

Funding Economic Recovery: Trends in Small Business Lending in Massachusetts

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PolEcon Research was commissioned by the Massachusetts Bankers Association (MBA) to examine small business lending trends in the state, and factors that may be influencing them. Although commissioned by the MBA, this report was prepared independently. PolEcon chose the data and methods used in the analysis. All data used in the report are publicly available from federal and state government agencies. PolEcon presented this report to the MBA without advance notice of the results. PolEcon agreed to make editorial changes in the report and to correct any errors of fact but did not make any changes to the results or conclusions of the analysis unless a factual error in data or calculations could be demonstrated. All interpretations of data, conclusions, and any errors contained in the report are the responsibility of the author and not the Massachusetts Bankers Association.

Executive Summary

This study uses required bank regulatory filings to document trends in the volume of small business loans in Massachusetts and the U.S. over the past several years. The analysis documents the structure of the market for small business credit in the state and examines changes in the supply of small business credit in Massachusetts from different types of small business lenders. The report also examines how changes in the volume of small business credit in Massachusetts have been affected by the demand for loans, and how financial and regulatory considerations of banks may have contributed to recent lending trends. Finally, the report discusses the implications of recent lending trends and the structure of the small business credit market in designing public policies seeking to increase the supply of small business credit in Massachusetts.

Key Findings Include:

- Community banks in Massachusetts increased their small business lending throughout the recession, increasing their volume of small business lending by \$467 million (or 5.3%) in 2008, \$622 million (or 6.7%) in 2009, and \$120 million (or 1.2%) as of Sept. 30, 2010. In comparison, community banks nationally increased small business lending by just 2.8% in 2008, while small business lending by community banks declined by 2.4% nationally in 2009, and by 4.4% in 2010.
- As the U.S. and Massachusetts economies hit bottom in 2009, the volume of small business lending in Massachusetts fell, but the decline was only about one-third the size of the decline in small business lending across the United States. Net small business lending in Massachusetts declined by about \$1 billion or 7.4% during the depths of the recession in 2009, compared to a decline nationally of 22.1%.
- Surveys by the Federal Reserve Board and the National Federation of Independent Businesses, as well as data on net borrowing (new borrowing less retiring of debt) by non-corporate businesses, all indicate that the demand for small business loans has not yet recovered to pre-recession levels.
- A lack of sales continues to be the major contributor to reduced demand for loans among small businesses. Other key factors affecting the volume of small business credit in recent years include:
 - De-leveraging by many small businesses after a period of rapidly increased borrowing.
 - Recession-induced damages to the balance sheet of most small businesses produced fewer qualified borrowers.
 - Declines in collateral values, often a small business owner's home, but also commercial real estate, limited the ability of borrowers to access credit.

- To the extent that the contraction in small business lending reflects a shortfall of demand rather than an insufficient supply of credit, any supply-side solutions that seek to influence bank lending will be ineffective.
- Reports on small business lending that do not currently include all lenders, including credit unions and banks that do not file Community Reinvestment Act reports on small business lending, miss an important source of credit for small business and likely overstate recent declines in small business credit in Massachusetts.
- National credit card companies and commercial lenders with few, if any, retail bank branches in Massachusetts accounted for the majority of the reduction in small business credit in Massachusetts during the recent recession.
- Tax-exempt credit unions in Massachusetts dramatically increased small business lending during the last decade, increasing their market share of small business lending relative to Massachusetts' community banks from 3.5% to 10.4%.
- Because more data is available on the supply of small business loans than is available on the demand for loans, there is a tendency to attribute changes in the volume of small business lending entirely to changes in the supply side, or the willingness of lenders to extend credit.
- Community banks in Massachusetts are healthier, on average, than are community banks across the country. Loan delinquencies are only about one-third as high at community banks in Massachusetts as they are at community banks nationally.
- Rising business loan delinquencies nationwide, especially at large national and regional banks, required some banks to increase their reserves against future loan defaults and in the process reduced their supply of funds available for lending.
- Increased oversight and regulation required the nation's largest banks to increase their capital and reduce their leverage, limiting their ability to increase the supply of credit.
- The structure of the small business credit market in Massachusetts will require that any policies to meaningfully address the supply of small business credit must rely on the lending resources and infrastructure of Massachusetts banks.
- Public policies that seek to increase the supply of credit to small businesses by expanding the size or capacity of quasi-public lenders and the Small Business Administration (SBA) will have only very limited impacts on the small business credit market in Massachusetts. Doubling the size of the SBA loan guarantee program and all quasi-public lenders in Massachusetts will increase the total volume of small business credit in the state by no more than two percent (2%).

I. Introduction and Overview

It has been over three years since the U.S. economy officially entered recession in December of 2007, and more than two years since the financial crisis in the Fall of 2008 caused a massive disruption in the flow of business and consumer credit. Some policymakers and elected officials in Washington, D.C. and throughout the country have attributed both sharp declines in employment and relatively slower job growth as the economy has emerged from recession to difficulties in obtaining credit, especially

among smaller businesses. According to this view, beginning with the financial crisis in 2008, lack of access to credit has inflicted significant damage on small businesses across the country, from which many have yet to recover. Reports documenting a decline in the volume of small business lending that use either incomplete or inconsistent data¹, or which fail to examine evidence on the demand for credit among small businesses, continue to contribute to this view.

“From an economic and public policy perspective, and for assessing the degree to which access to credit is influencing the current economic recovery, it is important to understand how much of the decline in small business credit is driven by supply factors (less credit being made available) and how much is driven by demand factors (businesses seeking less credit).”

Still, there can be no disputing that across the nation, lending standards tightened and the volume of credit to small businesses and households declined during the recession. Commercial and industrial loans outstanding are a good barometer of the availability of credit and nationally in 2009 they dropped at a record rate of over 15 percent. Nationwide, outstanding loans to small businesses dropped from over \$711 billion in the second quarter of 2008 to approximately \$652 billion in the second quarter of 2010.² The number of credit cards also declined. In 2009 the number of credit cards in circulation dropped to their lowest level in a decade.

An economy in recession, with weak demand for goods and services, will generally result in less business expansion and lending. But is a lack of small business lending a primary impediment to a stronger U.S. and Massachusetts economic recovery? Differences of opinion about what is contributing to lower credit volumes matter; whether a solution is likely to work depends on whether it accurately targets the problem. From an economic and public policy perspective, and for assessing the degree to which access to credit is influencing the current economic recovery, it is important to understand how much of the decline in small business credit is driven by supply factors (less credit being made available) and how much is driven by demand factors (businesses seeking less credit). While good data on the supply of credit is available from required bank

¹ Specifically, assessing lending trends using only aggregated Community Reinvestment Act reports can be problematic because each annual report contains a changing population of reporting institutions. In addition, less than 20 percent of Massachusetts banks have assets of more than \$1 billion that require them to file CRA small business lending reports (although many Massachusetts banks file voluntarily). To draw accurate conclusions about small business lending patterns of institutions in Massachusetts over time, analysts must use data on individual institutions and that data must be aggregated in a way that changes in the mix of institutions filing annual CRA reports do not influence conclusions. Similarly, comparing aggregated annual data from bank “call reports” would tell little about the lending behavior of banks if the population of banks changed annually.

² Federal Deposit Insurance Corporation. “Statistics on Depository Institutions,” accessed online at [www.fdic.gov/http://www2.fdic.gov/sdi/main.asp](http://www2.fdic.gov/sdi/main.asp).

quarterly and annual regulatory filings, empirical data on the demand for loans is less direct and generally limited to surveys such as the Federal Reserve’s “Senior Loan Officer Survey,” and the National Federation of Independent Businesses’ “Small Business Economic Trends.”

During 2010 signs of an economic recovery clearly emerged in Massachusetts, where about 45,000 private sector jobs were added from January through December of 2010.³ But questions about the availability of credit for small businesses remain and are likely to increase even as the economy continues to recover and the demand for small business and consumer credit rises.

As economic and employment growth again become a dominant public policy issue in Massachusetts and the nation, it will be critical for policymakers to identify the economic and public policy factors most likely to contribute to stronger economic growth. Nationally there is a continued desire by policymakers to increase small business lending. The recently enacted federal *Small Business Jobs and Credit Act of 2010* includes additional initiatives to increase the supply of small business credit, including funding for states to implement their own capital access programs, as well as a \$30 billion pool of funds for capital injections into community banks. Separately, Massachusetts recently enacted economic development policies that include changes to some of the state-supported business financing programs.⁴ But whether any national- or state-level initiative to spur small business lending is successful is contingent upon several factors including:

- A thorough understanding of lending trends.
- An accurate diagnosis of the economic, financial, and regulatory factors that contribute to lending trends.
- A solid understanding of the structure of the small business lending market and sources of credit.
- A viable strategy for spurring lending.
- Policy mechanics that will implement that strategy effectively.

To the extent that the contraction in small business lending reflects a shortfall of demand rather than an insufficient supply of credit, any supply-side solutions that seek to influence bank lending will be ineffective. Accurately assessing lending trends, understanding the incentives and disincentives facing different small business lenders and their relative capacity to increase lending, as well as the economic and regulatory factors influencing their ability and willingness to make small business loans, will be essential to any successful policy. This report can help inform public policy by contributing to an understanding of the dynamics of small business lending in Massachusetts.

“To the extent that contraction in small business lending reflects a shortfall of demand rather than an insufficient supply of credit, any supply-side solutions that seek to influence bank lending will be ineffective.”

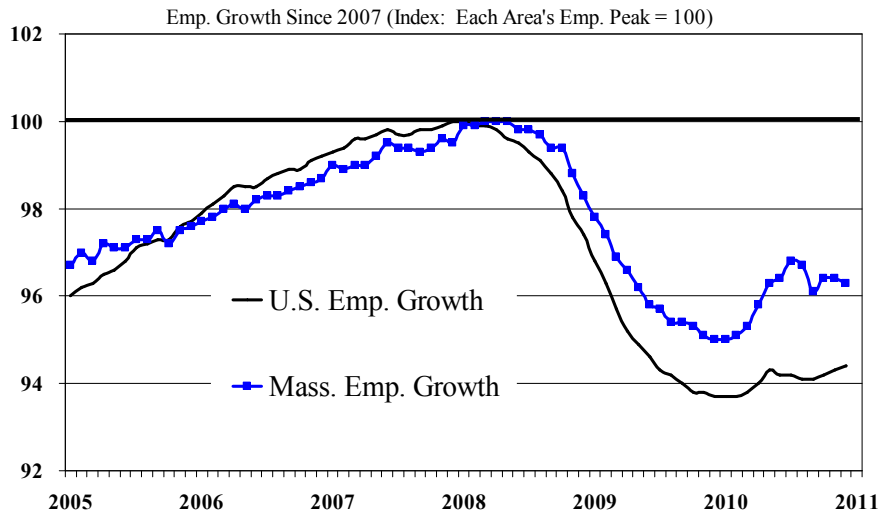
³ U.S. Bureau of Labor Statistics

⁴ See Chapter 240 of the Acts of 2010 for details of the changes.

