Main Street Finance: How Can the Financial System Better Serve Entrepreneurs and Small Businesses?

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FURTHER INFORMATION

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Introduction

Entrepreneurs and small businesses are a key source of job creation and economic growth. Yet many small businesses and entrepreneurs face challenges accessing affordable financing, especially loans that are less than $250,000. This paper will explore these challenges, highlight recent trends in small-business financing, and present issues for further exploration.

The Bipartisan Policy Center launched the Task Force on Main Street Finance to address the challenge of affordable financing for small businesses and entrepreneurs. The task force has spoken with small businesses, financial firms, regulators, and other experts, and believe the time to act is now. The recent surge in financial-technology, “fintech,” companies is disrupting small-business lending and requires appropriate policies to nurture its development while still protecting consumers and financial stability. Policymakers are currently reviewing post-crisis financial reforms, and it is important that any review focuses on how the financial system can better serve entrepreneurs and small businesses to help grow the U.S. economy and create jobs.

Next year, the task force will make specific recommendations to improve access to affordable financing for all qualified small businesses and entrepreneurs, regardless of gender, race, geographic location, or size of the business. This means evaluating the role of traditional sources of financing, including the Small Business Administration, as well as the potential for emerging fintech companies to meet the financing needs of small businesses and entrepreneurs. The task force will look at the impact of existing laws and regulations on access to affordable financing and will distinguish between different types of small businesses, from high-growth firms to Main Street firms. In each case, the task force will make recommendations to improve financing to help reverse the long-term decline in small-business formation and to foster more economic growth and job creation.
The State of Small Businesses and the Importance of Financing

Small businesses are responsible for half of all private-sector jobs in the United States, and they create 60 percent of the net new jobs.¹ These small businesses include sole proprietorships, high-growth firms, supplier firms, and “mom-and-pop” Main Street firms.² These different types of small businesses have different financing needs that change throughout their business cycle.

The formation of new businesses has been in decline since the 1970s, when this data was first collected.³ Not only are there fewer new firms, but those start-ups that do exist are creating fewer jobs. The gross number of jobs created by new firms fell by more than 2 million between 2005 and 2010.⁴ A recent study by Goldman Sachs found that between 2007 and 2012, the absolute number of small firms declined for the first time since data became available in 1977.⁵ The authors of that study estimate that if small businesses had followed traditional growth patterns during that period, there could have been an additional 600,000 small businesses and about 6 million jobs created.

The availability of private capital and access to affordable financing are critical components of a healthy and dynamic economy that promotes entrepreneurship and economic expansion as well as the formation of new small businesses. Without debt or equity financing, many companies would not exist. An analysis by the National Small Business Association (NSBA), which examined data from 1993 through 2016, found a correlation between small-business owners’ ability to hire and their ability to access credit. This same study found that, while not the sole cause of contraction, “the inability to secure financing may have led 16 percent of small businesses to reduce the number of employees and approximately 10 percent of small businesses to reduce employee benefits.”⁶

Another recent analysis has found that access to financing for small businesses is more difficult for businesses located outside major urban areas. According to the Economic Innovation Group, the “uneven geography of new business formation tracks very closely with that of access to capital—particularly venture and other forms of risk capital.”⁷ The authors of that analysis conclude that facilitating the growth of small businesses outside major urban areas must involve solving the challenges related to access to capital and financing.

The challenges facing small businesses in rural areas were emphasized by Eric Dinger, an entrepreneur who works closely with rural America, in a recent hearing before the Senate Small Business Committee: “If you live in the right place and start the right kind of business, access to capital may not be one of the biggest challenges. But, for the people who live outside of the right hubs, for the Main Street businesses, access to capital has never been tougher. Tech start-ups aren’t going to make up for the decline in formations.”⁸

Women-owned and minority-owned businesses have continued to grow, but they have trouble accessing adequate levels of financial capital.⁹ Recent studies have shown that women-owned businesses are less reliant on external equity funding than businesses owned by men, and they rely more on owner equity and insider and outsider debt. Women may be more reluctant than men to apply for credit because they fear that their loan application will be denied.¹⁰ Similarly, a study for the U.S. Department of Commerce found that minority-owned businesses were less likely to receive credit than non-minority owned businesses.¹¹

