MARCH 2009

Seedco Financial
Innovations in Community Lending

POLICY BRIEF

Crisis on Main Street

Recommendations for Small Business Recovery

2.16 million
jobs lost in the private sector from November 2008 through February 2009, nearly 40% from businesses with fewer than 50 employees

75%
of domestic banks have implemented stricter lending standards for small businesses

70%
fewer loans backed by the U.S. Small Business Administration in October 2008 compared to October 2007

EXECUTIVE SUMMARY

The small business sector is the cornerstone of the American economy, bringing commerce, revenue, and jobs to neighborhoods. Small businesses have been responsible for 60 to 80 percent of annual job creation since the 1990s, creating 79 percent of net new jobs in 2005.[1] But the current recession has fallen hard on small businesses, restricting their access to critically needed capital and forcing many to cut investments in payrolls, facilities, inventory, equipment, and more.

Even in the best of times, the capital market available to small businesses is insufficient. Banks can offer fair terms and interest rates but use approval formulas that rule out most small firms; subprime and predatory lenders offer accessible capital on terms that put many firms at risk; and the "ethical" alternative capital market is simply too small to help most firms in need. As banks decrease their lending to small firms in this recession, many more entrepreneurs will be forced to find financing for their businesses elsewhere—often at exorbitant expense and on risky terms. While the federal government has attempted to help small businesses and their employees, its new recovery initiatives are unlikely to reach those firms unable to qualify for traditional bank loans.

Small businesses across the country need a response that is equal to the current crisis. In the aftermath of recent crises, such as in New York City after 9/11 and in New Orleans after Hurricane Katrina, government support helped to expand the alternative lending market's capacity to serve small businesses in need. Today, the federal government must mount a similarly aggressive effort to help small businesses grappling with the economic crisis. They need access to low-cost capital, alternative lenders from which to borrow, and technical services in conjunction with loans. It is time to take bold action to prevent escalating small business closures and employee layoffs, and to protect our communities from economic disaster.

BIG PROBLEMS FOR SMALL BUSINESSES

Small businesses drive neighborhood economies; their income and profits are essential to the health of communities around the country. They provide jobs that support millions of individuals and families and often serve as an entry point into the workforce for vulnerable and poor populations such as ex-offenders and immigrants. Nationwide there are a total of 7.6 million establishments with fewer than 500 employees. Of those, fully 95 percent have fewer than 50 employees, and those firms account for more than half of all employment.[2]

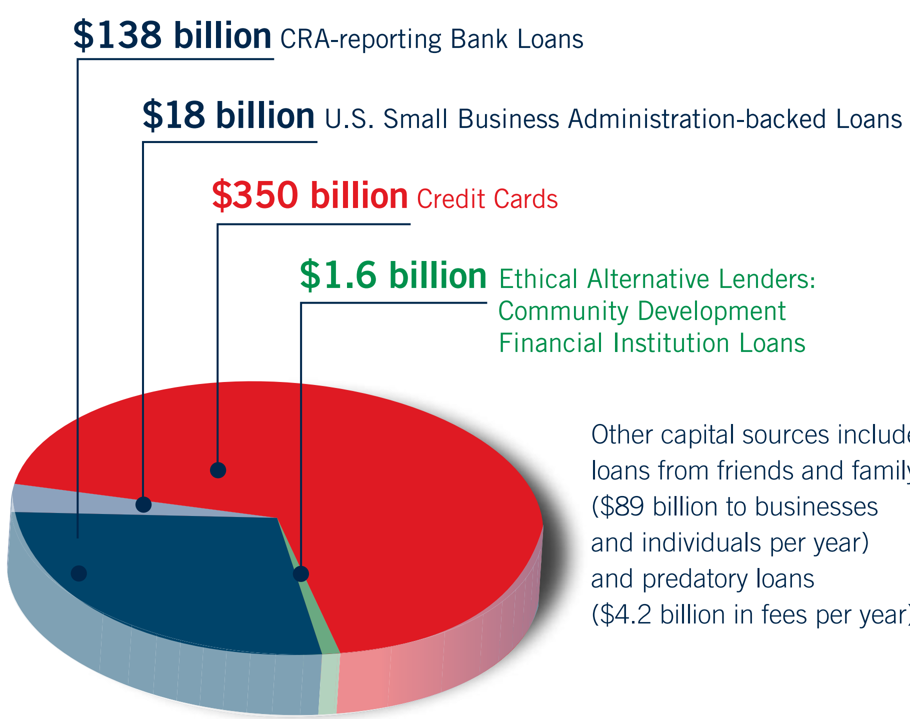
Reginald White and his wife, Josephine, are co-owners of the Magic City Grill in Birmingham, AL. The restaurant, which they have owned and operated for more than 25 years, is renowned as one of the best spots for soul food in the Birmingham area. Seedco Financial provided the Whites with a $90,000 loan for leasehold improvements and equipment purchases. As a result, the Whites expanded to a second location just outside Birmingham, in Fairfield, creating 13 new jobs.

