Credit Where Credit Is Due: Public Policy and Small Business Financing

August 2021

Bipartisan Policy Center

Goldman Sachs 10,000 small businesses VOICES

CENTER FORWARD

BPC Action

Key Takeaways

- Two-thirds of small businesses remain concerned about the impact of COVID-19.
- In June, 82% of respondents in a Goldman Sachs *10,000 Small Businesses Voices* survey said their Paycheck Protection Program (PPP) funds would run out by the end of July.
- Just 24% said they were confident they could maintain payroll after depletion of PPP funds.
- Many small businesses said they're stuck in limbo: Emergency assistance is dwindling and debt needs to be repaid—yet revenues have not fully recovered.
- For those seeking new sources of credit, pandemic disruptions are hindering their ability to secure financing.
- While PPP was broadly effective in sustaining employment at small businesses, its design reflected underlying disparities in access to finance.
- Prior to the pandemic, Black-owned small businesses and those that were medium/high credit risks were more likely to use online lenders (broadly defined) than banks or credit unions.
- Black-owned businesses that are low credit risks are half as likely as white-owned firms to receive all the financing they seek.
- To address these challenges, Washington policymakers can consider several actions:
    - Policymakers should consider creation of a long-term, low-interest loan guarantee program to provide flexible, patient credit to allow small businesses to rebuild balance sheets as they restore revenues.
    - The Small Business Administration (SBA) should reevaluate policies regarding financial performance in previous years to account for the impact of 2020 on small business balance sheets.
    - The SBA should make subordination agreements as easy as possible regarding Economic Injury Disaster Loans (EIDL).
    - Policymakers should consider actions that will expand the lender base in government guarantee programs.
    - Federal, state, and local governments should prioritize small business financing as they distribute relief funds.

Executive Summary

Small businesses are staring down the barrel of a double set of challenges. As they look forward to recovery, many are seeking fresh sources of credit to help them hire and invest in the future. Yet they are finding that the pandemic's negative impact on their balance sheet is hindering their ability to access further capital. When lenders—and, in the case of government loan guarantees, the SBA—evaluate the creditworthiness of a small business, 2020 financial performance will burden many small business owners in the near term.

At the same time, many small businesses are finding that emergency relief was a two-edged sword. It helped them survive the pandemic, but it's hampering their ability to access new credit. This is the case with EIDL. The structure of EIDL relief means the SBA has priority liens, and subsequent lenders must seek subordination from the SBA. The agency is not actively barring further credit, nor is it resistant to subordination. Instead, the sheer volume of EIDL assistance is creating a bottleneck in the credit market.

Exacerbating these challenges is the recent resurgence of COVID-19 in parts of the country. Nearly every small business owner is, by nature and necessity, an optimist. According to surveys, many of them see a bright economic recovery just over the horizon. But that optimism is being severely tested at the moment.

Eight out of 10 small businesses, in a recent survey, are on the brink of exhausting relief funds received through the PPP. Yet just a quarter of them think they can maintain payroll after depletion of PPP funds. For many, revenues have not yet recovered from the sharp declines of 2020. A potential new wave of COVID-19 has created great uncertainty about the durability of economic recovery. The share of small businesses reporting a weekly decline in revenues has ticked up slightly in July—the share reporting a weekly increase in revenues has fallen 3 percentage points since April.[1]

Small businesses are thus stuck. Recovery is stalled and perhaps backsliding. Relief funds are running out—and there are hangover effects from such funds. Bottlenecks in the credit market are appearing. Congress has demonstrated responsiveness to continuing struggles with the creation of the Restaurant Revitalization and Shuttered Venue Operator funds. Other sectors continue to struggle too.

We recommend several policy actions that might be considered—by Congress, the SBA, and others—to further support small businesses' recovery and lay a strong foundation of expanded access to credit for future growth.