Traditionally, small banks have been the primary source of financing for small business. However, the 15-year-long consolidation of the banking industry has reduced the number of small banks, which are more likely to lend to small businesses. Increased competition in the banking sector has led bankers to move toward bigger, more profitable loans. That has meant a decline in small-business loans, which are less profitable, because they are more difficult to automate, have higher costs to underwrite and service, and are harder to securitize.¹²
Online lenders and other fintech firms are filling some of this gap, but as of 2014, they represented just 2.1 percent of the market. Many borrowers are dissatisfied with the high interest rates and unfavorable repayment terms they get from these online lenders. Platforms like Amazon and Square have begun to enter the small-business lending market, with Amazon doing $3 billion in small-business loans to date.
**Current Trends**

The task force identified the following trends during its research:

**Technology is lowering the costs of underwriting, servicing, and customer acquisition.** This has encouraged the rise of online lenders and the adoption of new technology by traditional lenders. However, many traditional lenders are dependent on third-party vendors to adopt this technology and have found that the current vendor requirements imposed by banking regulators impede the adoption of new technology. Additionally, there are concerns about how online lenders should be regulated to encourage innovation while also ensuring that small-business borrowers and the financial system as a whole are protected from bad actors.

**The combination of data and technology can help allocate capital more efficiently.** There has been a surge in platforms and fintechs—like Amazon, PayPal, and Intuit—that are disrupting small-business lending by leveraging data from their other businesses to better evaluate the credit of a potential borrower. This use of data can help better allocate capital to qualified borrowers, while rejecting unqualified ones. However, concerns have also been raised about the potential for discrimination resulting from the use of this data.

**Compliance burdens are making lending costlier.** Post-crisis financial reforms have made the system safer, but they also have imposed unintended costs and consequences. Smaller lenders, which traditionally serve entrepreneurs and small businesses, have been affected disproportionately by these compliance burdens. According to the St. Louis Federal Reserve, community banks with assets less than $100 million have compliance costs that are 9 percent of expenses, while those between $1 billion and $10 billion have compliance costs that are 3 percent of expenses.

**There has been a decline in the number of community banks due to consolidation.** Community banks have traditionally lent more to small businesses than larger banks, in part due to having more personal relationships in their communities. But over the last three decades, there has been consolidation in community banking and a decline in the total number of community banks, from 14,000 in 1985 to 5,000 in 2016.

**There has been a decline in lending based on personal relationships in favor of more automated processes.** Technology and regulation have changed the nature of lending and have made loans based on personal relationships less cost effective. Based on task-force interviews so far, this seems to have made it more difficult for some qualified individuals to gain access to capital. Policymakers should be concerned about what has been gained and lost because of this trend.

**There are government policies in place to promote access to capital for borrowers.** For example, the loan guarantees from the Small Business Administration (SBA) and the Treasury’s Community Development Financial Institution Fund are designed in part to help qualified but underserved communities and groups get access to capital. Some have called for these programs to be expanded or reformed to make them more accessible.

**Data on small-business lending is patchy and not comprehensive.** There is simply a lack of high-quality, real-time data available on small-business lending in the United States, which makes it difficult to make informed policy decisions. The Dodd-Frank Act included a new requirement that is designed to collect data on lending to small businesses, women, and minorities. However, this requirement has not been implemented and remains a point of contention among various parties.
Access to Capital and Other Relevant Financial Services

According to a Bank of America survey, only 38 percent of small businesses have at some point funded their operations with a loan or gift from friends and family.¹ This suggests that most small businesses must rely on banks and other external sources of credit to operate.

Chobani, the Greek yogurt company, is an example of a high-growth company that relied on a bank loan. When Chobani started in 2005, founder Hamdi Ulukaya did not have the money to buy a factory, hire employees, and do the research necessary to create and produce his product.²³ To get the business off the ground, Ulukaya was able to get a loan from Key Bank that was guaranteed by the SBA. Today, Chobani is a billion-dollar business and employs roughly 2,000 people.

