The SUPPORT CENTER

Your Partner in Small Business Growth

SMALL BUSINESS LENDING IN NORTH CAROLINA:

The Increasing Role of Community Lenders

May 2012

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Executive Summary

Accessing capital is increasingly difficult for small businesses, particularly very small firms in underserved communities in North Carolina. As job creators and drivers of local economic development, it is vital that small businesses are able to secure the resources they need to grow and thrive. In this tightening market, while banks have been receding from small business lending, other lenders are working to fill this gap. Community Development Financial Institutions (CDFIs), Community Development Credit Unions (CDCUs), and credit unions provide affordable, specialized financial services and small business loans in low- and moderate-income areas of the state. As a source of capital for many small businesses, these much smaller, local financial institutions are playing an increasingly important role in sustaining local economies. However, to meet the demand for affordable capital, they will require additional public and private support—in the form of investments, policy, and grants.

This study examines the small business lending patterns of credit unions, CDCUs, CDFIs, commercial banks, and savings institutions, highlighting the unique role that these alternative lenders play in low- and moderate-income communities. As such, it argues for increased resources for CDCUs, CDFIs, and credit unions to expand their small business lending capacity and reach more potential borrowers in underserved markets.

Key Findings

- Small businesses create jobs. Between 2005 and 2008, small businesses created 80 percent of the net new private sector jobs in North Carolina.
- Accessing capital is becoming increasingly difficult, particularly for very small businesses. Sixty-one percent of entrepreneurs surveyed report that it is harder to get loans today that it was a few years ago.
- Large banks have been pulling back from small business lending. The total outstanding small business loans among the largest banks fell by 1.2 percent, or $7.2 billion, between June and September of 2011.
- In North Carolina, small business lending by large banks is concentrated in upper- and middle-income areas. In looking at the lending volume at the census tract level, the amount of investment by large banks in upper income tracts is 250 percent greater than in lower income tracts.
- In contrast, CDFIs in North Carolina place a greater emphasis on low-income areas. The volume of small business loans per low-income census tracts for CDFIs is 40 percent greater than it is in upper-income census tracts. In regard to volume, CDFIs focus a greater share of their lending resources on low-and moderate-income tracts, as compared to large banks—26 percent, compared to 16 percent, respectively.
- CDFIs, CDCUs, and credit unions also focus on very small loans. The average loan size is $68,500 for CDCUs, $135,300 for credit unions as a whole, and $101,700 for CDFIs. For CDFIs, 72 percent of all their business loans are under $100,000, and 87 percent are under $1 million.
- CDFIs, CDCUs, and credit unions are able to lend to a borrowers who are unable to access financing from mainstream banks. They can evaluate borrowers on a broader range of criteria offer lower rates and fees, and provide localized service and personal connections. CDCUs, in particular, specifically target their services to the underserved, including low-income families and individuals.
- However, these community-based lenders are very small and need both public and private investments, policy support, and grants to reach these underserved borrowers.

Introduction

With job creation and economic development a top priority at the federal and state level, providing support to small businesses as engines of economic growth is an important policy objective. In North Carolina, small businesses play a significant role in the state and local economies, making up the majority of employer firms in the state (96 percent). Firms with less than 20 employees are particularly significant, accounting for 87 percent of all employer firms.[1] Between 2005 and 2008, small businesses with fewer than 100 employees created 80 percent of net new private sector jobs.[2]

However, small businesses cannot continue to generate jobs, revenue, and income in the state if their avenues for starting up and growing are limited. While larger banks provide the vast majority of capital to small businesses, borrowers in low- and moderate-income parts of the state face significant barriers to accessing it. Tighter bank standards, financial management troubles, and problematic credit histories prevent many small entrepreneurs from accessing financing from mainstream or traditional banks. Many smaller lenders and institutions, such as credit unions, Community Development Credit Unions (CDCUs), and Community Development Financial Institutions (CDFIs), are working to fill the lending gap with products designed and targeted specifically for those in underserved areas.

CDCUs, CDFIs, and credit unions are comparatively much smaller institutions than mainstream banks and will require additional public and private support in order for them to expand their capacity for small business lending. Investments can help expand and enhance the portfolios of these institutions, allowing them to increase their lending. Key policy changes can lift restrictions on credit unions' lending activities and create a more effective regulatory environment for small business lending. Finally, grants can provide the operational support needed to maintain branches, provide financial education and training, and expand their internal capacity.