Methodology

For this work, the Bipartisan Policy Center collaborated with the Goldman Sachs 10,000 Small Businesses Voices program and Center Forward. We spoke to small business owners through roundtable discussions and individual meetings, and conferred with subject matter experts and current and former government officials. BPC also convened two events focused on small business capital in March and May 2021. The latter was done in partnership with PayPal. Additionally, we reviewed government reports, congressional testimony, academic research, and publicly available data."

Dickensian Times

This report is being written in the summer of 2021. The national economy, still recovering from the COVID-19 pandemic and economic crisis of 2020, feels as if it's balanced on a fulcrum. The unemployment rate has fallen steeply from its official peak of nearly 15%—yet it remains twice as high as the level before the pandemic. After steadily declining since the beginning of 2021, the level of weekly jobless benefits claims has recently plateaued and even ticked up.

Lurking behind these oscillating trends is the virus, with new variants popping up and spreading rapidly. Restrictions have already been reinstated in some parts of the country. There is growing concern that the autumn and winter of 2021 will look too much like the previous year. This creates particular difficulty for one of the most vulnerable parts of the U.S. economy: small businesses.

For this large and diverse group of companies, "it's the best of times and the worst of times," one small business owner told us.

On the positive side, small businesses' economic outlook continues to improve. Over the last year, new business formation has surged at a record pace.[2] In the latest Small Business Index from the U.S. Chamber of Commerce and MetLife, over half of small businesses (57%) expect their revenue to increase this year.[3] Responses collected in the large-scale Small Business Pulse Survey by the Census Bureau indicate that the overall need for financial assistance has continuously dropped on the list of small business priorities. In mid-July, 14% of small businesses said they would need financial assistance or additional capital in the next six months.[4] This varies by sector, however. The need for financial assistance is more acute in some parts of the economy than others.

> **"Small businesses today are stuck between several rocks and hard places."**
>
> — Louis-Caditz Peck, Director of Public Policy and Regulatory, LendingClub, speaking at a BPC event, "Show Me the Money: What's Next for Small Business Finance?"

For existing small businesses, which account for nearly half of private-sector employment, fear and concern are palpable. In the U.S. Chamber-MetLife Small Business Index, two-thirds of small businesses "remain concerned about the impact of COVID-19 on their business."[5] This survey result predates the latest COVID resurgence.

Small business owners also fear what a return to "normal" might look like. There is concern over withdrawal of the massive government support that's been provided over the last year and a half. Through the PPP and the EIDL program, Congress authorized about $1 trillion in small business loan guarantees and grants. In a June 2021 survey by the Goldman Sachs 10,000 Small Businesses Voices program, eight out of 10 small business respondents said their PPP funds would be exhausted by the end of July.[6] Just 24% were confident they could maintain payroll once their PPP funds were depleted. PPP officially closed at the end of May.

Stark Contrast: Small Businesses Running Out of PPP Funds, But Unsure They Can Maintain Payroll

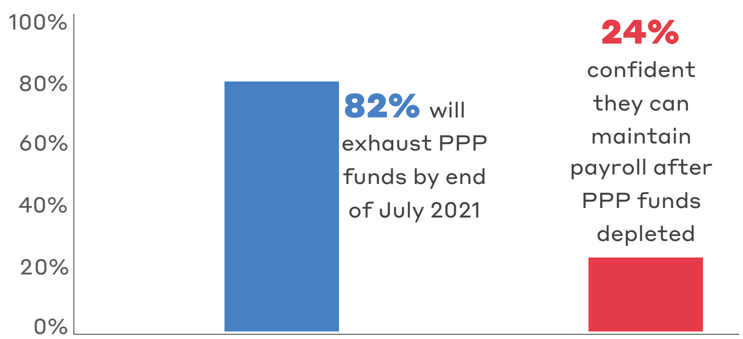


Figure 1. Source: Goldman Sachs 10,000 Small Businesses Voices.