The small business capital market is inadequate.

Small firms need financing to make investments that help them sustain their competitiveness and grow their profits. While a wide range of sources exist, from prime to subprime markets, only a fraction of small firms have access to affordable capital.

The prime lending market is primarily made up of traditional bank loans that offer favorable lending terms and affordable interest rates. Community Reinvestment Act (CRA)-reporting banks, approximately 1,000 of the Federal Deposit Insurance Corporation (FDIC)-insured banks, provided $138 billion in loans to small firms in 2007.[3] While FDIC-insured banks reach a substantial number of businesses, they leave out a significant portion of firms in need. Banks depend on rigid formulas to assess the risk of potential borrowers, considering measures such as number of employees, financial performance records, and credit histories. Most small businesses, and especially the smallest ones, are deemed too risky under these criteria.

Sources of Small Business Capital (annual)



Other capital sources include loans from friends and family ($89 billion to businesses and individuals per year) and predatory loans ($4.2 billion in fees per year).

As traditional lenders move upmarket to avoid riskier borrowers in this recession, the number of small businesses seeking financing from the relatively small source of ethical alternative lenders will continue to grow.

Byron Enclade (above right) is the sole proprietor of Enclade Trucking and Fisheries in the New Orleans area. Hurricane Katrina wiped out his house, destroyed his fleet of three oyster harvesting boats and disrupted his business operations. A $200,000 loan from Seedco Financial helped Enclade pay for boat repairs, get back in the water, and restore his workforce of seven employees.

The Small Business Administration (SBA) also helps make capital available to businesses. The SBA backs loans that banks make to small businesses, hoping to encourage investment in smaller and riskier firms. Due to program guidelines, SBA guarantees only marginally increase the amount of capital available to small businesses. In total, the SBA was responsible for only 80,000 loans in 2008, totaling about $18 billion.[4]

Some small firms unable to access bank and SBA-backed loans resort to person-to-person transactions rather than institution-based capital. Studies estimate that loans made by friends and family total $89 billion annually.[5] While these loans often have favorable borrowing terms, they are not consistently accessible for all entrepreneurs. For many, especially low-income and minority business owners, finding capital through their social networks is not a viable option.

Most businesses unable to qualify for prime capital market loans turn instead to high-cost products offered by credit card companies and "predatory" lenders of the subprime capital market. In 2002, small firms borrowed $140 billion from credit card companies to meet their capital needs; that amount was expected to grow to $350 billion in 2008.[6] It is estimated that all types of borrowers—small businesses and individuals—annually incur $4.2 billion in fees from fees on payday loans.[7] Not surprisingly, many small businesses are trapped in a cycle of debt that too often leads to layoffs and, eventually, bankruptcy.

