Small Business Finance and Personal Assets

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Introduction

Small business owners have historically relied on personal assets as an important source of support for their enterprises — from the aspiring restaurant owner relying on personal savings to the toy distributor using a line of credit secured by her home. However, the recent bursting of the credit bubble has led to a plunge in values across most asset categories. Consider the following: according to the Case Schiller Index, national housing values have dropped 32% from their peak in 2006 to the first quarter of 2009; the Dow Jones Index has dropped 29% in value since its peak of 14,093 points the week of October 8, 2007. This loss of personal wealth has affected small business owners who rely on their assets to support their enterprises. At a time when many potentially viable businesses are in dire need of credit to keep their struggling businesses alive, owners have fewer personal assets to leverage. These problems are compounded for business owners facing home foreclosures. In this article, I will discuss how small business owners have historically relied on personal assets for credit and how current economic challenges may affect these borrowing patterns. In addition, I will discuss the possible implications for business owners and providers of credit.

The Need for Healthy Small Businesses

Maintaining healthy small businesses is often cited as an important element to the economic recovery because of their considerable contributions to the overall economy. Small businesses employ more than half of private sector workers and have generated well over half of net new jobs annually over the past decade. They have created more than half of non-farm business gross domestic product. A vibrant small business development strategy is usually an integral part of larger community development strategies within low- and moderate-income (LMI) communities because of the vital local jobs these firms create and the essential products and services they provide to their local communities. Recognizing their importance, the Administration recently reduced fees and increased guaranty levels of the Small Business Administration's (SBA) loan programs to increase access to credit and to encourage small business economic activity. These measures have recently begun to demonstrate improved credit flow to small businesses through the SBA programs. As of August 2009, the monthly SBA loan approval rate of $1.37 billion is now closer to the FY08 monthly average of $1.5 billion.[1]

Credit Supply and Demand Both Impacted

In spite of this progress, the supply of credit still remains restricted. According to the July 2009 Federal Reserve Board's Senior Loan Officer Survey, banks have slightly tightened (35.2% of all banks) or maintained their previously tightened lending standards (61.1% of all banks).[2] A large percentage (60.4%) of small business owners report using some type of credit to finance their firms[3], and for those who are now seeking credit, they may need to make adjustments. One method for small business owners seeking credit in a more difficult lending environment is to provide credit enhancements namely in the form of personal commitments, which are personal guarantees or pledges of personal collateral such as stocks or real estate. This personal pledge provides lenders additional assurances against risk of loss in the event that the borrower is unable to repay his loan.

Generally, knowing how and when small business owners use personal assets is challenging due to the very limited small business data sources available. Although slightly dated, an informative research paper by Avery,

Bostic and Samolyk, "The Role of Personal Wealth in Small Business Finance,"[4] provides one of the most detailed studies on this topic using data from the Federal Reserve's National Survey of Small Business Finance (NSSBF) and the Survey of Consumer Finance (SCF). The study concludes, "The role of personal wealth in small business financing certainly appears to be significant" and "for firms that rely heavily on loan financing, the use of personal commitments appears to be very important, if not vital."[5] Indeed, loans having a personal guarantee comprise 40.9% of all loans and account for 55.5% of small business credit dollars.[6]

The type of firm also seems to influence the type of commitment it makes. Corporations (i.e. "C" or "S" corporations) are more likely than unincorporated firms to be associated with guarantees, while unincorporated firms (e.g. – sole proprietorships) are more likely to use personal collateral.[7] Generally speaking, sole proprietorships have an implicit personal guarantee due to the way they are organized, which may explain their greater use of personal collateral pledges. For unincorporated firms (e.g. sole proprietorships) the reduction in value of personal assets could have a more dampening effect on their ability to access credit. For very small businesses or micro-businesses in LMI areas, difficulty in accessing credit may be even more difficult as loans have been historically more difficult to obtain in economically distressed communities. In a forum sponsored by the Federal Reserve Bank of San Francisco and the Asian Pacific Islander Small Business Program, some bank lenders had reported reducing the amount of their extended lines of credit as a result of lowered appraisal values on personal homes that secured these small business loans. For other businesses that borrowed directly through a home equity line of credit, notably immigrant micro-businesses, a similar reduction in credit resulted as home values were reassessed.[8]

Further, the Avery, Bostic and Samolyk study finds strong evidence of the pledge of personal guarantees in the use of lines of credit: personal guarantee incidence is twice that of personal collateral among unincorporated firms (39.6% versus 17.9%) and four times that of collateral among corporations (65.5% versus 16.0%).[9] If lines of credit have become relatively more difficult to obtain because of reduced asset values, then an important cash flow management tool may be less accessible for the small business. Like credit cards for individuals, one way small business owners use their lines of credit is to manage the mismatch in timing of cash flow between revenues and expenses. Used this way, lines of credit augment a firm's working capital. However, when owners face credit restrictions on their lines of credit, they lose cash flow flexibility and would likely have to manage their expenses more tightly. Owners who then must manage cash more conservatively are more likely to pull back on their overall use of credit as business confidence wanes and concerns about being overextended on credit become greater. Indeed, the most recent Senior Loan Officer Opinion Survey cited lower business loan demand as one of the most important factors in the reduction of lending activity. Interestingly, lower small business loan demand has also paralleled the recent reduction in demand for consumer credit.

For those business owners who have pledged personal commitments and unfortunately succumb to economic pressures and fail, the loss can have an amplifying effect on their personal finances. For those owners who lack sufficient resources to satisfy their credit obligations, they may need to rely on personal resources to fulfill their credit obligations. In these cases, the owner would likely benefit from professional legal or accounting counsel to minimize the loss of personal assets. Many LMI business owners may have their personal finances co-mingled with their business finances, which makes the unwinding of the business more difficult, and possibly more painful. In more extreme cases, the fear of significant loss or uncertainty has led some of these borrowers to flee their creditors. While this is anecdotal, lenders and small business technical assistance providers have promoted the importance of contacting a delinquent borrower early to minimize losses on both sides of the credit transaction.