That stark juxtaposition is accompanied by another small business fear: Resumption of "normal" credit market conditions will be marred by the lingering effects of the crisis. In that same June survey, over half (52%) of small business respondents didn't think they would qualify for an SBA-backed loan this year because of the pandemic's impact on their financial statements. Janice Jucker, owner and president of Three Brothers Bakery and co-chair of the Goldman Sachs 10,000 Small Businesses Voices National Leadership Council, pointed to the source of such doubt:

For those [small businesses] that have been through disasters, it can be three to four years before you can actually access capital. Most of us are S-Corp pass-throughs, and so we have losses on our tax returns. You need two good tax returns in order to access the capital.[7]

Another small business owner, in a private roundtable, said "our balance sheet doesn't look great" because of the pandemic. As a result, they're finding it difficult to secure a bank loan, even one backed by an SBA guarantee.

Complicating small business efforts to access credit today is the structure of relief received through EIDL. Unlike PPP, EIDL predates the pandemic; it has been part of the SBA's disaster assistance programs. Under EIDL agreements, the SBA has first lien on company assets. Subsequent lenders approached by the small business will need to seek a subordination agreement from the SBA before providing new credit. That in itself is not an insurmountable hurdle. But the SBA is so overstretched and overworked right now that the process of doing so is extremely difficult and time-consuming. As one small business owner told us, "That's really going to hinder growth, because the small business might lose the opportunity for the loan."

Small businesses are thus stuck. They're optimistic about the prospect of overall economic recovery, but they're still reeling from sharp declines in revenue. The government's relief effort helped many survive the pandemic, but it was, as one business owner told us, "a patch." Sales have not yet recovered, emergency funds are running out, and additional pandemic restrictions could further disrupt operations. Many are on the hook for repaying loans taken out during 2020. Yet there is little additional small business relief in the offing from the federal government.

Reaching All Small Businesses

The PPP was built on top of existing SBA infrastructure; namely, the 7(a) loan guarantee program. This means it relied, at least initially, mostly on banks. Banks continue to be the primary source of external credit relied upon by small businesses when they seek financing. Credit mechanisms provided by banks include loans, lines of credit, and credit cards. In the five years prior to COVID-19, nearly half of small businesses had sought financing at a bank. Smaller community banks play an especially important role in providing credit to small firms.

The pre-pandemic distribution of external financing, however, left large gaps in terms of what types of small businesses could and could not access credit. Prior to COVID-19, Black-owned small businesses were less likely than others to use banks, and more likely to use online lenders.

Funding Sources Used by Small Businesses, 2015-2020

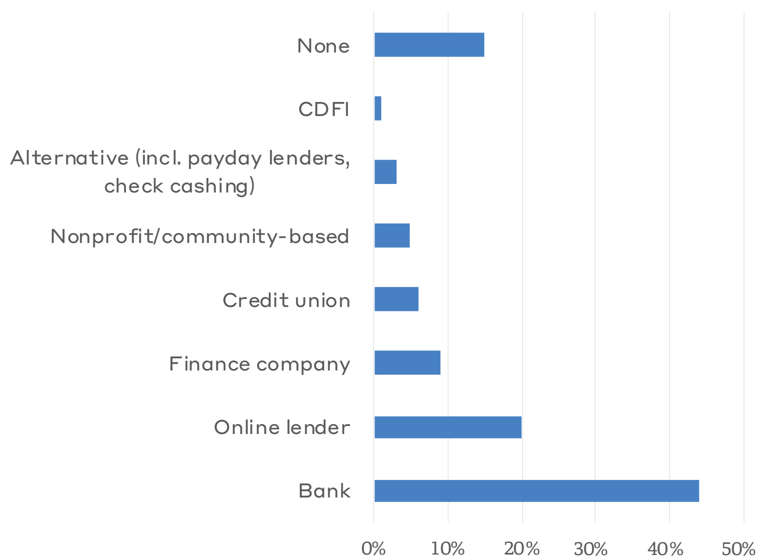


Figure 2. Source: Federal Reserve Banks, "Small Business Credit Surve 2020 Report on Employer Firms," April 2020.