II. Trends in Small Business Lending in Massachusetts

The Massachusetts economy did not fall as far as did the U.S. economy during the recent recession and the Massachusetts economy is recovering faster (Figure 1). Nevertheless, the volume of small business loans declined in Massachusetts during 2009, as the depths of the recession occurred and economic growth bottomed in the middle of the year.

Figure 1
The Mass. Economy Did Not Fall as Far and is Recovering Faster than the U.S. Economy

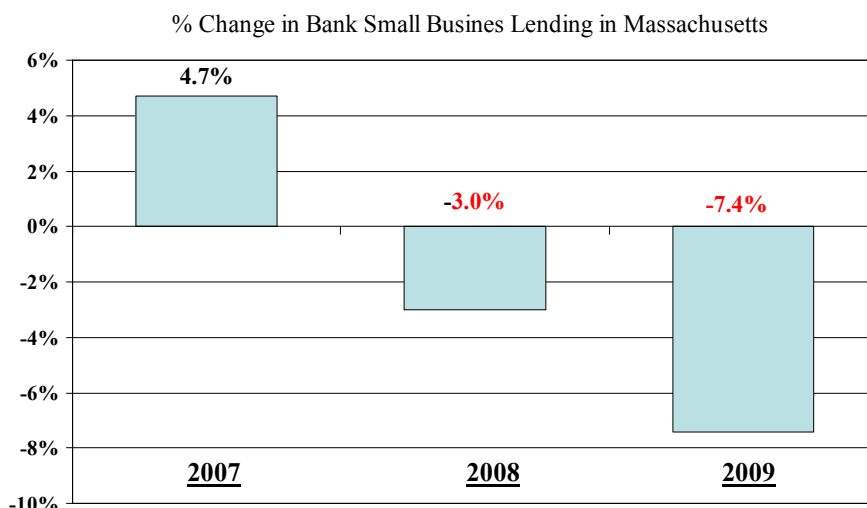


Using both Community Reinvestment Act (CRA) and quarterly FDIC call report data, we estimate that the volume of small business credit declined by more than 7 percent in Massachusetts during 2009.⁵ Although Massachusetts' economy was badly hurt during the recession, its stronger economic performance, relative to the U.S., is reflected in the volume of small business lending in the state. The dollar volume of small business loans in the U.S. fell by 22 percent, a decline that is three times larger than the reduction in small business lending that occurred in Massachusetts (Figure 2).

⁵ It is necessary to examine both CRA data and *Consolidated Reports of Condition and Income of Banks* or "call report" data to fully document trends in small business lending. Only banks with assets over \$1 billion are required to file annual CRA small business lending reports. The Federal Financial Institutions Examination Council (FFIEC) estimates that CRA reports capture about two-thirds of small business lending throughout the country, but that the percentage varies significantly by state. A majority of Massachusetts banks do not file CRA small business lending reports but information on the volume of their small business lending is now available from their quarterly "call report" filings. As importantly, as documented later in this report, smaller banks are more dependent than are larger banks on small business lending for their earnings. Not including smaller banks in an analysis of small business lending thus biases lending trends towards the experience of larger banks and away from the experience of smaller banks with the strongest incentives to make small business loans.

Figure 2

Loans to Small Business in Mass. Dropped by \$1 Billion or 7.4% in 2009 as the Economy Hit Bottom.



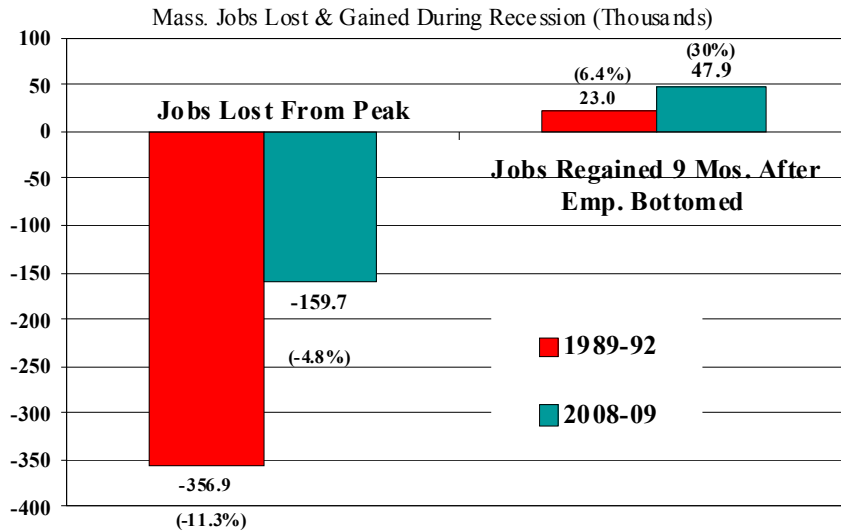
Sources: Federal Financial Institutions Examination Council (FFIEC) - bank Community Reinvestment Act reports, FDIC *Consolidated Reports of Condition and Income of Banks*, PolEcon Research

It is not surprising that the volume of small business loans decreased in Massachusetts in 2009, as the recession deepened and as the full effects of the nation's financial crisis took hold. Massachusetts was hurt badly during this recession, but less so than the U.S. economy. That would not have occurred if the state's financial system was weakened and bank lending had fallen further in Massachusetts than it did across the country. For Massachusetts, and New England generally, the recession of 2008 and 2009 was not as severe as the recession that pummeled the region from 1990 to 1992. Figure 3 compares the impact of the 1990-1992 recession in Massachusetts to the impact of the 2008-2009 recession. The chart shows that job losses were more than twice as large during the 1990-92 recession and at equivalent points in the state's economic recovery, jobs regained are much larger following the recent recession. A primary reason that the 1990 recession was more severe in Massachusetts was that it was amplified by the effects of a larger financial crisis in New England that culminated in the failure of large and small banks throughout the region. The resulting disruption in credit markets dramatically deepened and prolonged the state's economic contraction into the early 1990s. In contrast, the recent recession has had less of an affect on the banking industry in Massachusetts, and credit has been more available than it was in the early 1990s.

Still, it is important to understand the dynamics underlying the trends in small business loan volume in Massachusetts if we are to have confidence that credit markets in Massachusetts are healthy enough to fuel the state's recovery and return to prosperity.

Figure 3

In Massachusetts, the “Great Recession” Wasn’t the “Worst Recession Since the Great Depression,” Nor is it a “Jobless Recovery”



Source: U.S. Bureau of Labor Statistics, PoIEcon

Small Business Lending Trends Vary by Type of Lender

The aggregate volume of small business credit masks important information about the supply of credit from different types of business lenders. Some lenders, like community banks in Massachusetts, continued to increase small business lending even during the recession. In part, this reflects Massachusetts’ small businesses establishing or re-establishing credit relationships with local banks after the financial crisis disrupted credit markets across the country.

Other lenders, including some national credit card companies, reduced lines of credit, cancelled cards, or simply stopped issuing business credit. This was the case with one lender with \$41 million in Massachusetts small business loans in 2008, but \$0 dollars in 2009.⁶ The number of business and personal credit cards in circulation has fallen 24 percent since peaking in 2008.⁷ Business credit card loans by national credit card lenders fell by \$815 million in Massachusetts in 2009, after falling by \$521 million in 2008, accounting for the majority of the decline in small business credit during each of those years. Credit cards, along with home equity lines of credit, are important sources of funds for the smallest businesses in Massachusetts. Across the country, both of these sources of credit have seen the largest contractions of any forms of credit.

⁶ Advanta Corp stopped issuing new cards in 2009, then filed for bankruptcy and went into FDIC receivership. It is possible that affected small businesses were able to secure credit card financing from other sources. Aggregate data reported here on credit card loans reflects a consistent group of lenders over time, providing a better assessment of the lending patterns of banks than would occur if patterns reflected a changing population of banking institutions from year to year.

⁷ Mark Zandi, “U.S. Macro Outlook.” *Economy.com*, December 22, 2009.

This report groups small business lenders into five categories for analysis:

- National credit card companies. These firms provide business credit cards (and credit cards to individuals but the numbers here reflect only business credit cards). This group includes well known companies such as American Express, Discover, Chase, and Capital One, and others that issue credit cards across the country. These companies generally have no physical presence in the states in which they lend.
- Commercial lenders that primarily lend to business. These lenders may, with exceptions (for example Citibank in Massachusetts), have little or no physical presence (retail branches) in most of the states in which they make loans and do little or no retail banking.
- Massachusetts community banks. These retail banks include state- and federally-chartered community banks that have one or more branch offices in Massachusetts. Most of these banks (86%) have total assets of under \$1 billion.
- Massachusetts large national and regional banks. These include the four largest depository institutions with retail branches in the state – Bank of America, RBS Citizens Bank, TD Bank, and Sovereign Bank.
- Massachusetts credit unions. This group includes more than 60 tax-exempt credit unions in the state that reported making business loans.

National Credit Card Companies and Commercial Lenders Account for a Majority of the Decline in Small Business Credit

Figure 4 shows that, at the depths of the recession, small business credit supplied by national credit card companies, commercial lenders, and large national and regional banks declined by about \$1.6 billion in Massachusetts in 2009, or about twice the decline that occurred in 2008 when the nation fell into recession and the financial crisis hit in the fall of that year. But the data also show that increased lending by community banks, and to a lesser extent tax-exempt credit unions, offset a significant portion of the decline in credit from all other institutions.