The average start-up cost for a new business is roughly $30,000.²¹ This funding is needed to hire employees, pay rent, and buy the equipment small businesses need to operate. The Federal Deposit Insurance Corporation (FDIC) collects statistics on commercial bank loans of $1 million or less. These can be used as a gauge of small-business lending. This data, seen in Figure 1, shows a decline in these loans during the 2008 financial crisis. (The long-term decline in new business formation accelerated during this period.)

Figure 1. Commercial and Industrial (C&I) and Nonfarm Nonresidential Loans Under $1 Million Since 1995

Source: Federal Deposit Insurance Corporation Call Report Data.

Similarly, the Federal Reserve’s Small Business Credit Survey (SBCS) suggests challenges in accessing sufficient funding for small businesses. According to the survey, 60 percent of the small businesses surveyed reported a financing shortfall. This number jumps to 67 percent and 69 percent respectively for small businesses with less than $1 million in revenue and small businesses that are up to five years old (see Figure 2).
Figure 2. Share of Surveyed Small Businesses Reporting a Financing Shortfall

Some of the decline in bank lending revealed in the FDIC data may be due to a decline in loan demand. Also, some of the shortfall in financing shown in the Federal Reserve data may be due to borrower qualifications. Figure 3 indicates that firms with medium to higher credit risk are less likely to obtain the full amount of needed financing. However, even within credit risk categories, differences exist based on the age of the small business, indicating a gap in the provision of small-business credit.
Figure 3. Share of Surveyed Small Businesses Receiving the Full Amount of Financing Sought by Age and Credit Risk

Note: The Federal Reserve survey uses “self-reported business credit score or personal credit score, depending on which is used to obtain financing for their business. If the firm uses both, the highest risk rating is used. ‘Low credit risk,’ is a 80–100 business score or 720+ personal credit score. ‘Medium/high credit risk’ is a 1–79 business score or <720 personal credit score.”


The Federal Reserve survey also shows that 74 percent of all the firms surveyed are looking for loans of $250,000 or less. What’s more, 86 percent of firms with revenues of less than $1 million and 81 percent of young firms are both looking for loans of $250,000 or less (see Figure 4). Loans of this size, however, may not be profitable for banks given their current cost structures and the need to earn a competitive rate of return on their cost of capital for their investors.
Small businesses on average hold only 27 days of cash in reserve and often need financing on short notice. The time it takes to obtain financing and the amount of information required by a lender can be important factors in the selection of a lender.

Excluding loans from friends and family, small businesses primarily access credit through traditional banks. However, online lenders are a growing source of credit for small businesses. Traditional banks are often seen as slower than online lenders. A high percentage of new small businesses complain about the “long wait for a credit decision” and “difficult application process” when applying for a loan through a bank. Online fintech lenders may be able to provide financing more rapidly, but that funding is often costlier than a bank loan and sometimes comes with terms that are difficult to understand. The entrance of platforms like Amazon and Square—companies with immense amounts of information on their small-business customers—could represent the newest means of accessing capital. Whether that capital is affordable and contains transparent terms remains to be seen.

Many entrepreneurs and small businesses are new to the world of business and finance. In addition to access to affordable funding in a reasonable time frame, they need a good understanding of the different competitive providers in finance, the different financial products available, and the best use of those products to meet their individual needs. As one study has noted: “[B]y educating small businesses on a variety of lending models and financing products available, we can enhance the ability of owners to select the right sources of capital to meet their business needs and stimulate growth.”

There are also other ancillary financial services that entrepreneurs and growing small businesses need. A business can have capital and advice, but also have trouble processing payments effectively and efficiently or getting adequate insurance to help manage risks and protect investments.
Availability of Capital

Entrepreneurs and growing small businesses rely on a variety of lenders and investors to meet financing needs, including banks, credit unions, online lenders, other nonbanks, community development financial institutions, venture capital firms, angel investors, friends, and family.

These lenders and investors provide capital in various forms, including traditional business loans and lines of credit, loans and lines of credit guaranteed by the SBA, auto or equipment loans, personal loans, cash advances, home equity loans and lines of credit, credit cards, equity investments, grants, and gifts.

The decision to provide funding to a business is based upon the cost of providing the funding and the return a lender or investor can expect to receive relative to the risk taken. The costs of providing funding include items such as:

- Loan-underwriting costs
- Loan-servicing costs
- Customer-acquisition costs
- Compliance costs
- Expected loss from defaults

As Figure 5 indicates, a loan or investment that cannot cover these costs will be unprofitable.