An alternative and "ethical" subprime capital market exists to serve small businesses unable to access the prime capital market, offering rates and terms similar to those of banks. But this market serves only a fraction of the need. Rather than relying on low-cost loan approval formulas, alternative lenders—nonprofit community development financial institutions (CDFIs), community development corporations, and community development credit unions—perform intensive and costly analyses of future profitability, reviewing documents such as business plans, tax returns, and financial projections. As a result, their administrative costs are high, ranging from $2,500 to $10,000 per loan. Additionally, their capital reserves are drawn from program related investments (PRIs) from banks. These PRIs are loans that must be repaid with interest, leaving alternative lenders susceptible during tighter credit markets—such as the current recession.

Despite its small size, the alternative capital market plays an important role for the businesses it serves. Over the past 30 years, alternative lenders have provided $19 billion in financing; 58 percent of borrowers are minorities and 70 percent low-income. In 2006, alternative lenders provided a total of $4.75 billion in financing to a variety of borrowers, of which 33 percent, or $1.6 billion, was lent to businesses. Alternative lenders assisted 8,185 businesses, helped to create or maintain 35,600 jobs, and provided an estimated 32,700 alternatives to payday loans.[8] Furthermore, banks and traditional

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lenders are far more likely to invest in small businesses that have already received financing from alternative lenders.

The recession has elevated the capital gap to a state of emergency.

Fearful of risks heightened by the recession, banks have scaled back their lending dramatically and tightened their lending guidelines. Despite the federal government's lowering of interest rates in an attempt to boost lending, many of the select small businesses that could once qualify for bank or even SBA-backed loans are no longer able to do so. The statistics are harrowing:

- 75 percent of domestic banks have implemented stricter lending standards for small businesses.[9]
- Today, only 28 percent of small businesses are using bank loans, the lowest rate since 1993.[10]
- Fewer banks are participating as SBA lenders, and approvals for the largest SBA loan program declined 30 percent between fiscal year 2007 and 2008. The number of SBA loans dropped by 68 percent in October 2008 compared to October 2007.[11]

This creates a bleak situation for small businesses and their workers, especially those businesses historically ineligible for the traditional banking market. The credit crunch has significantly contributed to the following small business indicators:

- From November 2008 through February 2009, the private sector lost approximately 2.16 million jobs—nearly 40 percent of them from businesses with fewer than 50 employees.[12]
- SBA loan failures reached 12 percent in fiscal year 2008, an increase of 500 percent since 2004, when the failure rate was 2.4 percent.[13]
- Small firm bankruptcies have risen steadily over the past year, from 8,000 bankruptcies in the final quarter of 2007 to 11,500 in the third quarter of 2008.[14]
- A recent survey found that small business optimism was at the lowest it had been since 1980 and the percentage of small firms reporting higher sales was the lowest since 1973.[15]

It is typical for demand for capital to drop during a recession as businesses scale back investments in inventory and improvements, but the need for affordable financing does not disappear. Fewer firms borrowed on a regular basis in 2008 than in 2006, and owners reduced inventories, but capital remained important. Loans, especially large ones, are essential to businesses' survival during recessions because they help to finance firms' ability to retain employees, remain competitive, and adjust their business model to emerge from the recession.

As a result, more and more small businesses are looking for capital beyond the traditional bank outlets, increasing the demand for the already-small pool of alternative capital: 51 percent of CDFIs and alternative lenders reported an increase in loan applications during this recession.[16] At the same time, alternative lenders rely on PRIs from the same banks that are tightening their credit offerings. The result is increased competition for a shrinking pool of dollars from alternative lenders.

RECOMMENDATIONS FOR A RECOVERY

Small business recovery is essential to America's economic recovery. We know that neighborhood economies depend on the health of their small and mid-sized firms, but the national response has failed to provide the right kinds of assistance to help them.

The American Recovery and Reinvestment Act provides SBA with an additional $714 million in funding, of which $645 million will directly fund loans and fee reductions; an additional $100 million will go to the CDFI Fund to support alternative lenders. Small business relief announced more recently promises to unfreeze small business credit markets by spending $15 billion to purchase securities made up of packaged SBA loans, raising the guarantee limits and eliminating fees for many SBA loans, and offering new tax breaks to small business owners. These heightened investments in small business lending are laudable, but funding remains heavily weighted toward firms that can already qualify for traditional capital, leaving out many businesses in need.