Conclusion

Personal assets are often closely tied to the ability of small business owners to access credit, making them an important factor in the financing of small businesses. The relationship between personal assets and small business financing has presented particular challenges during this economic downturn. On one hand, the pledging of personal commitments can help banks mitigate against greater risk associated with the economic downturn. On the other hand, the drop in asset values as a result of the recession makes it more difficult for small business owners to pledge personal commitments. The net result may be that on the supply side, access to credit is further constrained for small businesses because of this dynamic. On the demand side, a small business owner will be reluctant to pledge his own assets or provide a personal guarantee if he has a pessimistic outlook for his business or the economy. Fundamentally and not surprisingly, to increase credit supply and demand, asset values and business prospects need to improve. Commendable efforts have been made by the Administration through the SBA enhancements to improve access to credit supply. Addressing the demand side for credit by businesses will be the larger challenge as there are fewer "government levers" to affect this part of the economy. CI

Endnotes

Strength in Adversity: Community Capital Faces Up to the Economic Crisis

1. This article is a condensed excerpt of a Community Development Investment Center Working Paper, entitled "The Economic Crisis and Community Development Finance: An Industry Assessment." For the full article by Nancy Andrews, see http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf
2. Among the eleven interviews, six were with national or large regional CDFIs; two were rural CDFIs; and three were small and locally targeted CDFIs. Two were in the Midwest, three were headquartered on the West Coast, and six were headquartered on the East Coast.

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2. Board of Governors of the Federal Reserve System, "Senior Loan Officer Opinion Survey on Bank Lending Practices, July 2009.
3. Board of Governors of the Federal Reserve System, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finance," October 2006.
4. Robert B. Avery, Raphael W. Bostic, Katherine A. Samolyk, "The Role of Personal Wealth in Small Business Finance," *Journal of Banking and Finance*, 1998.
5. Avery, Bostic, Samolyk, p. 1052.
6. Ibid, p. 1052
7. Ibid, p. 1059
8. Federal Reserve Bank of San Francisco, "Proceedings From the Impact of the Mortgage Crisis on Asian Small Businesses," July 1, 2008.
9. Ibid, p. 1045.

Strengthening the Low Income Housing Tax Credit Investment Market

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2. Source: National Council of State Housing Agencies
3. Ernst & Young, "Understanding the Dynamics IV: Housing Tax Credit Investment Performance," (2007), p. 49.

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2. David J. Erickson (2009). *The Housing Policy Revolution: Networks and Neighborhoods.* Washington, D.C.: The Urban Institute; Lester Salamon (1994). "The Rise of the Nonprofit Sector," *Foreign Affairs,* Jul/Aug, Vol. 73, Issue 4.
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5. Ibid.
6. Naomi Cytron (2009). "The Enduring Challenge of Concentrated Poverty in America: Case Study of Fresno, California," Federal Reserve Bank of San Francisco Community Development Working Paper 2009-04.
7. This article draws heavily from the special edition of *The Nonprofit Quarterly entitled Strange Accounts: Understanding Nonprofit Finance,* published in 2005.
8. Clara Miller (2005). "The Looking-Glass World of Nonprofit Money: Managing in For-Profits' Shadow Universe," Strange Accounts: Understanding Nonprofit Finance, Compiled articles from *The Nonprofit Quarterly,* pp. 5 – 14.
9. Gregory A. Ratliff and Kirsten S. Moy (2004). " New Pathways to Scale for Community Development Finance," The Federal Reserve Bank of Chicago, *Profitwise News and Views,* December 2004.
10. For more information on the Nonprofit Overhead Cost Study and its data and publications, visit http://nccsdataweb.urban.org/FAQ/index.php?category=40.
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12. Ibid.
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Peer-to-Peer Lending and Community Development Finance

1. This article is a condensed version of the working paper entitled "Peer to Peer Lending and Community Development Finance." The full article can be downloaded from http://www.frbsf.org/publications/community/wpapers/2009/wp2009-06.pdf
2. Interview with Prosper CEO Chris Larsen on July 23, 2009. Source: Celent, a research and consulting firm focused on the application of information technology in the global financial services industry.
3. Laura Choi, "Creating a Marketplace: Information Exchange and the Secondary Market for Community Development Loans." Federal Reserve Bank of San Francisco's Working Paper Series: 2007–01. Available at http://www.frbsf.org/publications/community/wpapers/2007/wp07-01.pdf.
4. Nancy Andrews, "The Economic Crisis and Community Development Finance: An Industry Assessment," Federal Reserve Bank of San Francisco Working Paper Series, June 2009. Available at http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf.
5. To date, only one platform, MicroPlace, has been granted approval from the Securities and Exchange Commission (SEC) to sell third-party-issued securities to multiple individual investors on its site without triggering a suitability requirement. While this is a key regulatory achievement, it is important to note that securities sold on MicroPlace are backed by their issuer—not the lender or the end borrower. The SEC has yet to allow any P2P finance platforms to sell third-party issued securities backed by assets (loans) online.
6. Low Income Investment Fund Frequently Asked Questions, available at http://www.liifund.org/ABOUTLIIF/FAQ.htm#averageLoanSize.
7. Interview with Chris Larsen on July 17, 2009.
8. Opportunity Finance Network's CARS website available at http://www.opportunityfinance.net/financing/finance_sub4.aspx?id=56.