Using online lenders is not necessarily a bad thing. An increasing share of small businesses used online (or "alternative" lenders, or fintechs) over the last decade. From 2016 to 2019, the share of small businesses applying to an online lender for funds rose from 21% to 33%.[8] This growth has been facilitated by a shrinking supply of small business lending from traditional banks, particularly the largest U.S. banks.[9] There is considerable variety, too, within the universe of online lenders. While some likely meet the popular image of predatory lending, others are seeking to bring greater transparency and standardization to the market.

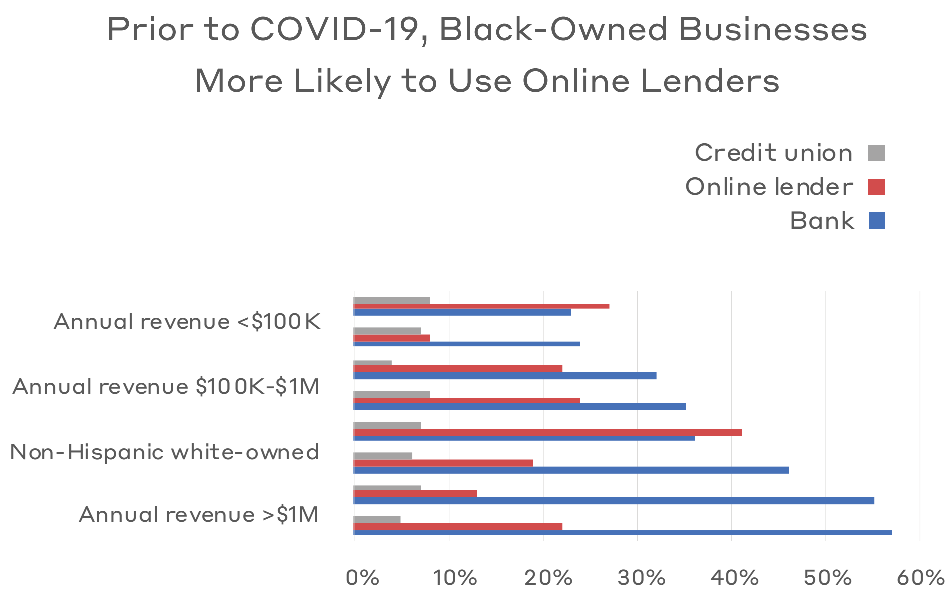


Figure 3. Source: Federal Reserve Banks, "Small Business Credit Survey: 2020 Report on Employer Firms," April 2020.

It seems clear from the data that some types of online and alternative lenders help fill a gap for those small businesses that don't have a preexisting relationship with a bank, don't have high credit scores, or don't have as much collateral as others. Speed of funding decision was cited by 54% of applicants to online lenders as the biggest factor in their choice of source. For large and small banks, existing relationship was cited by nearly two-thirds. Other factors cited by small businesses in their choice to use an online lender were the chance of being funded and flexibility of product.[10]

> **"The credit box is currently very, very tight, so it's difficult to get credit into the hands of small businesses."**
>
> **— Scott Stewart, CEO, Innovative Lending Platform Association, speaking at a BPC event, "After PPP: How Should Small Business Lending Programs Be Reformed?"**

This means online lenders can be particularly effective in assisting these small businesses—including those owned by Blacks—access capital. It may come with a higher price, but that's clearly a trade-off that many small business owners are willing to make. The role these lenders played in distributing PPP funds highlights the gaps they help fill. Prior to 2020, online lenders were not included within the 7(a) program. Amendments to PPP, made in the interest of getting money into the hands of small businesses, brought online lenders into the program. Online lenders were found to have been more effective than banks in getting PPP loans to Black- and Hispanic-owned businesses.[11]

Demographic disparities in small business financing reflect a variety of factors. More Black-owned businesses are a high credit risk (24%) compared to white-owned businesses (5%).[12] Astoundingly, even Black-owned businesses that are low credit risks are half as likely as white-owned firms to receive all the financing they seek. And white-owned firms are twice as likely to receive all financing sought even when they are a medium/high credit risk.