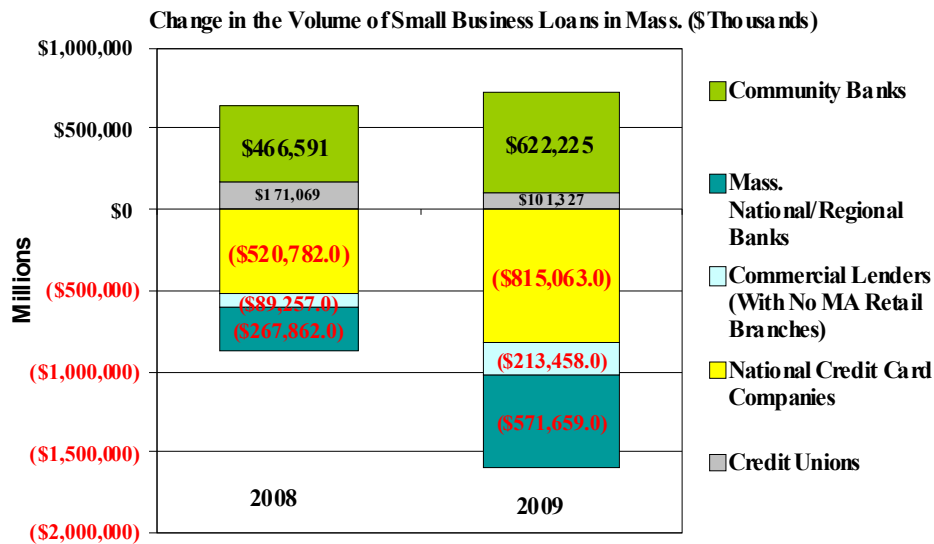
As was the case in 2008, the decline in small business loan volume was most significant among national credit card companies, commercial lenders with no retail depository branches in Massachusetts, and large national and regional banks. Many of the largest of these institutions were weakened by the financial crisis and they were subject to more scrutiny over lending practices following the financial crisis. They were also most likely to be facing uncertainty over financial industry regulatory reforms being debated at the national level. A recent study by the Small Business Administration found that the 34 largest banks in the U.S. accounted for 39 percent of all small business lending in the U.S. and 42 percent of the total decline in small business lending between June 2009 and June 2010.⁸ A 2010 study by the Federal Reserve Bank of Boston also noted that community banks in New England offset some of the decline in small business credit from other sources, but the study did not attempt to quantify the degree to which community banks were able to offset declines from other sources.⁹ Reports on small business lending that use only CRA data miss this important trend in the lending data because more than 80

⁸ George Haynes and Victoria Williams, “Small Business Lending in the United States, 2009-2010,” *U.S. Small Business Administration, Office of Advocacy, Office of Economic Research*, 2010.

⁹ Robert K. Triest, et. al., “Evidence of a Credit Crunch? Results From the 2010 Survey of First District Community Banks,” *Federal Reserve Bank of Boston*, September, 2010.

percent of Massachusetts’ community banks are not required to file annual CRA small business lending reports because they have total assets under the \$1.2 billion.

Figure 4
Community Bank & Credit Union Lending Helped Offset the Decline in Small Business Lending by other Institutions



Source: Federal Financial Institutions Examination Council (FFIEC) - Bank Community Reinvestment Act Reports, FDIC Consolidated Reports of Condition and Income of Banks, Policy Research

In general, the types of lenders and institutions that showed the greatest declines in small business lending in 2008 and 2009, were also the institutions most likely to be constrained by external and internal financial factors in their ability to make loans (discussed later in this report).

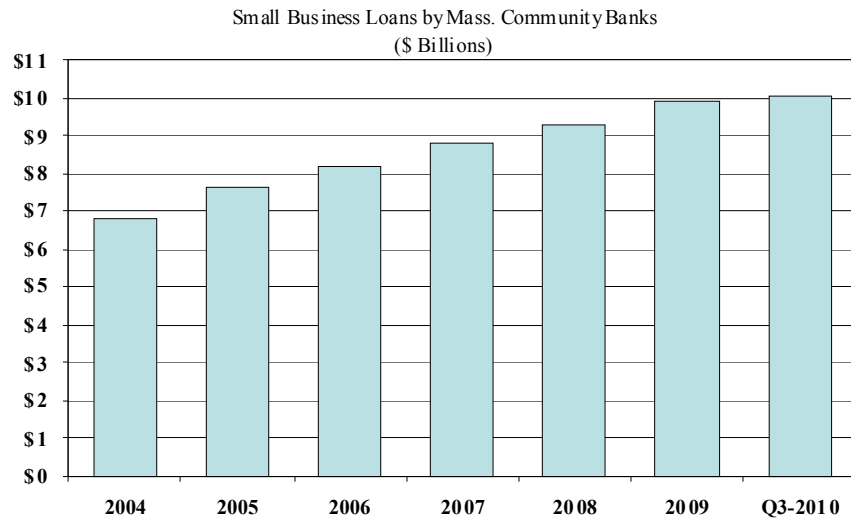
The data in Figure 4 do not indicate that all business credit card companies, or all commercial lenders reduced small business lending in Massachusetts, or that all community banks increased their small business lending in the state. In the aggregate, however, the sum of the changes in lending among community banks and credit unions resulted in a higher volume of lending in 2009 than in 2008, while the aggregate sum of changes in lending among other types of lenders resulted in a lower volume of loans in 2009 than in 2008.

Community Banks Increased Small Business Lending Throughout the Recession

For banks that lend predominately in Massachusetts – Massachusetts chartered, community banks, we can use more recent data from their third-quarter 2010 regulatory filings to assess the volume of small business lending in the state. Examining data from quarterly “*Consolidated Reports of Condition and Income of Banks*” for Massachusetts state- and federally-chartered community banks for the years 2004 to 2010 shows that small business lending increased from \$6.8 billion in 2004 to \$9.9 billion in 2009, to just over \$10 billion as of Sept. 30, 2010 (Figure 5).¹⁰

¹⁰ Prior to 2010, small business lending data was only reported by banks on their June quarterly call report. Beginning in 2010, each quarterly report contains small business lending data.

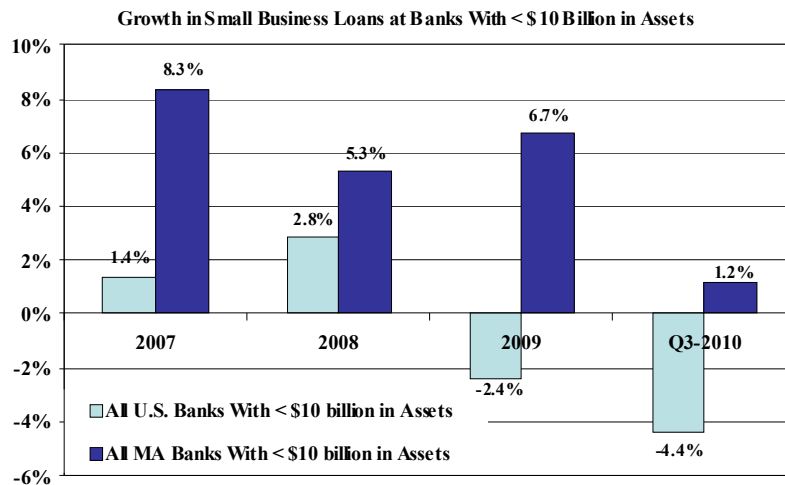
Figure 5
Small Business Lending by Mass. Community Banks



Source: FDIC *Consolidated Reports of Condition and Income of Banks*. Annual data adjusted by Polecon to account for bank mergers, acquisitions, closures etc., and to create consistent data for time series analysis.

In 2009, Massachusetts’ community banks with less than \$10 billion in assets increased small business lending by 6.7 percent, and in 2010, by 1.2 percent. By comparison, community banks nationwide experienced declines in small business loan volume of -2.4 percent in 2009 and 4.4 percent in 2010 (Figure 6).¹¹

Figure 6
Lending Trends by Massachusetts Community Banks Compared to U.S. Trends



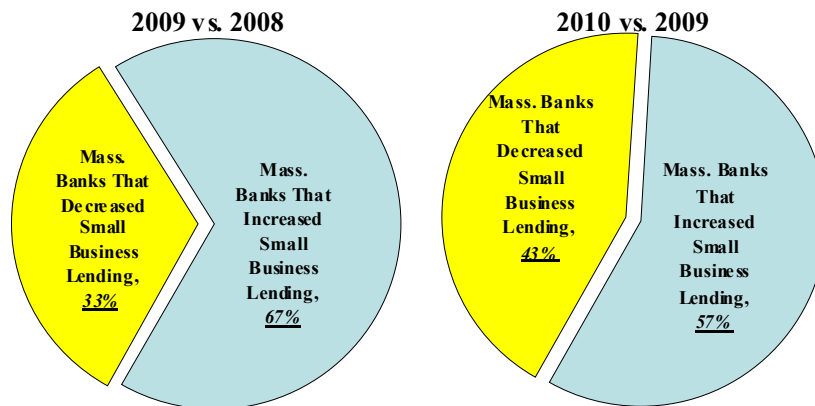
Source: FDIC *Consolidated Reports of Condition and Income of Banks*, Polecon Research.

¹¹ This analysis employs a commonly used (by the FDIC and others) definition of a “community bank” as a commercial or savings bank with less than \$10 billion in total assets.

Increases in Loan Volume Were Broad-Based

Increases in the dollar value of small business lending at retail depository institutions in Massachusetts were broad-based in 2009 and 2010. Compared to the dollar volume of their small business lending in 2008, two-thirds (67%) of Massachusetts banks (state- and federally-chartered plus four large national/regional banks) increased their volume of small business lending in 2009, and 57 percent increased their lending volume in 2010 (Figure 7).

Figure 7
Growth in Small Business Lending Among Mass. Banks*
is Broad-Based.



* “Mass. Banks” here include all state- and federally-chartered, retail deposit banks that make business loans, as well as national/regional banks with branch networks in Mass. The national/regional banks included are: Bank of America, RBS Citizens Bank, TD Bank, and Sovereign Bank. Mass.-specific small business lending by the national/regional banks is not yet available for 2010, each was assigned to a category (increase/decrease in lending) based on the change in their small business lending nationally from 2009 to 2010.

III. The Structure of the Small Business Lending Market in Massachusetts

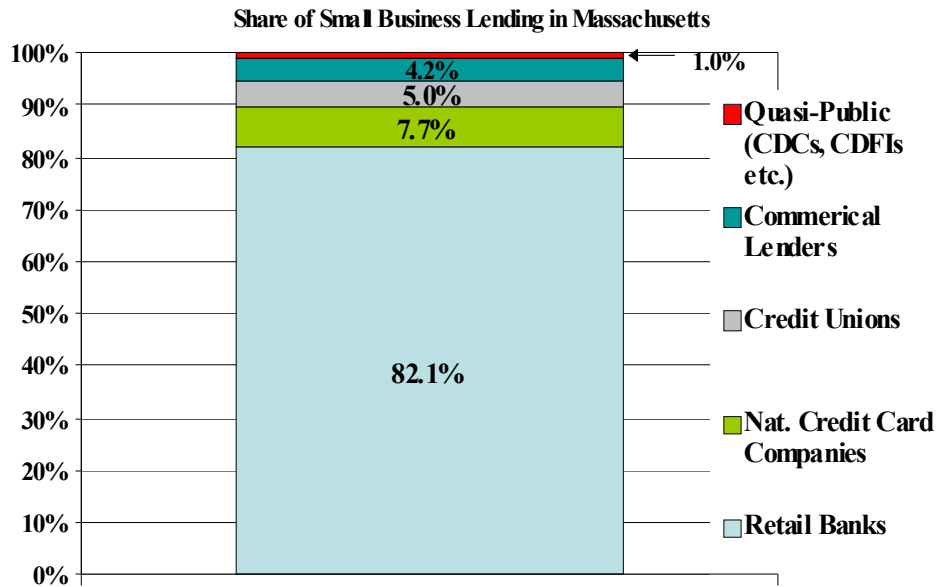
Depository institutions with at least one retail branch in Massachusetts provide over 80 percent of the small business loans in the state (Figure 8). National credit card lenders provide less than eight percent (8%) of small business credit, down significantly from about 13 percent in prior years, following a combined decline in loan volume of over \$1.3 billion in 2008 and 2009.

