Small biz loan failure rate hits 12%

A report on the Small Business Administration's loan guarantee program shows a sharp jump in the default rate.

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NEW YORK (CNNMoney.com) -- Bank lending to small businesses has dried up in recent months. One reason credit has grown scarce: They're risky loans. A new analysis of Small Business Administration-backed loans found that the failure rate has hit the double digits, with 11.9% of the SBA's loans last year going into default.

The Coleman Report, which provides lenders with small business data and SBA news, calculated the failure rate by dividing the number of loans liquidated or charged-off last year by the total number of loans made through the SBA's flagship lending programs.

Last year's failure rate is a sharp increase over past years. In 2004, the SBA loan failure rate was 2.4%, but it has increased each year since, rising to 8.4% in 2007, according to Coleman's calculations. The 2008 failure rate of nearly 12% covers the fiscal year that ended on Sept. 30. In that year, the SBA's 7 (a) and 504 programs approved 78,324 loans, totaling $18.2 billion.

"The numbers are brutal, but it validates what we already know," said the report's editor and publisher, Robert Coleman. "In towns, we see established businesses going under every day, and [I've heard] bankers say their small business portfolios have become a disaster."

Doing its own calculations based on defaults in December - which falls in the agency's 2009 fiscal year - the SBA came up with a annualized default rate of around 5%, based on the total dollars lent. Calculating defaults based on the number of loans made, the default rate for the 2008 calendar year was around 10%, according to the SBA.

"The real point is, of course, that both rates - number of loans and dollars - have been rising. That increase is a reflection of what's going on in the general economy," said SBA spokesperson Mike Stamler. "It could not be a surprise to anyone that loan defaults rise when the economy turns difficult, and the economy has been getting more and more difficult for some time now."

The SBA's loan programs offer banks insurance on a percentage of qualifying small business loans: If the borrower defaults, the SBA pays the bank back for the portion of the loan it has guaranteed. This approach makes small business loans more enticing to risk-averse lenders. But the number of loans the SBA backed plunged in 2008, thanks to stricter bank lending standards and a frozen secondary market for the loans.

"Lenders are criticized for not getting capital to Main Street, but the problem, as this report shows, is that it's hard to justify getting capital out there when there's a 12% failure rate," Coleman said. "That's why they tightened the credit box."

Congress has picked up on the problem. The stimulus bill passed last week included a provision allowing the SBA to increase its guarantees to 90% of qualifying loans, up from a current maximum of 85%.

But that won't solve the problem of loan failures - it will only transfer the losses from banks to the government. The SBA's loan charge-off rate - the actual cash paid by the agency to honor its guarantees divided by the total dollars disbursed - has increased from 0.4% in 2004 to 1.9% last year, according to The Coleman Report.

"Credit got easier, and there was too much capital for too little demand. So more and more loans went out to those who were going to fail," Coleman said. "But now we have the opposite problem, and the clamp-down has made loans too scarce."

"The magnitude of the credit crunch, a uniquely cruel feature of this particular recession, only makes things worse," said the SBA's Stamler. "This situation won't turn around until we can get capital flowing again to small businesses. That's what the TARP and the TALF and the recovery act are designed to do."

In the meantime, while the government and lenders try to find that steady middle-ground for small business lending initiatives, Coleman suggests the SBA and lenders try to curb the fear they're bound to feel when they see the grim statistics.

"We all want to be good stewards of tax payers' dollars," Coleman said. "Because 50% of the GDP is driven by small businesses, we need to focus on the flip argument: There's an 88% success rate. Just face that we will have losses right now, and that those losses have to be at the government level so that we can protect what we have." ■

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