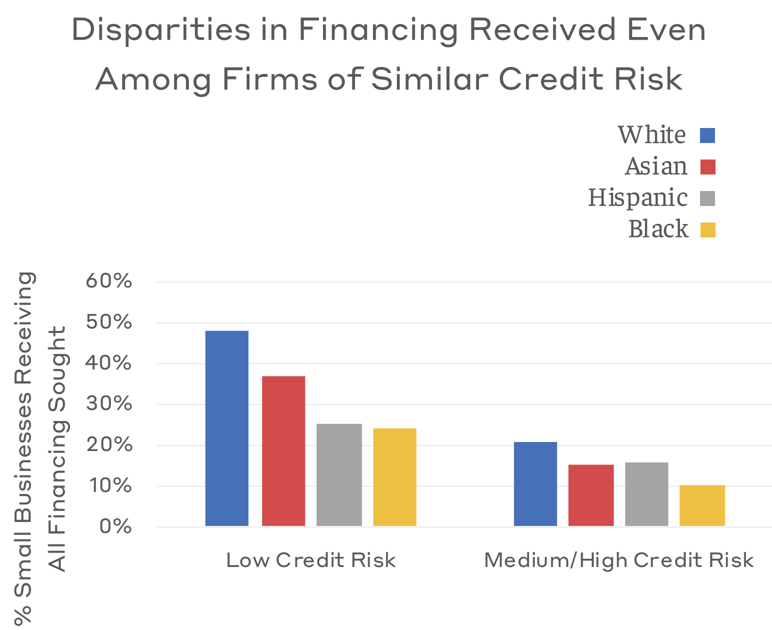


Figure 4. Source: Federal Reserve Banks, "Small Business Credit Survey: 2021 Report on Firms Owned by People of Color," April 2021. Excludes emergency funding applications filed in 2020.

Those figures reflect differences among small business owners who applied for external financing. Research also finds racial differences in the decision to apply. Black small business owners with high credit scores "are more than twice as likely to report a fear of denial than white founders with below median credit scores."[13] The gap measured in financing received thus understates the actual credit gap.

Closing demographic gaps in small business financing will need to go beyond small business policy. Blacks and Hispanics, in general, "are less well-positioned than other business owners to have assets available to use as collateral or to guarantee credit personally."[14] This means that the fate of small business owners of color applying for external credit is a function of their personal credit score.

> **"It's important to note that entrepreneurs seek speed and coaching, along with their capital, which is often better served outside traditional institutions."**
>
> — Melissa Bradley, founder and managing partner, 1863 Ventures, BPC video, "Ideas to Expand Access to Capital for Small Businesses and Entrepreneurs

Voices of Small Business

Together with the Goldman Sachs 10,000 Small Businesses Voices program, we held roundtable discussions with small business owners about their experience during the pandemic and the challenges they continue to face in financing.

- “There’s a lot of redundancy. There has to be something you fill out just one time and that’s it for the SBA and IRS. There should be streamlined tunnels for certain small business characteristics.”
- “They [the banks and SBA] want so much documentation, it takes days and weeks.”
- “I love the 7(a) program in concept, as a public-private partnership, but it’s a mess.”
- “There should be some way to take the best of PPP and repackage it for small businesses going forward.”
- “Capital is a big worry going forward. We had to pay bills the entire pandemic. We took out loans before that and had to pay them back and the fees. They didn’t pause. PPP was able to fill a gap, but we still need a little help.”

Policy Recommendations

Access to capital for small businesses is an extremely broad topic. Full consideration of public policy in this area would include everything from personal and household liquidity to equity financing to innovation-based grants from the government. We focus here on external institutional credit, especially those relating to government lending support programs.