Credit unions supply about \$1 billion or approximately five percent (5%) of the volume of small business loans but this figure understates the role of credit unions because of the unique way in which small business loans are accounted for by tax-exempt credit unions.¹² Commercial lenders (banks with no depository branches in Massachusetts) supply less than \$1 billion in small business loans or 4.2 percent.

¹² Credit unions are not required to report loans of under \$50,000 to member businesses as “business loans.” In addition, loans to member businesses that are fully secured by a member’s 1-4 family primary residence or by deposits at any financial institution are not required to be reported as business loans. Finally, the dollar amount of reported

Figure 8

Depository Banks With Branches in Mass. Are the Dominant Source of Small Business Credit in Massachusetts



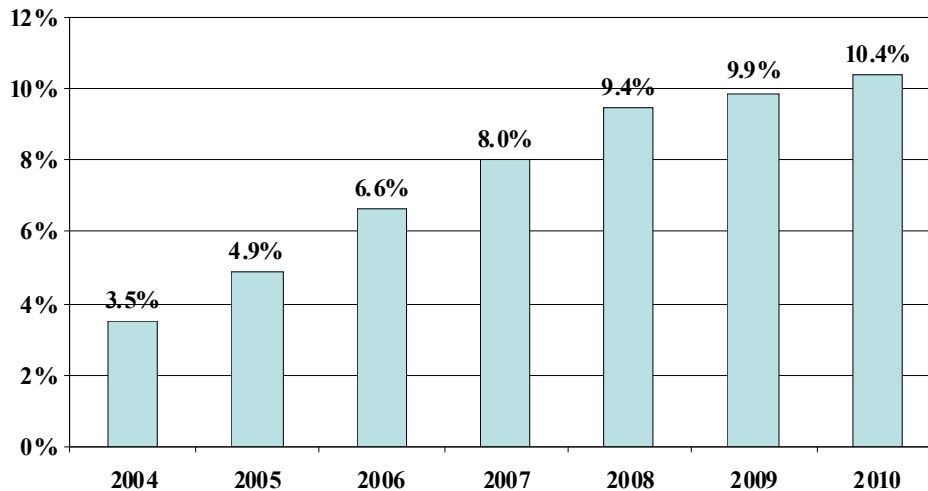
Tax-Exempt Credit Unions are Increasing Their Share of Small Business Lending in Massachusetts

The number of credit unions in Massachusetts making small business loans has increased from 51 in 2004 to 63 in 2010. The \$1 billion in reported small business loans they supplied in 2010 is up dramatically from \$250 million at the beginning of 2004. More significantly, credit unions have tripled their share of small business lending relative to Massachusetts' state- and federally-chartered community banks. As Figure 9 shows, small business lending by Massachusetts credit unions has increased from 3.5 percent of the amount of small business lending by community banks in 2004, to over 10 percent in 2010. The larger role of credit unions in credit markets in Massachusetts is consistent with the stated objectives of national credit union regulators who have looked to expand beyond the traditional role of credit unions in credit markets by facilitating and urging members to increase market share.¹³

business loans by credit unions are reduced by the portion of any loan that is guaranteed by any federal or state agency or entity (see National Credit Union Administration publication *Call Report Form and Instructions*).

¹³ National Credit Union Administration media advisory, "Vice Chairman Hood Stresses Member Business Lending to CUSO Leaders," November 2, 2006.

Figure 9
 Small Business Lending by Tax-Exempt Credit Unions in
 Massachusetts as a Percentage of Lending by Community Banks



The dollar volume of loans reported here understates the small business lending of credit unions because credit union regulations do not require loans to businesses that are under \$50,000 or that are secured by residential properties or secured by deposits at any depository institution to be classified as business loans. In addition, business loans made through affiliated *credit union service organizations* (CUSOs), if any, are not included in these numbers.

Quasi-Public Lenders Participate in only a Small Fraction of Small Business Lending in Massachusetts

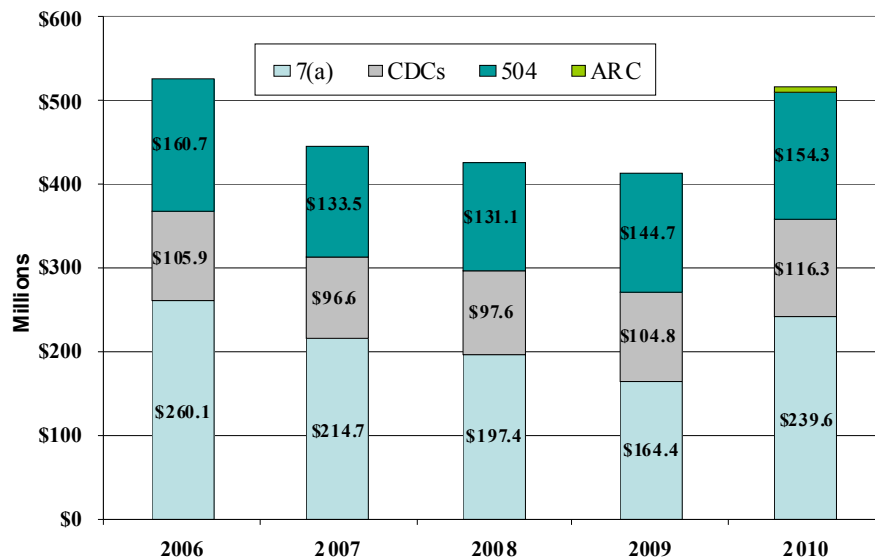
Annual data on small business lending by quasi-public economic development organizations is extremely limited and not reported in a consistent manner across the various organizations in Massachusetts. Nevertheless, examining the largest organizations (Mass Development, Community Development Finance Corp., SEED, etc.) and estimating the remainder based on a review of several smaller organizations, reveals that the volume of all lending by these organizations is under \$200 million, or about one percent of the total small business market. It is important to note, however, that the \$200 million does not include lending programs by quasi-public organizations that are not expressly directed at small businesses. Specialized lending for such things as brownfields redevelopment, health care facilities, or educational institutions are not included in the \$200 million total for quasi-public organizations.

SBA Programs are Popular But Represent Less Than Three Percent of Loans

The Small Business Administration (SBA) is responsible for the largest small business lending program in the nation. It facilitates small business lending by guaranteeing a portion of loans made primarily by financial institutions, but also quasi-public organizations. SBA lending relies on the infrastructure of the private lending market and thus as a public policy, has greater capacity for expansion to increase small business lending. SBA guaranteed loans have been the lifeblood for many small businesses over the years and the program has widespread support among businesses, lenders, and policymakers.

In Massachusetts, the volume of small business lending had been on the decline in recent years before rebounding in 2010, a pattern similar to trends throughout the U.S. In part, the rebound in SBA lending is due to increased funding from the 2009 American Recovery and Reinvestment Act (the so-called “stimulus bill”). The SBA is the largest government program affecting the small business credit market. In fiscal year 2010, the SBA provided just over \$500 million in credit enhancements¹⁴ in Massachusetts (Figure 10). However, SBA programs, affect less than three percent (3%) of the dollar volume of small business loans in the state, approximately equal to the percentage of loan volume affected by SBA loan guarantees nationally.

Figure 10
 SBA Loan Program Volume in Massachusetts Has Recovered But Still Involves Less Than 3% of Small Business Credit in the State



The impact of SBA loan guarantees on the small business credit market and on expanding access to credit in Massachusetts is actually more limited than suggested by the total volume of SBA loan guarantees. SBA guarantees can make some loans more attractive to lenders, and given a choice between making a loan with a guarantee and one without, many lenders would prefer to make the loan with a guarantee, but that does not suggest that all loans with SBA guarantees would not have been made without SBA backing. A sizable percentage of the SBA loans would have been made even in the absence of an SBA guarantee. A Sept. 2010 study by the Federal Reserve Bank of Boston that examined evidence of a credit crunch in New England noted this issue in discussing the role of the SBA in expanding access to credit in New England.¹⁵ Thus even in an unrealistic scenario where a doubling of SBA loan guarantee capacity in Massachusetts occurred, it would likely only produce a true expansion of small business credit of no more than one percent (1%) throughout the state.

¹⁴ The SBA does not directly lend to small businesses, but rather, its key programs provide guarantees or “credit enhancements” that make it easier or more attractive for banks and other institutions to make loans to small businesses.

¹⁵ Triest, et. al, op. cit., pg. 11-12.

IV. Lending By Depository Banks in Massachusetts

Banks with retail deposits in Massachusetts account for the vast majority (over 80%) of small business lending in the state. Because retail branch banks supply such a large percentage of small business credit in Massachusetts, even small, marginal increases in the volume of lending by banks will produce total dollar volume increases in credit in the state that far exceed any increase that could be produced by government or quasi-public lending or loan guarantee programs.

For example, doubling the lending capacity of quasi-public lenders in Massachusetts (an unlikely scenario in any state given fiscal strains and a general reluctance to expand government programs) would increase overall small business credit by one percent (1%) in the state. As discussed above, a doubling of SBA loan guarantees would appear to increase lending by about 2.5 percent, but because many loans would be made even in the absence of guarantees, credit would actually increase by perhaps one percent. But even if all SBA guarantees actually expanded access to small business credit, the current mood of fiscal austerity makes such a large increase in the SBA program an unlikely scenario. In contrast, community banks in Massachusetts would only need to make low, single-digit, percentage increases in their overall lending, placing little strain on lending infrastructure (credit officers, asset management etc.) to compensate for declines among most other lenders and return to pre-recession levels of overall small business lending volume in the state.

Using Massachusetts community banks to address any credit constraints is the most economical and efficient strategy to address concerns about the availability of small business credit, but its viability depends on three factors:

- The demand for small business loans among credit-worthy borrowers. Bank lending to small businesses fluctuates with the business cycle, economic conditions, and the growth and expansion plans of small businesses. Historically small business credit markets have responded to real, rather than artificial or unsustainable demand, and have avoided “bubbles” that have affected other types of lending.
- A regulatory environment that is compatible and supportive of lending to borrowers with damaged balance sheets.
- Understanding the incentives different banks have for making small business loans.

