For release on delivery
10:00 a.m. EDT
July 12, 2010

Restoring the Flow of Credit to Small Businesses

Remarks by

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at the

Federal Reserve Meeting Series:
"Addressing the Financing Needs of Small Businesses"

Washington, D.C.

July 12, 2010

Let me begin by thanking the staff of the Board's Division of Consumer and Community Affairs, especially the Division's director Sandra Braunstein, for the hard work they have done to prepare for today's discussion about improving access to credit for sound small businesses. And thanks also to the many partners who helped us organize today's event, particularly the Small Business Administration and the Treasury's Community Development Financial Institutions Fund. I am pleased to welcome all of you to the Federal Reserve Board.

This gathering, "Addressing the Financing Needs of Small Businesses," serves as a capstone for a series of more than 40 meetings. They were conducted across the country, starting in February, by the Federal Reserve System's community affairs offices. These meetings provided forums for small business owners; trade associations; lenders; bank supervisors; federal, state, and local government officials; and other stakeholders to exchange ideas about the challenges facing small businesses, both in the near term and in the longer run.

Some of these meetings were small-group discussions, while others were larger sessions that addressed specific topics, such as minority entrepreneurship or guaranteed loan programs. For example, I attended a meeting in Detroit that combined a general discussion of small business credit issues with a session focusing on the specific case of suppliers to the auto industry, many of which are small or medium-sized firms. Participants in that session highlighted the interconnectedness of the auto supply chain and the crucial role of stable financing for small businesses ranging from parts suppliers to independent automobile dealers in the recovery of the auto industry as a whole. This was, of course, just one meeting in one city. A meeting in Miami focused on the needs of

Hispanic-owned businesses. Similarly informative discussions took place in cities such as New York, San Francisco, and Chicago, among many others, including Omaha, Nebraska; Morgantown, West Virginia; Toledo, Ohio; and Little Rock, Arkansas.

Our objective in organizing this series was to gather information that we and others can use to help develop policies that will support the flow of loans to creditworthy small businesses--for instance, by identifying and addressing specific credit gaps or impediments to lending or improving the access of small businesses to critical support services, including assistance in filing loan applications. This information serves as the basis for today's discussion of the next steps that policymakers and stakeholders can undertake to ensure that small businesses are able to participate in and contribute to the economic recovery.

Before we get to the next steps, however, I would like to provide context by briefly discussing the importance of small businesses to job creation and the economic recovery, reviewing the actions that the Federal Reserve has taken to support small business financing, and offering some observations about what we heard during this small business meeting series.

Small businesses are central to creating jobs in our economy; they employ roughly one-half of all Americans and account for about 60 percent of gross job creation.[1] Newer small businesses, those less than two years old, are especially important: Over the past 20 years, these start-up enterprises accounted for roughly one-

[1] Small businesses are defined here as firms with fewer than 500 employees.

quarter of gross job creation even though they employed less than 10 percent of the workforce.[2]

The formation and growth of small businesses depends critically on access to credit. Unfortunately, those businesses report that credit conditions remain very difficult. For example, the net percentage of survey respondents telling the National Federation of Independent Business that credit conditions have tightened over the prior three months has remained extremely elevated by historical standards.[3] And one measure of banks' loans to small businesses dropped from more than $710 billion in the second quarter of 2008 to less than $670 billion in the first quarter of 2010.[4] An important but difficult-to-answer question is, How much of this reduction has been driven by weaker demand for loans from small businesses, how much by a deterioration in the financial condition of small businesses during the economic downturn, and how much by restricted credit availability? No doubt all three factors have played a role.[5] Clearly, though, to support the recovery, we need to find ways to ensure that creditworthy borrowers have access to needed loans.

Over the past two years, the Federal Reserve and other agencies have made a concerted effort to stabilize our financial system and our economy. These efforts, importantly, have included working to facilitate the flow of credit to viable small

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[2] See John Haltiwanger, Ron S. Jarmin, and Javier Miranda (2010), "Who Creates Jobs? Small vs. Large vs. Young," working paper (February); and the U.S. Census Bureau's Business Dynamics Statistics database for statistics on job creation for new and small businesses (www.ces.census.gov/index.php/bds).
[3] William C. Dunkelberg and Holly Wade (2010), *NFIB Small Business Economic Trends* (Nashville: NFIB Research Foundation, June), www.nfib.com/Portals/0/PDF/sbet/sbet201006.pdf.
[4] Data are from the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Report), where loans to small businesses, as stated in the reporting forms FFIEC 031 and 041, schedule RC-C, part II, are defined as loans with original amounts of $1 million or less that are secured by nonfarm nonresidential properties or are commercial and industrial loans. *Correction: On July 27, 2010, this footnote was revised to remove "plus loans with original balances of $500,000 or less that are secured by farmland or are for agricultural production."*
[5] Charge-offs have also contributed to the decline in outstanding credit.