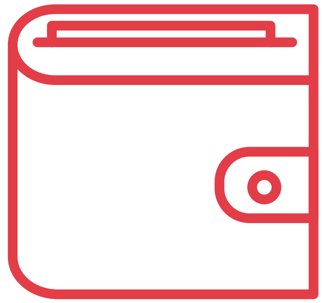
Policy Recommendation:

Congress should consider reviving the RESTART Act.

Background: Conceived as a pandemic emergency response during the 116th Congress, the RESTART Act would have created a new long-term loan guarantee program. The bill had strong bipartisan support. Introduced by Sens. Michael Bennet (D-CO) and Todd Young (R-IN), 58 other senators joined as co-sponsors, nearly evenly split across parties. The House version, introduced by Reps. Jared Golden (D-ME) and Mike Kelly (R-PA), was also bipartisan, with 178 co-sponsors.

Detail: The new loan program, as originally designed, was geared toward the crisis, building on PPP. With long repayment periods—including deferment of principal for two years—RESTART loans would have provided small businesses with the patient, flexible type of credit that many say they need.

Need: RESTART was introduced in the Senate in May 2020, with hearings in December—both, that is, extremely dark points in the course of the pandemic. The need today, in mid-2021, is arguably greater for what RESTART loans would have provided. Small businesses don't know which side of the fulcrum their economic fortunes will tip toward. Long-term, guaranteed loans will help small businesses rebuild their balance sheets, survive another virus spike, and invest in the future.[15]



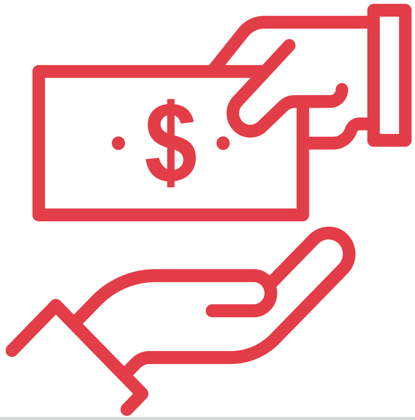
Policy Recommendation:

Together with lenders, the SBA should consider ways to cabin small businesses' 2020 balance sheets when determining new loans and loan guarantees.

Background: Revenues dipped sharply for many small businesses in 2020, with some of those declines persisting into 2021. Damaged balance sheets are a burden for small businesses seeking new credit this year and next.

Detail: Many small businesses are worried that tarnished balance sheets as a result of 2020 will continue to dog them in new financing applications. While lack of profitability is not a strict barrier to accessing SBA-backed loans, it can be a blemish on an application. It's not clear yet how guaranteed lenders and the SBA are treating 2020, but small business owners and advocates hope they aren't penalized for pandemic- and lockdown-induced losses.

Need: We heard in our conversations that some banks are already accounting for the 2020 anomaly in assessing small business credit applications. To facilitate this, the SBA should make clear to guaranteed lenders and their prospective borrowers that 2020 will be marked with a heavy asterisk, and not serve as a bar to new loans. A safe harbor loss threshold might be considered as a way to account for pandemic revenue declines.



Policy Recommendation:

The SBA should assess the feasibility of subordinating liens on COVID-19 EIDL distributions.

Background: Nearly 4 million EIDL distributions were made in 2020 and 2021. Based on a preexisting disaster assistance program at the SBA, these small but rapidly distributed loans and grants were extremely helpful to small businesses during the pandemic. The structure of this emergency assistance, however, is proving to be a hindrance to present and future financing by small businesses.

Detail: By design, the SBA has priority interest in debt provided to small businesses through EIDL funds. When a small business that received EIDL money goes to another lender for new credit, that lender must seek a subordination agreement from the SBA. In some cases, small businesses themselves are contacting the SBA for this. Given the sheer volume of EIDL, this is a heavy administrative burden for lenders, borrowers, and the agency.