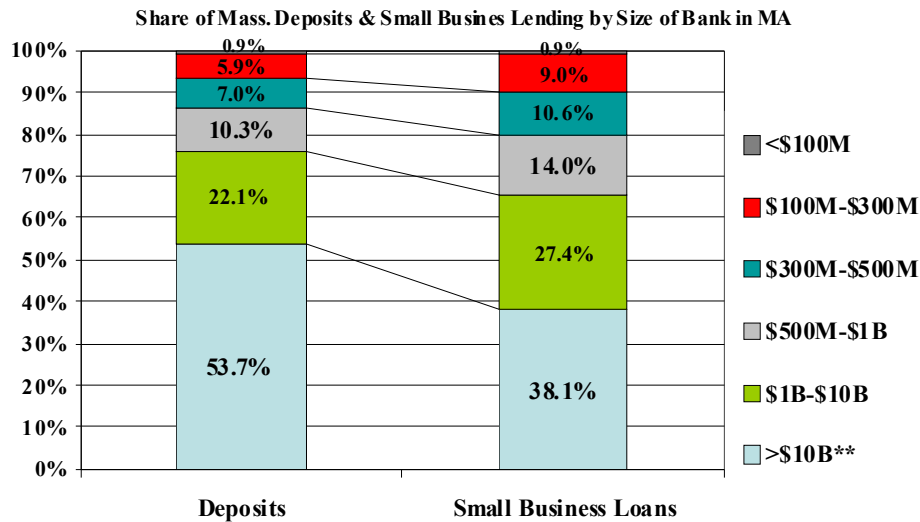
Banks can do little about the demand for credit and state policy makers have only limited impact on the overall regulation of bank lending to small businesses. Understanding small business lending patterns among Massachusetts banks can, however, inform and help guide any future public policies.

Small and Mid-Sized Banks Provide a Disproportionate Amount of Small Business Credit

In Massachusetts, smaller and medium-sized retail banks use a higher percentage of local deposits for small business lending than do the four large national and regional banks in the market. Figure 11 shows that the four largest national and regional banks in Massachusetts hold about 54 percent of the bank deposits in the state, while accounting for about 38 percent of small

business loan volume by banks with retail branches in the state.¹⁶ Banks in three size categories, ranging from \$300 million to \$10 billion, hold just under 40 percent of deposits in the Massachusetts banking market, while accounting for 52 percent of small business loans made by banks located in the state.

Figure 11
 Small and Mid-Sized Banks Account for A Disproportionate Share of
 Small Business Lending



**The percentage of small business loans in Mass. made by national/regional banks (Bank of America, TD Bank, RBS Citizens Bank, and Sovereign Bank) is estimated based on Massachusetts CRA and quarterly call report data.

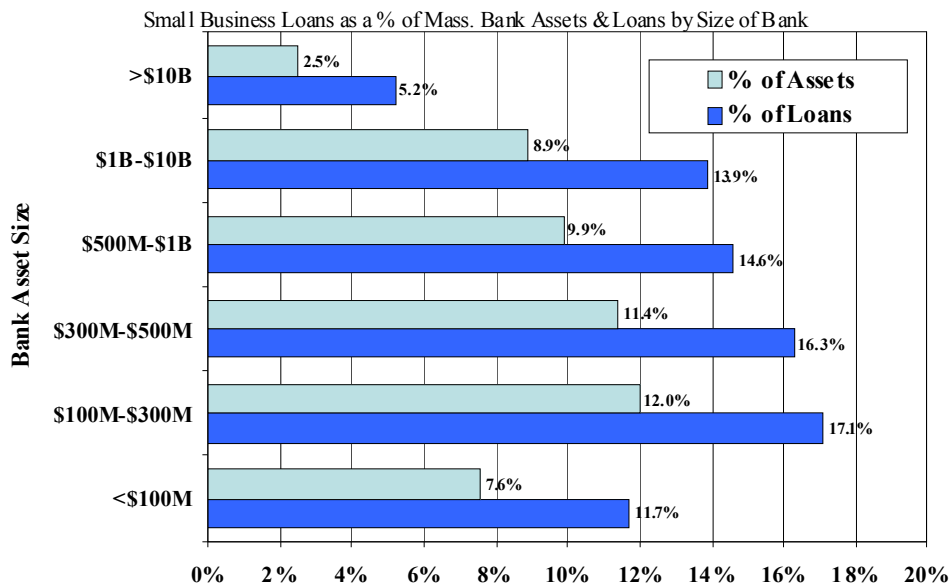
Diminished demand for loans plays a significant role in declining small business credit (discussed in Section IV of this report) but to the extent that the supply of small business credit has been constrained by other factors, Figure 11 provides some clues why past national efforts have been relatively unsuccessful in stimulating small business lending. Prior to the passage of the *Small Business Jobs and Credit Act of 2010*, the federal government’s approach to stimulating small business lending was largely focused on capital infusions into banks, especially large banks. The nation’s largest banks were the primary participants in programs such as the Troubled Asset Relief Program (TARP), while smaller banks, which rely more on small business loans to generate revenue, largely shunned TARP-related programs. Thus efforts were concentrated among the banking sector that is least dependent on small business loans for revenues and thus less affected by a decline in small business lending volume.

Figure 12 shows that among Massachusetts’ state- and federally chartered banks (as well as four large national and regional banks), the percentage of bank loan portfolios devoted to small business loans generally decreases as the size of the bank increases, except among the smallest banks (those with assets of less than \$100 million). Nevertheless, although small business loans comprise only about 12 percent of the loans of Massachusetts banks with less than \$100 million in

¹⁶ Deposit market share data from the FDIC online at: <http://www2.fdic.gov/sod/sodMarketBank2.asp>.

assets, that percentage is still more than twice the 5.2 percent that small business loans comprise of the loan portfolios of large national and regional banks.

Figure 12
Smaller Banks Rely More on Small Business Loans



Source: FDIC, *Consolidated Reports of Condition and Income of Banks*, PolEcon Research

Figure 12 also shows how important small business lending is in the overall asset mix of banks, according to bank size in Massachusetts. The largest national and regional banks in Massachusetts make nearly 40 percent of the small business loans made by banks in the state, but nationwide, small business loans comprise only 2.5 percent of the assets of these banks. In contrast, the percentage of assets at state- and federally-chartered banks in Massachusetts is three to five times (from 7.6% to 12.0% of assets) as important to the asset base of smaller banks in the state.

Implications of these findings include:

- Although large national and regional lenders are active small business lenders, they are relatively less dependent on small business lending for revenue generation. As a result, they may have less incentive to participate in and respond to programs directed at increasing small business lending. In addition, as discussed in Section IV of this report, economic, regulatory, and credit-quality issues appear to be having a larger impact on the lending trends of large, national and regional banks.
- Because of differences in their asset mix, banks of different sizes are likely experiencing different credit quality, regulatory and revenue/earnings pressures that make designing one policy to stimulate lending among the entire banking industry difficult.

V. Supply, Demand, and Regulatory Impacts on Lending Trends

There are a number of reasons why small business lending volume has declined in Massachusetts and throughout the country since the recession began, most unrelated to the willingness of banks to extend credit to small businesses. Hard data (as opposed to survey data) is virtually non-existent on the demand for small business loans or the financial health of small businesses. Even the Federal Reserve Bank of Boston's recent survey of community banks in New England noted the difficulty in trying to collect quantitative data on loan demand.¹⁷ Yet good data on both supply and demand for credit are needed to accurately assess how well the market for small business credit is functioning in Massachusetts and across the nation. In contrast, the regulatory filings of banks provide a solid empirical measure of the supply of credit extended by banks. One result of the difference in the availability of data on the supply of and demand for credit is a tendency to attribute all changes in the volume of small business lending entirely to changes in the supply side, or the willingness of banks to extend credit. But ignoring demand factors that influence the volume of credit will produce an inaccurate understanding of the small business credit market and result in ineffective or counterproductive policies directed at increasing credit availability.

“One result of the difference in the availability of data on the supply of and demand for credit is a tendency to attribute all changes in the volume of small business lending entirely to changes in the supply side, or the willingness of banks to extend credit. But ignoring demand factors that influence the volume of credit will produce an inaccurate understanding of the small business credit market and result in ineffective or counterproductive policies directed at increasing credit availability.”

The Demand for Small Business Loans Has Declined

Some factors thought to influence the volume of small business credit in recent years include:

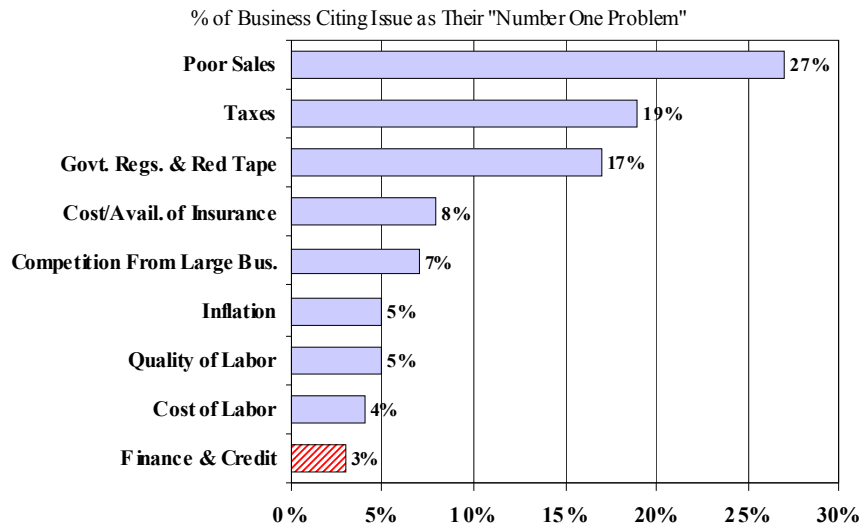
- Reduced sales lowered growth and expansion plans, and reduced the borrowing needs of many small businesses.
- De-leveraging by many small businesses after a period of rapidly increased borrowing.
- Recession-induced damages to the balance sheet of most small businesses produced fewer qualified borrowers.
- Declines in collateral values, often a small business owner's home, but also commercial real estate, limited the ability of borrowers to access credit.

According to the monthly “*Economic Trends Survey*” conducted by National Federation of Independent Businesses, a lack of sales continues to be the biggest problem facing small businesses (Figure 13).

¹⁷ Triest, et. al., Federal Reserve Bank of Boston, op. cit.

Figure 13

Credit & Finance Rank Low on the List of Problems Facing Small Businesses



Source: NFIB. Small Business Economic Trends Survey, February 2011.

