for small businesses in particular.

Demand for Loans

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 would a riskless investment, such as U.S. Treasury bonds, to compensate for the risk 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 typically 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 change. 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 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 or a deteriorating economic outlook can impact some sectors, such as new home construction, more than others, such as fast food. Some other factors influencing business demand are the cost of investment goods, the durability of the goods, and tax treatment of investments. These factors are discussed in more detail in "Likely Impact of Economic Fluctuations on Small Business Borrowing."

A business's alternatives to finance a project may depend in part on its size. Many lenders, whether banks, other corporations, individuals, or governments, 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 its microloan program.[1] Large loans could exceed the financial capacity or legal limits on lending.

If a firm decides to finance through debt, it can take out a loan or 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.[2] 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 inflation, interest, and exchange rates.

Supply of Loans

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. Financial intermediaries like banks regularly 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 (FDIC's) guarantee to collect inexpensive, relatively small deposits that are then combined into much larger loans.[3]

Businesses lend money to other businesses for a variety of purposes, including financing the purchase of goods and services from the first firm. Profitable companies may accumulate funds for possible future investment. For example, in 2011, Microsoft bought Skype Communications, a telecommunications firm, for $8.5 billion,[4] and in 2012, it invested $605 million in Barnes & Noble, a book retailer.[5]

---

[1] For more details on the SBA's microloan program, see CRS Report R41057, *Small Business Administration Microloan Program*, by Robert Jay Dilger.

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

[3] 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.

[4] U.S. Securities and Exchange Commission, Microsoft Corporation, Form 8-K, May 20, 2011, available at http://edgar.sec.gov/Archives/edgar/data/789019/000119312511134416/0001193125-11-134416-index.htm.

[5] Microsoft Corporation, "Barnes & Noble, Microsoft Form Strategic Partnership to Advance World-Class Digital Reading Experiences for Consumers," press release, April 30, 2012, available at http://www.microsoft.com/en-us/news/Press/2012/Apr12/04-30CorpNews.aspx.

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 tax-favored vehicles like Individual Retirement Accounts (IRAs) and Section 529 college savings accounts.[6]

Governments use financial intermediaries to lend either short or long term. For example, local 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 past few decades, many governments have created sovereign wealth funds (SWFs) to invest internationally.[7]

Debt and Equity

An alternative to borrowing to finance projects is to find investors to purchase ownership shares or equity. There are numerous differences between debt and equity. Holders of common stock (usually just called stockholders) do not have a 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 in the future. Shareholders unhappy with a management 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.

Lenders, whether through loans or bonds, 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 agree to set aside money in a sinking fund that is pledged to pay the interest or principal. Lenders to small businesses sometimes require an SBA 7(a) or 504 guarantee to reduce the loan's risk to an acceptable level.[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.

Business interest payments are tax deductible from corporate profits, which are subject to corporate income taxes. Dividends and interest are taxable to their recipients.

The SBA's Small Business Investment Company (SBIC) program is designed to stimulate private equity investments and long-term loans to small businesses.[10] The Jumpstart Our Business

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

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

[8] The SBA can guarantee 75%-85% of 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 Robert Jay Dilger and Sean Lowry.

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

[10] See CRS Report RL33243, *Small Business Administration: A Primer on Programs*, by Robert Jay Dilger and Sean Lowry, for additional information on SBICs. The SBA's website on the SBIC program is at http://www.sba.gov/

Startups Act (JOBS Act; P.L. 112-106) makes it easier for certain small firms to sell stock to investors.[11]

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 do 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 an equally risky 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 any of several 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.[12] 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 all 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 full business cycle. 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 to pledge for a loan than do large businesses. This can lead to lenders (and the SBA) requiring owners to pledge 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.

---

aboutsba/sbaprograms/inv/index.html.

[11] See CRS Report R42427, *U.S. Initial Public Stock Offerings and the JOBS Act*, by Rena S. Miller and Gary Shorter.

[12] Board of Governors of the Federal Reserve System, *Report to Congress on the Availability of Credit to Small Business*, September 2012, available at http://www.federalreserve.gov/publications/other-reports/files/sbfreport2012.pdf.

Likely Impact of Economic Fluctuations on Small Business Borrowing

Over a business cycle, small business borrowing is likely to fluctuate.[13] Normally, as the economy slows down, lending (including to small businesses) declines. Business lending tends to pick up during an economic recovery.

An economic slowdown (recovery) could have several impacts on small business borrowing.