Need: As an emergency measure, the SBA should explore ways to make subordination as simple and smooth as possible. This will help relieve an emerging bottleneck in small business finance.

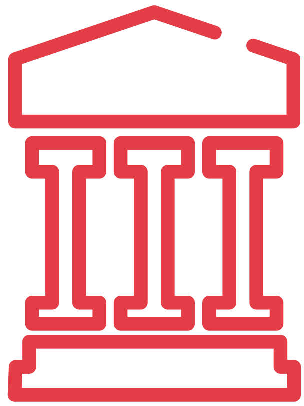
Policy Recommendation:

State and local governments should use federal relief funds to help their hardest-hit and hard-to-reach small businesses.

Background: Under the American Rescue Plan passed in March, an additional $350 billion was allocated to states, cities, counties, and tribal governments for recovery funds.

Detail: A permissible use for these funds is alleviation of economic harms incurred by small businesses. In 2020, many state and local governments, together with private money, established relief funds dedicated to small businesses. With the latest round of federal money, there is high demand—from public health spending to infrastructure to replacing lost public sector revenues. Recovery for small businesses remains uneven across sectors—restaurants remain much more pessimistic than, for example, those in construction.[16]

Need: Credit provision for small businesses should be a top priority for state and local governments. While the extent of need will vary across the country, in many places the smallest, hardest-to-reach, and hardest-hit businesses are on the brink of failure. Relief fund efforts for small businesses should be targeted to maximize effectiveness.



Policy Recommendation:

Build on PPP by continuing to broaden the lender base of the SBA's 7(a) loan guarantee program and incorporate new technologies with existing lenders.

Background: Some online lenders already participate in 7(a) by partnering with traditional banks. Yet overall, there is limited competition in government guaranteed lending. While there has been some adoption of new financial technologies by traditional lending institutions, the scope for further penetration remains broad. One expert we spoke to foresees "companies figuring out how to take the good things of what fintech can do and combine them with what works in the banking system."

Detail: Certain types of online lenders proved their ability to serve hard-to-reach small businesses during the crisis. There is concern among small businesses and advocates about what one owner told us were extremely high rates. Inclusion of online lenders in the 7(a) program would presumably require these lenders to adhere to existing SBA interest rate requirements.

Need: With appropriate oversight and regulatory safeguards, long-term participation of online lenders in 7(a) should be considered. SBA should also continue to work with existing guaranteed lenders to widely deploy the technologies being pioneered by fintechs. A positive outcome for small business borrowers would be further development of a hybrid system, drawing on the expertise of government guaranteed lenders and innovative fintech firms

Policy Recommendation:

Continue to extend—and consider making permanent—the Community Advantage program.

Background: Begun as a 7(a) pilot in 2011, the Community Advantage program has been continuously extended by Congress and now expires in September 2022

Detail: There has been consistent bipartisan support for extending the program, which targets small businesses in underserved communities by including, for example, community development financial institutions (CDFIs) in the 7(a) loan guarantee program. A bipartisan House bill in the 116th Congress would have extended Community Advantage through 2025 and added more training and assistance resources to businesses through SBA.

Need: By many accounts, Community Advantage has demonstrated its ability to get capital to hard-to-reach and underserved small businesses. After a decade of being a pilot program, Congress should consider establishing Community Advantage as its own program with a subsidy separate from the overall 7(a) program

Policy Recommendation:

Strengthen the capacity of CDFIs to distribute more small business credit in their target communities.

Background: CDFIs account for a very small share of the overall small business credit market. But they serve a key niche for small businesses in underserved communities and can build strong relationships with business owners.

Detail: CDFIs had the highest satisfaction scores of any financial institution participating in PPP. Consumer finance and residential real estate finance are currently the top two lines of business across certified CDFIs. Bank and loan fund CDFIs engage in much more business finance than, for example, credit union CDFIs.[17]

Need: A principal source of capital for CDFIs is banks. Dedicated support from banks for small business lending at CDFIs can increase lending to underserved areas.