The authors of the NFIB monthly survey report write:

"Interest rates are low, yes, but there is little motivation to borrow even cheap money since there are few uses that promise a return on their investment. Most owners (75 percent) feel it is not a good time to expand their firms."¹⁸

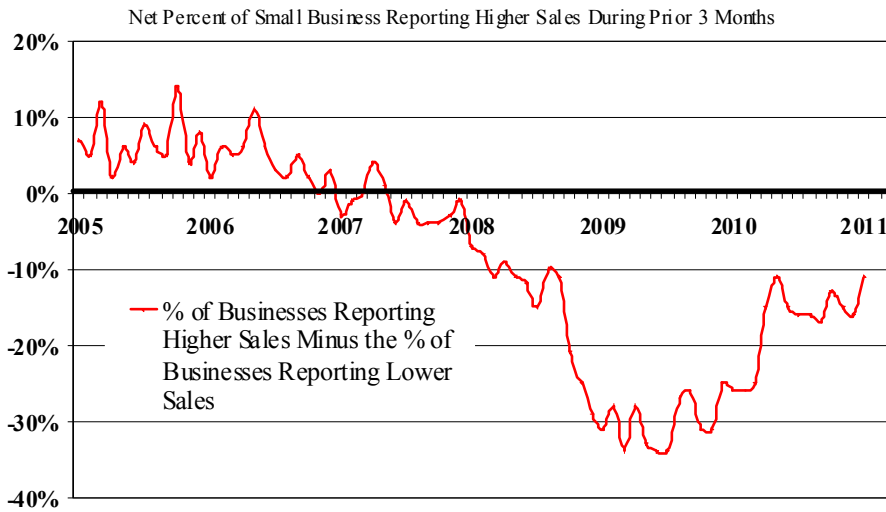
The net percentage of businesses reporting higher sales over the past three months, minus the percentage sales increases continues to show that more businesses are experiencing sales declines than are experiencing sales increases (Figure 14). One result is lower investment and less need for credit. But it is also true that the length and severity of this recession disproportionately harmed the smallest businesses reducing their need for working capital and making them less creditworthy when they are in need of credit.

According to the Federal Reserve's quarterly "*Senior Loan Officer Survey*," demand for loans from small business plummeted after the financial panic that began in the Fall of 2008. As of the third-quarter of 2010, more senior loan officers continue to report lower demand for loans from small businesses than report increased demand for loans, even as more senior loan officers report that bank lending standards are loosening. Figure 15 shows that demand for loans typically declines during recessions and credit standards tighten as the finances of businesses become more strained: that pattern was followed to the extreme nationally during the recent recession.

¹⁸ William C. Dunkleberg, Holly Wade, "NFIB Small Business Economic Trends," *National Federation of Independent Businesses*, November, 2010.

Figure 14

A Lack of Sales Continues to be the Major Contributor to Reduced Demand for Loans

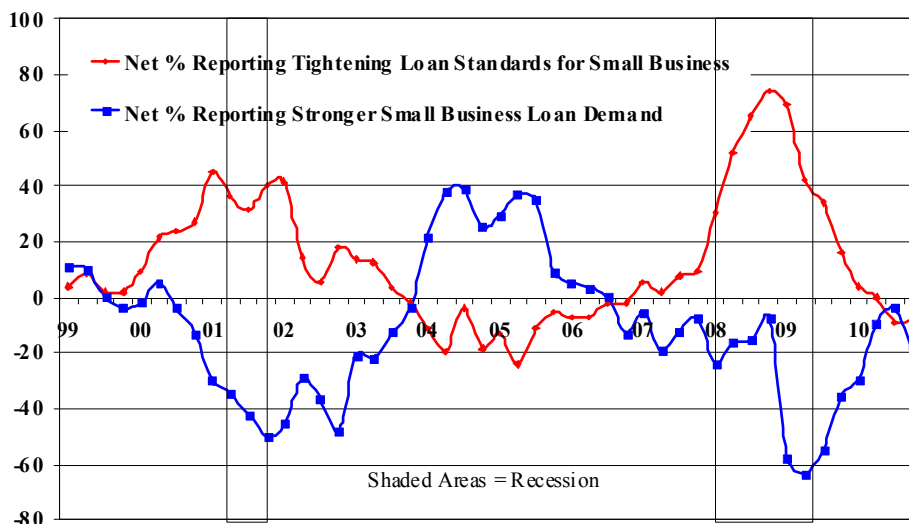


Source: National Federation of Independent Businesses (NFIB) Economic Trends Survey.

No single, definitive source of data on the demand for small business loans exists and as a result reports on trends in small business credit often fail to account for the important role demand plays in the market for small business credit. This report uses several surrogate measures of demand to help assess the impact that demand for credit has had on recent trends in small business lending.

Figure 15

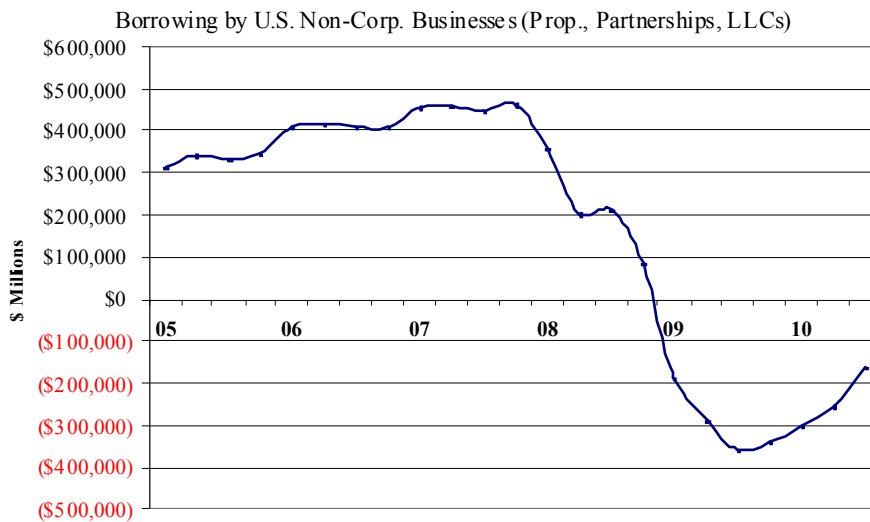
The Fed's "Senior Loan Officer Survey" Suggests Demand for Small Business Credit is Still Relatively Weak



Source: Federal Reserve Board Senior Loan Officer Survey

One surrogate measure of demand is the net borrowing of non-corporate, non-farm businesses, reported in the Federal Reserve Board of Governor’s quarterly statistical release *Flow of Funds Accounts of the United States*. The data on net borrowing of non-corporate businesses reflects new credit minus retirement of existing debt by unincorporated business such as proprietorships, partnerships and limited liability companies. Figure 16 shows that the aggregate net borrowing of these businesses follows a pattern similar to the net percentage of businesses experiencing sales increases, presented in Figure 14, demonstrating a significant drop during the recession. Figure 16 confirms that non-corporate businesses (proprietorships, partnerships, and limited liability companies) have been de-leveraging, or retiring more debt than they have been adding since 2009.

Figure 16
 Net Borrowing by Non-Corporate Businesses Plummeted and is Recovering Slowly



Source: Federal Reserve Bank Board of Governors, *Flow of Funds Accounts*, December 9, 2010

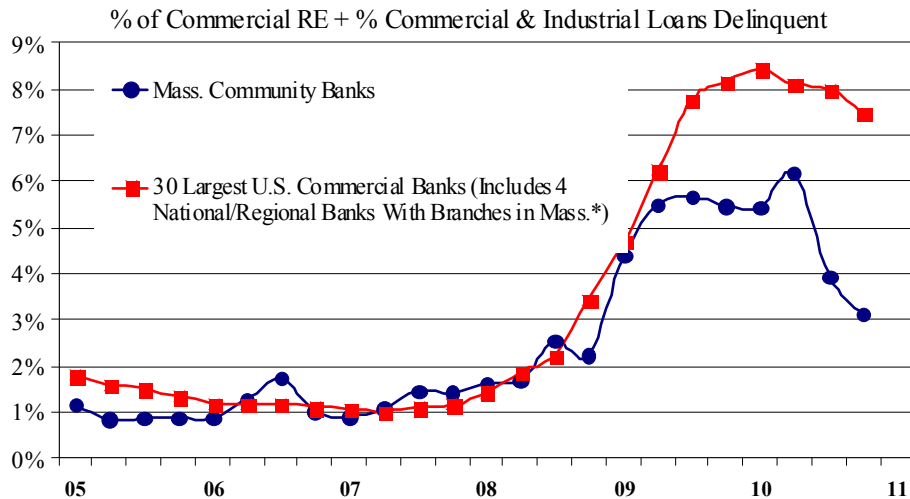
The “Effective Demand” For Small Business Loans Has Fallen

“Effective demand” is a measure that combines the desire or demand for a good or service along with the resources necessary to obtain it. For small businesses, there is no direct measure of the effective demand for loans because there is no publicly available source of financial information on individual small businesses. Anecdotal and survey reports of unmet credit needs provide an incomplete and inadequate measure of demand because they provide no hard data or empirical evidence on the financial condition of potential borrowers.

One surrogate measure of the overall financial position of businesses is the percentage of business loans that are delinquent. Few policymakers would argue that the financial condition of households in Massachusetts today is as strong as it was three or four years ago, and few would suggest that extending additional credit to households with weaker balance sheets is a prescription for improving the financial health of households. As Figure 17 shows, the financial health of

business borrowers at banks rapidly deteriorated during the recession, especially at the nation's large national and regional banks, where the volume of small business loans has declined in recent years.¹⁹ Despite an economy that is slowly recovering, business loan delinquencies remain high. Delinquencies at Massachusetts' community banks, however, remain well below the national average for community banks and they are falling.

Figure 17
Loan Delinquencies Mean Fewer Qualified Borrowers



Source: FDIC, *Consolidated Reports of Condition and Income of Banks*

* Excludes some large banks that do not make small business loans and includes the following banks in Mass.: Bank of America, RBS Citizens Bank, TD Bank, and Sovereign Bank

Surveys by the NFIB and Federal Reserve System, as well as indirect or surrogate measures such as net borrowing by non-corporate businesses, and business loan delinquencies, suggest that both the demand and “effective demand” for small business loans in Massachusetts have declined. Going forward, increased regulatory scrutiny and credit quality issues (delinquency rates) may make it more difficult for some banks to heed calls for more small business lending, even as the economic recovery accelerates and demand for loans increases.