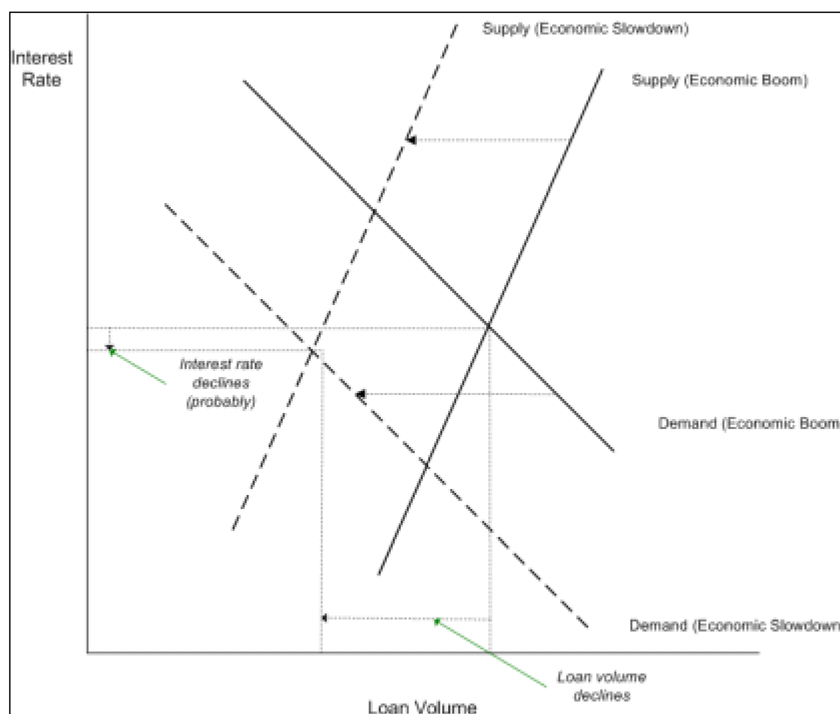
- As lenders become more (less) risk averse, they could decline (agree) to make loans that they would have made in other times. SBA loan guarantees might offset this caution during a slowdown and help small businesses to expand.
- An economic slowdown (recovery) could reduce (increase) the risk-adjusted profitable opportunities for small businesses to invest, reducing (increasing) small businesses' demand for loans.
- Small businesses might become more (less) risk averse and decline (decide) to undertake projects with risk and profit characteristics that previously would (not) have been undertaken.
- The 2007-2012 decline in house prices 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 illustrates the supply and demand for capital during times of economic prosperity and slowdown. The prevailing interest rate and the total dollar volume of loans made are determined by the intersection of the supply and demand curves. Economists refer to the interest rate where the supply and demand for business loans is equal as the equilibrium interest rate.

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 during a slowdown 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 obtain at various interest rates (also measured on the vertical axis), shifts to the left during a slowdown illustrating that fewer business loans are desired at the same interest rate.

[13] This section is an overview of the factors affecting lending to small businesses. For more information, see CRS Report R42045, *The Small Business Lending Fund*, by Robert Jay Dilger.

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 during a slowdown 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.

Figure 1 represents the overall market for business loans. Most businesses will pay a higher or lower rate depending on their relative riskiness. A more risky loan carries a higher interest rate. This risk premium can change as lenders' attitudes toward risk change.

Monitoring Small Business Borrowing

Information on small business borrowing is available from several sources. Statistics on the SBA's two largest business loan guarantee programs—7(a) and 504/CDC Loan Guaranty programs—can be found in CRS reports.[14]

The SBA's Office of Advocacy publishes research based on surveys concerning small business loans,[15] annual reports on small business lending,[16] and occasional reports on other small business issues. The SBA makes certain unpublished data available upon congressional request.

[14] CRS Report R41146, *Small Business Administration 7(a) Loan Guaranty Program*, by Robert Jay Dilger, and CRS Report R41184, *Small Business Administration 504/CDC Loan Guaranty Program*, by Robert Jay Dilger.

[15] Office of Advocacy, Small Business Administration, *Small Business in Focus: Finance*, July 2009, available at http://www.sba.gov/advocacy/7540/12137, and Office of Advocacy, Small Business Administration, and Victoria Williams, Small Business Administration, *Small Business Lending in the United States, 2010-2011*, July 2012, available at http://www.sba.gov/advocacy/7540/173967.

[16] Reports are available under various titles at http://archive.sba.gov/advo/research/banking.html and

The Federal Reserve also publishes occasional research from surveys.[17] The Federal Reserve's *Senior Loan Officer Opinion Survey on Bank Lending Practices* is conducted quarterly, in January, April, July, and October.[18] It asks those surveyed about changes in lending terms to small businesses (defined as those with annual sales volume 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 indicative than an exact measure of what is happening to small business lending as viewed by the SBA.

The Federal Reserve administers a quarterly *Survey of Business Lending* on loans made by various types of banks to businesses.[19] 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).

Policy Analysis

Analysis of how different events affect small business lending can provide different guidance on policy options. For example, if lending standards are becoming stricter, it may, or may not, be the case that this is an appropriate reaction to the economic conditions and recent experience with loan performance.

In general, there can be many reasons for declining employment by small businesses.

- It could be that small businesses could expand and hire more workers, but that problems in other parts of the economy are discouraging lending to small businesses. In this case, expanding SBA loan guarantees might help.
- In a recession, consumers purchase less and the problem faced by small businesses is usually a lack of demand for their products, not an inability to obtain loans. In this case, expanding SBA loan programs is likely to have little impact.
- It could be that the market is not purchasing the products made by certain small businesses, resulting in layoffs. Here the problem might be changing consumer tastes. Loans to expand production would not be helpful, but loans to update products or enter new markets might be useful.

Economic analysis usually concludes that competitive markets are beneficial for the national economy because they deliver the goods that consumers want at the lowest cost. Markets with less competition deliver less at a higher price, and government intervention is sometimes justified to correct this reduced competition, which economists term *market failures*. One policy challenge is to correct the market failure without overcorrecting, which would result in diverting resources from other more productive uses.

---

http://archive.sba.gov/advo/research/lending.html.

[17] Board of Governors, Federal Reserve, *Report to Congress on the Availability of Credit to Small Business*, September 2012, available at http://www.federalreserve.gov/publications/other-reports/files/sbfreport2012.pdf, and Board of Governors, Federal Reserve, *Survey of Small Business Finances: Occasional Staff Studies*, October 15, 2008, available at http://www.federalreserve.gov/publications/other-reports/files/sbfreport2012.pdf.

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

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

Conclusion

A number of factors affect the supply and demand for small business loans, independent of the SBA's guarantee. Forecasting the impact of the business cycle 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.

Author Information

N. Eric Weiss
Specialist in Financial Economics

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.