businesses. At the Federal Reserve, we helped bring capital from the securities markets to small businesses through the Term Asset-Backed Securities Loan Facility--the TALF program. More than 850,000 small business loans were financed in part by securities whose issuance was supported by TALF. We have also been focused on strengthening the nation's banks, so that they can resume normal lending as quickly as possible. For example, the stress tests that we conducted last year helped restore confidence in the banking system, allowing banks to raise the capital they need to help offset credit losses and, ultimately, to provide the basis for new lending.

We have heard the often-expressed concern that bank examiners have prevented banks from making good loans. We take this issue very seriously. The Federal Reserve has worked assiduously with the other banking regulators to develop interagency policy statements on this issue, aimed at both banks and examiners. Our message is clear: Consistent with maintaining appropriately prudent standards, lenders should do all they can to meet the needs of creditworthy borrowers.[6] Doing so is good for the borrower, good for the lender, and good for our economy. To ensure that this message is being heard and acted upon, we have conducted extensive training programs for our bank examiners as well as outreach with bankers, and we will continue to seek feedback from bankers and borrowers.

Though we believe that our and others' efforts are making a difference, we also know more must be done, and that additional effective action requires hearing firsthand from knowledgeable people who can speak from diverse perspectives about the

[6] For example, see Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Conference of State Bank Supervisors (2010), "Regulators Issue Statement on Lending to Creditworthy Small Businesses," joint press release, February 5, www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm.

challenges facing small businesses. The insights we obtained from small business owners, lenders, and others in this series of meetings have given us a more nuanced understanding of the problem and will help us identify areas where we might be able to do more. Not surprisingly, these meetings confirmed that facilitating small business financing is not a simple or straightforward matter. Notably, the term "small business" encompasses a heterogeneous mix of enterprises, ranging from pizzerias to start-up technology firms, and each small business faces a unique combination of local economic conditions and complex relationships with customers, suppliers, and creditors. Hence we should be wary of one-size-fits-all solutions.

One of the most important themes underscored during the meetings is that solving the issues faced by small businesses will require collaboration. The meeting series itself served as a model of collaboration, interactive discussion, and cooperative problem solving. Participants included community affairs officers, bank supervisors, economists, and policymakers from the Federal Reserve. We involved our fellow bank regulators, the Small Business Administration, and the Community Development Financial Institutions Fund. And, of course, small businesses and lenders played a central role. The meetings fostered stimulating conversations. Lenders heard from small business owners about their frustrations over tightened credit. Likewise, lenders were able to explain the considerations that go into making a small business loan. And regulators heard, in detail, concerns expressed about the effect their procedures and guidance would have on small business lending.

Some common themes emerged from the sessions. Business owners frequently noted that the declining value of real estate and other collateral securing their loans poses a particularly severe challenge. As one business owner at the Detroit meeting I attended put it, "If you thought housing had declined in value, take a look at what equipment is worth." Business owners cited credit lines and working capital as their most critical financial needs, followed by refinancing products that would permit them to take advantage of low interest rates. Many reported having had to resort to borrowing through their personal credit cards or from their retirement accounts. Several mentioned the need for small-value loans in amounts less than $200,000 as well as the need for "patient capital" from investors willing to commit funds for 5 to 10 years without an expectation of immediate returns.

Some of the lenders that participated in our meetings expressed the view that current lending conditions don't represent credit tightening as much as a return to more traditional underwriting standards following a period of too-lax standards. But, though some lenders said they were emphasizing cash flow and relying less on collateral values in evaluating creditworthiness, it seems clear that some creditworthy businesses--including some whose collateral has lost value but whose cash flows remain strong--have had difficulty obtaining the credit that they need to expand, and in some cases, even to continue operating. The challenge ahead for lenders will be to determine how to assess the credit quality of businesses in an uncertain and difficult economic environment. It is in lenders' interest, after all, to lend to creditworthy borrowers; ultimately, that's how they earn their profits. Regulators, for their part, need to continue to work with lenders to help them do all that they prudently can to meet the needs of creditworthy small businesses.

Making credit accessible to sound small businesses is crucial to our economic recovery and so should be front and center among our current policy challenges. We are pleased that you have accepted our invitation to participate in today's discussion of next steps in the effort to promote small business finance. You each bring valuable insights and perspectives to this issue, and I would like to thank you all for your willingness to share your ideas.