Supply Issues Can Limit Small Business Lending

To the extent that the contraction in credit is attributable to reductions in supply as opposed to lower demand for loans, several explanations have been offered, including:

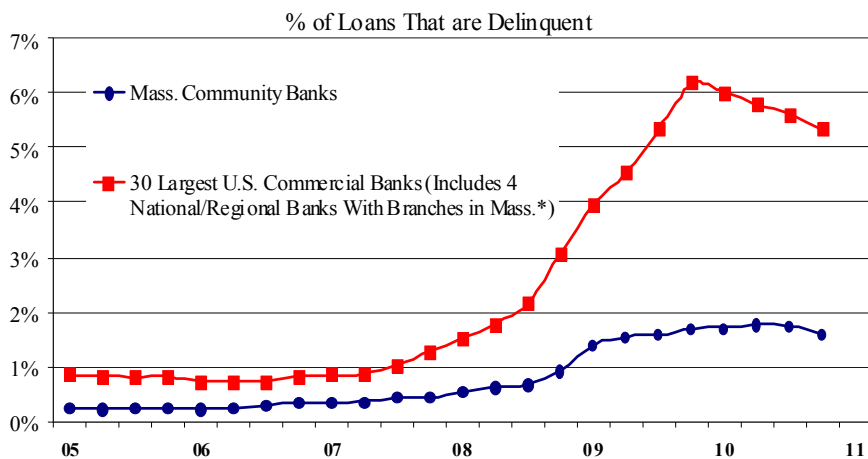
- Rising delinquencies have increased the loan loss reserves of banks, reducing lending capacity.

¹⁹ Delinquency rates for Massachusetts' national and regional banks reflect the entire regional and national loan portfolio of these banks. For all banks, delinquency rates here are determined by adding the percentage of loans that are delinquent in each category.

- Increased capital requirements under new banking regulations require that banks either raise more capital, (which can be difficult in a weaker economy), or reduce assets, (which can mean fewer small business loans are made).
- New financial regulations and aggressive application of existing regulations either require or have banks re-evaluating lending practices.
- Greater use of alternative (other than banks) sources of supply such as tax-exempt credit unions, changes in payment terms, and increased reliance on personal resources.

Delinquencies among loans of all types have risen sharply this recession (Figure 18). Nationally, healthy banks and community banks have had higher rates of small business lending growth since the financial crisis of 2008. One reason why community banks in Massachusetts have increased their small business lending more than have community banks nationally is that their prudent lending practices have resulted in lower levels of loan delinquencies and overall healthier banks, better able to meet the credit needs of small businesses.

Figure 18
Loan Delinquencies at Large Banks Remain High and Affect Ability to Lend



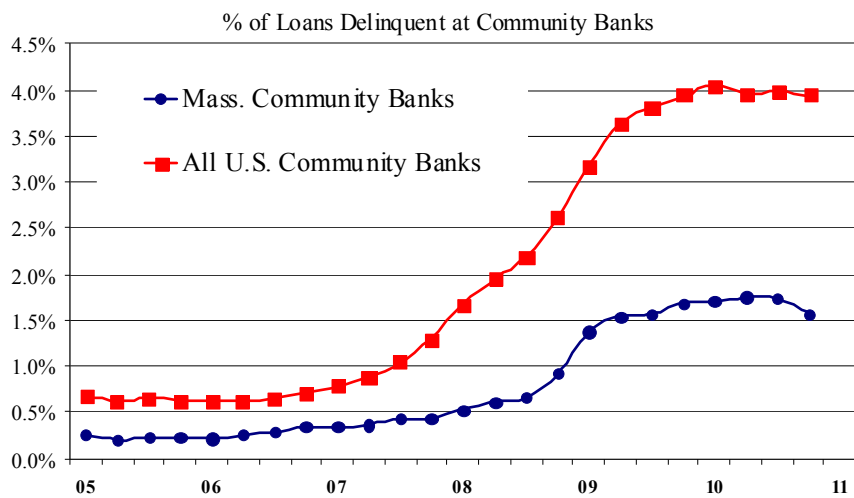
Source: FDIC, *Consolidated Reports of Condition and Income of Banks*

* Excludes some large banks that do not make small business loans and includes the following banks in Mass.: Bank of America, RBS Citizens Bank, TD Bank, and Sovereign Bank

Figure 19 shows that community banks in Massachusetts have much lower levels of delinquent loans than do comparably sized community banks across the country. Rising delinquencies have required banks in Massachusetts and elsewhere to increase their reserves against the possibility that more loans might default. This reduces the supply of funds banks have available to make loans. As Figure 20 shows, loan loss reserves increased sharply at large national and regional banks in response to rising loan delinquencies.

Figure 19

Massachusetts Community Banks are Healthier, on Average, than are Comparably Sized Community Banks Across the Country



Source: FDIC, *Consolidated Reports of Condition and Income of Banks*

The financial crisis also prompted efforts to increase the safety and soundness of the nation’s banking system. Regulations that increase capital requirements for banks can limit banks’ provision of credit. Higher capital ratios reduce bank leverage; banks must keep a higher percentage of core funds in reserve in relation to their assets (primarily loans). Banks can increase their capital ratios by raising core funds (primarily equity from investors) in which case lending may not fall. In a recession or weaker economy, however, raising bank capital from investors is difficult.

An alternative way for banks to increase their capital ratios (reduce their leverage) does not require banks to raise capital from investors. Bank capital ratios increase even if they do not raise capital when they reduce their assets (loans). In a weak economy, with banks experiencing rapidly increasing loan delinquencies, reducing assets is often the only certain way for a bank to increase its capital ratio. Thus while increasing the safety and soundness of financial institutions, higher capital ratio regulations can also result in a lower volume of lending. The degree to which higher capital ratios limit bank lending has been actively debated in recent years, but the debate is over the magnitude of the effect, not its existence. U.S. Treasury officials have argued that the impact of capital ratios is large, while a recent Federal Reserve Board of Governors’ study suggests more modest impacts on lending than found in some prior studies.²⁰

²⁰ Jose M. Berrospide, Rochelle M. Edge, “The Effects of Bank Capital on Lending: What Do We Know, and What Does it Mean?” *Federal Reserve Board of Governors Working Paper 2010-44*, August 2010.

Figure 20
**Loan Loss Reserves Have Increased Sharply at the Largest Banks
 (Reducing Supply of Funds for Loans)**

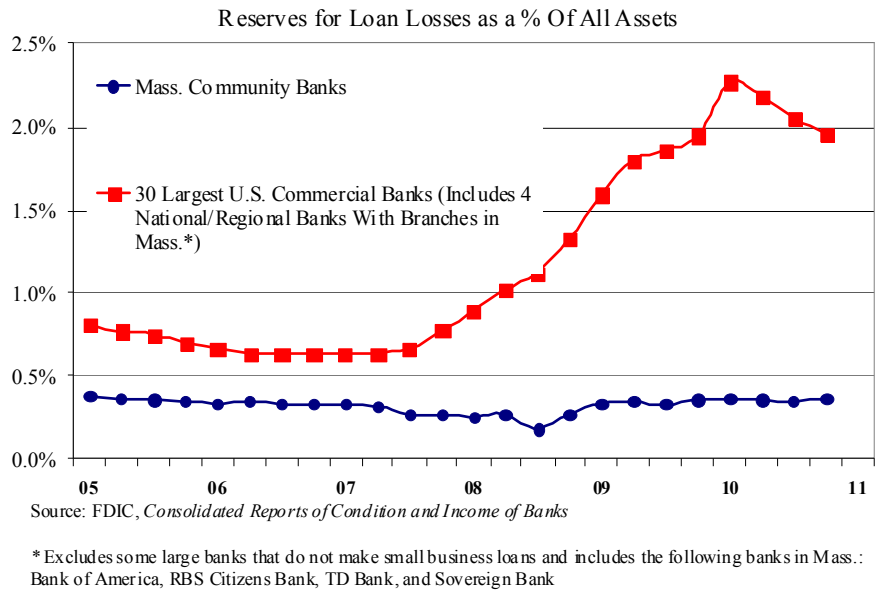
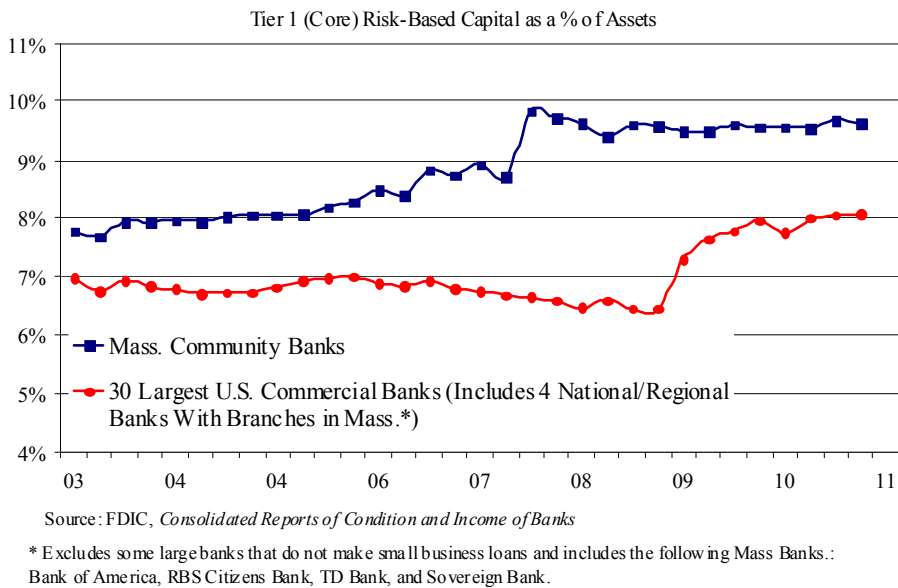


Figure 21 shows that the nation’s largest banks (including the four largest banks operating in Massachusetts) have increased their capital ratios since the financial crisis and recession, accounting for some of the decline in loan volume.

Figure 21
**Core Risk-Based Capital is Rising, Implying a Longer-Term
 Reduction in Growth in the Supply of Credit***



Finally, as documented in Section III (Figure 9) of this report, tax-exempt credit unions have gained small business lending market share in Massachusetts and their lending is not typically accounted for in assessment of the small business credit markets and, in particular, the competitive impact of their loans on the volume of small business lending by banks. Other supply factors related to small businesses' use of alternative sources of credit, including changes in payment terms and the increased use of personal resources are beyond the scope of this report, but have also had an impact of the volume of small business lending in Massachusetts.

In summary, from the analyses presented in this report, it is apparent that the supply of small business credit in Massachusetts is affected by many factors beyond the simple willingness or desire of banks to make small business loans. First and foremost among the factors is a lack of demand for loans from small business that have suffered with declining sales and limited expansion opportunities in recent years. Key factors affecting the supply of credit include: capital regulations and the need to reserve against higher loan losses; competition from tax-exempt credit unions; and an increase in the use by small businesses of alternative sources of funds.

VI. Implications for Public Policies to Increase Small Business Lending

In stable credit markets, the federal government's effort to facilitate small business lending relies chiefly on programs run by the SBA, with loan guarantee programs the dominant policy, along with a few direct lending programs. State level programs are generally much smaller in magnitude but are also a combination of guarantee, loan participation, and a few direct lending programs. For many reasons, including the small percentage of businesses affected by SBA programs and problems in the secondary market for SBA backed loans; these programs suffered declines in loan volume during this recession (but have since recovered) but nevertheless affect only a small percentage (less than 3%) of small business credit in Massachusetts and the nation.