Conclusion

In response to the continuing challenges of small businesses today—and in the face of massive uncertainty—the government can take action to boost private sector lending and widen the provision of credit to small business.

A new loan guarantee program—with long repayment terms, flexible uses, and low interest rates—can help bring certainty and security to small businesses as they rebuild revenue streams and repair balance sheets. The government also needs to ensure that pandemic-induced damage to small business balance sheets—and small firms' use of relief funds—don't hinder forward-looking efforts to access credit

Appendix: Bipartisan Bills in 117th Congress to Support Small Business Finance

Bill Number and Name	Sponsors	Description
S.119: Small Business Lending Fairness Act, introduced April 2021	Sens. Sherrod Brown (D-OH) and Marco Rubio (R-FL)	Extends ban on confessions of judgment from consumer to small business loans
H.R.1502: Microloan Improvement Act, passed House 397-16, April 2021	Reps. Andy Kim (D-NJ), Marie Newman (D-IL), Andrew Garbarino (R-NY), and Tim Burchett (R-TN)	Enhances participation of nonprofit, community-based lenders in SBA Microloan program
H.R.1487: Microloan Transparency and Accountability Act, passed House 409-4, April 2021	Reps. Tim Burchett (R-TN), Andy Kim (D-NJ), Marie Newman (D-IL), and Scott Fitzgerald (R-WI)	Adds metric and reporting requirements for SBA Microloan program
H.R.1490: 504 Modernization and Small Manufacturer Enhancement Act, passed House 400-16, April 2021	Reps. Angie Craig (D-MN), Sharice Davids (D-KS), Young Kim (R-CA), and Steve Chabot (R-OH)	Makes changes to SBA 504/CDC program, including higher maximum loan amount and revised collateral requirements
S.1587: Small Business Child Care Investment Act, introduced May 2021	Sens. Jacky Rosen (D-NV), Tammy Duckworth (D-IL), Joni Ernst (R-IA), and Marco Rubio (R-FL)	Expands eligibility of nonprofit child care providers for participation in SBA loan programs
S.160: Small Business Innovation Voucher Act, introduced February 2021	Sens. Catherine Cortez Masto (D-NV), Christopher Coons (D-DE), and Todd Young (R-IN)	Establishes grant program at SBA to support small business research and development
S.389: Next Generation Entrepreneurship Corps Act, introduced February 2021	Sens. Christopher Coons (D-DE) and Tim Scott (R-SC)	Establishes fellowship program to support entrepreneurs in distressed regions
S.1109: Minority Entrepreneurship Grant Program Act, introduced April 2021	Sens. Jacky Rosen (D-NV) and Thom Tillis (R-NC)	Requires SBA to award grants to support minority business owners

Bill Number and Name	Sponsors	Description
S.1058: Rural Capital Access Act, introduced March 2021	Sens. John Thune (R-SD), Jeanne Shahee (D-NH), and Deb Fischer (R-NE)	Expands federal leverage to increase capital deployment through SBICs to rural small businesses
S.3389: Expanding Access to Lending Options Act, introduced March 2021	Sens. Tim Scott (R-SC) and Catherine Cortez Masto (D-NV)	Raises the loan maturity cap on credit union lending products from 15 to 20 years
S. 2068: Minority Business Development Act, introduced June 2021	Sens. Ben Cardin (D-MD), Maria Cantwell (D-WA), Tim Scott (R-SC), and Roger Wicker (R-MS)	Among other steps, would establish new efforts to focus on access to capital for minority-owned businesses
H.R.809: Loan Interest Forgiveness for Taxpayers Under a Pandemic (LIFTUP) Act, introduced February 2021	Reps. Lizzie Fletcher (D-TX) and Michael McCaul (R-TX)	Puts pre-COVID disaster loans from SBA on equal footing for paydown and forgiveness provisions.

Endnotes

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