Figure 5. Hypothetical Loans—What Interest Pays for from a Lenders Perspective

Source: Generated by BPC
These costs are especially problematic for loans below $250,000. The cost of making a small-business loan is roughly the same regardless of the size of the loan. For example, it might cost a bank $3,000 to underwrite a $100,000 loan or a $1 million loan. This means a smaller loan requires a higher return before it can make up its underwriting costs, making it less appealing to lenders. Increased automation in banks could help to bring down some of these costs. JPMorgan Chase, for example, has partnered with online lender OnDeck to automate these loan processes, while smaller banks like Eastern Bank in New England have internally incubated new automated-lending products.

Additionally, lenders and investors require adequate compensation for the level of risk they take. A risky loan or investment requires a higher expected return than a less risky one. New and expanding firms are riskier than established and more stable firms. This makes it harder for new and expanding firms to access capital.

Technology, regulation, supervision, compliance, and other government policies (e.g., taxes, licensing) impact the costs and risks associated with financing small businesses and entrepreneurs.
Issues for Further Exploration

The task force has identified the following issues for further exploration:

1. Availability and Access to Capital
   a. How easy is it for qualified small businesses and entrepreneurs to access capital on a national and regional basis?
   b. What are their options (small-business loans, credit cards, merchant cash advances, home-equity lines, equity capital)?
   c. What regulations come into consideration when providing and using these options?

2. Role of Technology
   a. What is the current state of technology with respect to the availability and access to small-business and entrepreneurial capital?
   b. How is technology expected to change in the near- to medium-term, and what are the implications for economic growth and jobs?
   c. What role are online fintech lenders playing in financing for small businesses and entrepreneurs?

3. Current Federal Role
   a. What federal programs exist for small-business financing (e.g., Community Development Financial Institutions Fund, SBA loan guarantees, the Federal Small Business Innovation Research Program, the State Small Business Credit Initiative)?
   b. How well are these programs working and can they be improved?

4. Inclusion
   a. How inclusive is the availability and access to affordable capital (based on factors like geography, race, gender, and size)?
   b. How can policymakers ensure full and fair access for all worthy small businesses and entrepreneurs?

5. Small-Business Data
   a. What is the status of the collection, availability, and use of data on the availability and access to small-business capital among the federal financial regulators (e.g., Federal Reserve, Consumer Financial Protection Bureau) and government agencies (e.g., SBA, Internal Revenue Service)?
   b. What data are business credit bureaus (e.g., PayNet) collecting, and how are these bureaus expected to evolve in the near- to medium-term?
   c. How can data collection and use be improved?

6. Relationship Lending
   a. What is the current state of relationship lending?
   b. How is relationship lending expected to change in the near- to medium-term, and what are the implications for economic growth and jobs?

7. Transparency in Small-Business Lending
   a. What is the current state of disclosure and transparency of providing capital to small businesses?
   b. What is the impact of the current industry proposals to expand disclosures to small businesses?
8. Small Banks, Credit Unions, and Community Development Finance
   a. What is the current state of small banks, credit unions, and community development (e.g., the Community Development Financial Institutions Fund) financing for small businesses and entrepreneurs?
   b. How is it expected to change the competitive landscape in the near- to medium-term and what are the implications for growth and jobs?

9. Advisory and Ancillary Services
   a. What is the state of financial advisory and related services for small businesses and entrepreneurs?
   b. How can these services be improved?
Conclusion

Ensuring a well-functioning financial system that serves the needs of qualified entrepreneurs and small businesses and makes capital available at competitive terms and conditions is important for fostering a growing economy that creates jobs and innovation. Through our outreach to date, the task force has found that many of these businesses are facing challenges in accessing capital, advice, and ancillary services on reasonable terms. Businesses are especially concerned about access to small-dollar loans of $250,000 or less.

The Task Force on Main Street Finance is seeking to better understand these issues and challenges and will be hosting a series of public events and making recommendations on ways to improve the financial system to help entrepreneurs and growing small businesses bolster economic growth and job creation.
Endnotes


2. Ibid.


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FURTHER INFORMATION

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