The recently passed federal *Small Business Jobs and Credit Act of 2010* contains new initiatives to spur small business lending, including a \$30 billion bank capital infusion program designed to be more appealing to smaller banks. In addition, the Act provides resources to fund state-level capital access programs such as MassCAP program operated by the Massachusetts Business Development Corporation. Since the onset of the financial crisis and contraction in small business credit nationally, at least 13 states have enacted programs that mirror SBA loan guarantee programs or which establish direct lending programs to help reverse the widespread decline in credit available to small businesses. Most state programs are of a relatively small scale in relation to the decline in credit to small businesses they are designed to help offset.

The analyses presented in this report have several implications for public policies directed at influencing the market for small business credit, including:

- Most importantly, to the extent that the decline in small business credit is a result of declining demand rather than insufficient supply, any proposed policy initiatives are likely to be ineffective.
- Initiatives that rely on public and quasi-public organizations to fill any small business credit gaps must understand the limited capacity these organizations have to affect the larger market for small business credit.

- Initiatives to increase the supply of small business credit should involve the participation or rely upon the state's depository institutions to minimize start-up and administrative costs, as well as to allow any policy efforts to quickly achieve significant scale by making use of the lending infrastructure of the state's banks.
- A large increase in the SBA program in a short period of time, while benefiting many small businesses and lenders, would still not compensate for changes in the supply of small business credit from all private lenders in the state. SBA loan guarantees affect less than 3 percent of small business loans but a percentage of the loans made with SBA guarantees would have been made even without a guarantee. Thus the marginal increase in total small business credit in Massachusetts that would occur from even a doubling of the SBA program is likely to be only around 1 percent.
- Policies that seek to reduce the risk of lending, through loan guarantees, will increase the willingness of banks and others to lend, but in an era where banks face increasing regulatory scrutiny for risk taking, and when the public is growing wary of guarantees using public funds, the viability of this approach may be more limited.
- Any policy that seeks the participation of private sector lenders should look to create incentives that appeal most to the community banks that have the largest commitment to small business lending in their business models, rather than attempting to compensate for or reverse the decline in small business lending among groups of lenders which rely less on small business lending and who may face greater disincentives for small business lending.

Two additional factors are likely to affect policy choices:

- Given the current fiscal environment, additional state sources of funds for lending will be limited or non-existent.
- There will be little interest in increasing the size of any existing government agency.

Moving forward, this report documents the prominent role that a lack of demand for loans has played in the small business credit trends but Massachusetts policy makers may decide that supply issues are significant enough to warrant policy initiatives. If they do, the policy options available include:

- Increasing loan guarantee programs.
- Funding direct lending programs operated by state government, quasi-public lenders, or contracted for with private lenders.
- Reorganizing existing state programs and evaluating the roles of existing quasi-public agencies without adding resources. Adjusting and refining their mission to address niche lending markets that banks can't serve.
- Using federal *Small Business Jobs and Credit Act* funds to capitalize a lending consortium of private banks, managed by a public or quasi-public entity.
- Injecting capital into private lenders (using *Small Business Jobs and Credit Act* funds).
- Creating state level incentives for more bank small business lending, and working to remove any state or federal level disincentive for lending.

VII. Conclusions

Massachusetts lost almost 160,000 jobs during the recent recession but re-gained nearly one-third of those jobs during 2010. As difficult as the 2008-2009 recession was, the recession of 1990 and 1991 was more punishing for Massachusetts.²¹ The 1990-1991 recession was more severe in Massachusetts than was the recent recession, and more severe in Massachusetts than it was in the nation, because it was amplified by the effects of a larger financial crisis in New England that culminated in the failure of large and small banks throughout the region. The resulting disruption in credit markets dramatically deepened and prolonged Massachusetts' economic contraction into the early 1990s. In contrast, the recession that began in 2008 has had less affect on the banking industry in Massachusetts.

As the U.S. and Massachusetts economies hit bottom in 2009, the volume of small business lending in Massachusetts declined, but that decline was only about one-third the size of the decline in small business lending across the country. Moreover, Massachusetts' community banks increased their lending to small business in recent years, including during the recession. Massachusetts' healthier, more stable (than the U.S. as a whole) banking industry during this recession is one reason why Massachusetts suffered fewer economic and employment losses than occurred in a majority of states and why the state is recovering jobs at a faster rate than is the nation.

This report highlights several of the factors that have contributed to recent declines in small business loans in Massachusetts. Those factors include both lower demand for credit from many small businesses who disproportionately felt the effects of the 2008-2009 recession, as well as factors affecting the supply of credit, such as increased delinquencies and loan defaults at banks, the need for banks to reserve against losses, higher bank capital requirements, and increased regulatory scrutiny, each of which diminish the supply of loanable funds.

The greater progress toward economic recovery in Massachusetts compared to the U.S. would not have been possible in the absence of a healthy banking system, capable and willing to make credit available to small businesses. Although small business loan demand appears to be increasing, it is not yet where it stood prior to the recession. Policymakers, looking for ways to increase job growth in Massachusetts in 2011 should be mindful that policies directed at increasing the supply of small business loans will be ineffective as long as a lack of loan demand (or "effective demand") is a major contributor to declines in the volume of small business lending. Efforts to increase the "effective demand" for home purchase loans were a primary cause of the financial crisis that led to the nation's financial crisis in 2008.

To the extent that limitations in the supply of small business credit are impeding the Massachusetts economic recovery, this report highlights aspects of the structure of the small business credit market that can assist policy makers in the design of effective public policies to address the issue. Specifically, this report highlights some of the limits inherent in designing programs using quasi-public lenders to address any credit gaps. The analysis also suggests the

²¹ Massachusetts lost over 357,000 jobs during the 1990-91 recession, or about 11 percent of total employment; Massachusetts lost 157,000 jobs (peak-to-trough) during the 2008-2009 recession, or about 4.8 percent of all jobs.

importance of enlisting the private sector, especially small and medium sized banks because of the importance of small business lending to their business models, to fill any existing credit gaps.

Policymakers should also be wary of populist sentiments directed at banks that may directly or indirectly decrease the ability of banks to make loans and ultimately reduce the supply of small business credit in the Commonwealth. Nationally, some high-profile financial services companies have made well-publicized mistakes that have brought increased regulations and scrutiny. These actions may have an impact on a large majority of more prudent banks and their ability to provide needed credit to businesses and individuals in their communities. Understanding the factors affecting the volume of small business credit in Massachusetts is the first step toward sound policymaking.

Appendix A: Data, Methods, and Limitations

This report uses the FDIC and FFIEC standard designation of a small business loan as credit issued to businesses in an amount under \$1 million. This is a somewhat imprecise definition. While it does capture the fact that the loans made are small (by business standards), it does not provide information about the size of the borrowing businesses. Rather, it assumes that large businesses seek credit in larger amounts, an assumption that is true in the vast majority but not all cases.

To capture small business lending trends in Massachusetts among lending institutions of all types, our analysis uses annual Community Reinvestment Act (CRA) reports filed with the Federal Financial Institutions Examination Council (FFIEC) to supplement the quarterly *Consolidated Reports of Condition and Income of Banks* or “call report” filed by each bank with the Federal Deposit Insurance Corporation (FDIC). For our analysis of lending by credit unions we examined quarterly call reports filed by credit unions with the National Credit Union Administration. Prior to 2010, small business lending was reported only on a bank’s June, quarterly, call report. Concerns about the availability of data on small business lending have led federal regulators to now require that each quarterly call report filed by banks have data on small business lending. For smaller banks that lend primarily in one state, the latest small business lending data can be analyzed approximately two-months after the end of each quarter. But analyzing small business lending in Massachusetts by financial institutions that make loans throughout the nation or region (such as large commercial lenders, credit card companies, and national or regional banks) requires that banks report lending activity on a state-by-state basis. That reporting occurs annually in the Community Reinvestment Act filings required by banks with assets over \$1 billion.²² The most recent CRA small business lending data is for 2009, while quarterly call report data is available through June 2010. These two sources of small business lending data have differences but both are necessary to capture a more complete picture of small business lending than is offered by either individually.

Our approach offers a number of advantages over other lending reports which examine a single (typically CRA) source of data to glean lending trends. CRA reporting covers only a small percentage of Massachusetts banks (albeit all large banks) and can miss important recent trends among community banks. In addition, CRA data is affected by changes in the number of banks reporting, making it difficult to interpret trends and separate changes in lending behavior from changes in the composition of reporting banks. Our approach to CRA data is to keep constant the banks in each category of lender to allow for more accurate trend interpretation. On a national basis CRA data covers only about two-thirds of the small business lending in the nation but varies significantly by state. We take the same approach with bank call report data, adjusting the data to reflect changes in ownership, mergers, acquisitions and other factors that could affect trends in the number and dollar volume of loans over time. CRA reports require large banks and multi-state and national lenders to report on their lending activity at the state and county level (others may report voluntarily), allowing analysts to isolate the lending activity in Massachusetts of large, multi-state, regional, and national lenders. In combination, the CRA and June quarterly call

²² The threshold for reporting is adjusted annually. In 2008 it was \$1.061 billion. In 2009 it was \$1.109 billion and in 2010 it is \$1.098 billion.

reports provide a more complete picture of small business lending trends in a state but limitations remain.

One limitation in the data is that because more and better data exist on the supply of small business credit than on the demand for credit, changes in supply present an incomplete picture of the small business credit market. The Federal Financial Institutions Examinations Council, with whom CRA reports are filed, specifically warns against interpreting CRA lending data in the absence of evidence of the demand for loans in any geographic area.²³ Lack of data may account for why perspectives on credit availability differ among potential borrowers, lenders, and analysts according to the U.S. administrator of Small Business Administration. Anecdotal evidence on the demand for credit is not a substitute for empirical data.

The second limitation is that the CRA reports that are required for assessing the lending patterns of larger banks that make loans across the nation or a region are reported with a significant lag and the most recent data is for 2009. Thus we do not have the latest trends in lending among large banks as the economy has begun to recover.

In total, data limitations suggest that the estimates of changes in the supply of loans produced in this and other reports on credit markets should be viewed as an accurate assessment of the direction of change in credit in a region, with somewhat less accuracy in estimates of the specific dollar volume of change.

²³ According to the Federal Financial Institutions Examinations Council: “Interpreting the CRA data can be challenging.” Although CRA data provides information on extensions of credit in a geographic area, they do not indicate the amount or nature of the overall demand for credit in that area. Consequently, caution should be used in drawing conclusions from analyses using only CRA data, as differences in local loan volume may reflect differences in local demand.”