The ethical alternative capital lending market offers a proven model for reaching a broad range of vulnerable firms and thereby aiding in communities' swift economic recovery. The following broad recommendations will help strengthen and expand the capacity of the alternative lending market.

1. Expand the availability of capital to small businesses.

The ethical alternative lending industry should receive an infusion of non-recourse capital (grants restricted to lending activities) to allow it to expand the availability of affordable financing, and loan guarantees should be created to mitigate the potential risk to small business lenders. Banks' reluctance to lend to nontraditional borrowers is unlikely to abate in the near future, and CDFIs and community development corporations offer a viable way to circumvent banks' eligibility formulas. For those firms that do qualify for traditional bank loans, investment in the entire range of existing SBA loan products should be continued and expanded.

Other financial products can also support small businesses and strengthen neighborhood economies. "Green" incentives for businesses that invest in environmentally sound facilities and energy-efficient practices, wage subsidies for businesses to retain workers, preferential government contracting for smaller firms, and enhanced tax credits would all help ensure that support is available to a broad range of firms.

Karena Nigale owns KK Salon in lower Manhattan's financial district. She launched her business in 2004, largely on credit cards and personal savings. A $25,000 loan from Seedco Financial allowed her to restructure high-interest credit card debt and make renovations to her salon that enabled her to expand her services. The loan helped keep her—and her eight employees—in business.

2. Provide alternative lenders with resources to deploy capital.

A small-business relief package must include funding that allows alternative lenders to actually deliver capital to more small businesses. Ethical alternative lenders are the only entities for whom serving small and riskier businesses is mission-driven. Without grants to pay for high loan assessment costs, lenders must pass the costs to their borrowers, diminishing the affordability of the loans. Extending additional funding would cover administrative and loan-servicing costs, thus enabling high-quality lenders to offer more affordable financing to small businesses.

3. Pair financing with technical support.

To use their loans wisely, it is essential that small businesses have access to comprehensive business services, including help with financial planning, debt management, and loan restructuring services for businesses with loans with unfavorable terms. Utilizing capital effectively takes skill and savvy, and technical assistance should be offered in tandem with loan services as an integral part of a small-business recovery plan. These services could be provided by a range of organizations, including CDFIs and credit unions.

Notes

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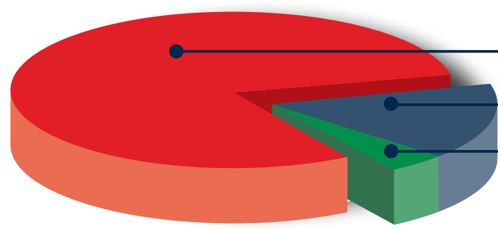
ABOUT SEEDCO FINANCIAL

Seedco Financial Services is the community development financial institution (CDFI) subsidiary of Seedco, a national nonprofit organization that helps low-income people and communities move toward economic prosperity. Seedco Financial provides affordable financing and technical assistance to small businesses, nonprofit organizations, and large-scale commercial projects. Seedco Financial has extensive experience serving small businesses in crisis, launching comprehensive economic revitalization strategies in New York following the 9/11 terrorist attacks and in Louisiana following Hurricanes Rita and Katrina. In New York City, Seedco Financial issued $40 million in capital and business services to 1,500 small firms following 9/11, helping to save over 6,500 jobs. In Louisiana, Seedco Financial has issued over $20 million in capital and business services to hundreds of entrepreneurs since Hurricane Katrina.

Seedco Financial Loan Portfolio (529 loans, February 2009)



441 of the 529 loans in Seedco Financial's active portfolio are held by small businesses

$58,000 is the average small business loan amount in Seedco Financial's portfolio

64% of Seedco Financial's small business loans are issued to minority- or women-owned businesses

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