This report provides an overview of the small business lending occurring in North Carolina by different size and type of financial institutions, highlighting the different roles they play in the overall landscape of small business lending. Specifically, this analysis examines commercial banks, savings institutions, credit unions, CDCUs, and CDFIs.

Financial Institutions Defined

Commercial Banks are traditional banks that provide savings and checking accounts, commercial and consumer loans, credit cards, and other services. They are regulated by the Office of the Comptroller of Currency, the Federal Reserve, and the Office of Thrift Supervision. Deposits of up to $250,000 are insured by the Federal Deposit Insurance Corporation. **Savings Institutions** are similar to commercial banks, but have a focus on real estate development.

Credit Unions are member owned, cooperative, non-profit institutions that provide financial services, including savings and checking accounts and consumer and business loans. They can offer members lower rates for financing and lower fees for services. They are regulated by the National Credit Union Association. Deposits up to $250,000 are insured through the National Credit Union Share Insurance Fund. Credit unions are often driven by the mission to serve communities by providing more affordable financial services. There are 95 credit unions in North Carolina.

Community Development Credit Unions have the express purpose of serving low-income and minority communities. CDCUs provide financial services and literacy to communities that are not served by mainstream financial institutions. CDCUs are also member owned, non-profit cooperatives. They are chartered and regulated by the NCUA. There are six CDCUs in North Carolina.

Community Development Financial Institutions are designated by the U.S. Department of Treasury Community Development Financial Institutions Fund, established to promote revitalization and community development in underserved communities. Their mission is to expand access to capital and financial services to low-income urban and rural communities. A range of institutions can be designated as CDFIs, including CDCUs, community development banks, community development loan funds, community development venture capital funds, microenterprise funds, and community development corporations. There are 21 CDFIs in North Carolina.

[1] U.S. Census Bureau, Statistics of U.S. Businesses, 2009.
[2] U.S. Small Business Administration, Office of Advocacy. North Carolina Small Business Profile, January 2012.

Overview of Small Business Lending

In North Carolina, commercial banks with the largest asset size are responsible for the vast majority of small business lending.[3] As charts 1 and 2 illustrate, 93 percent of loans under $100,000 and 97 percent of loans under $1 million are issued by commercial banks with assets of $1 billion or more. In terms of numbers, this translates to 99 percent of all loans under $100,000 and 99 percent of all loans less than $1 million.

Chart 1. Sum of Loans with Original Amounts Less than $100,000 (in thousands)

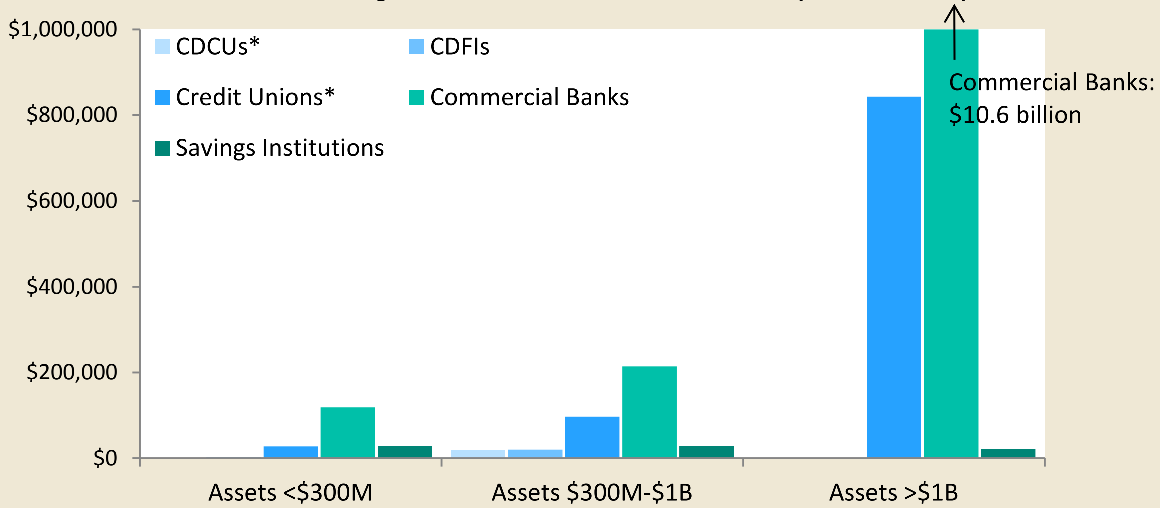
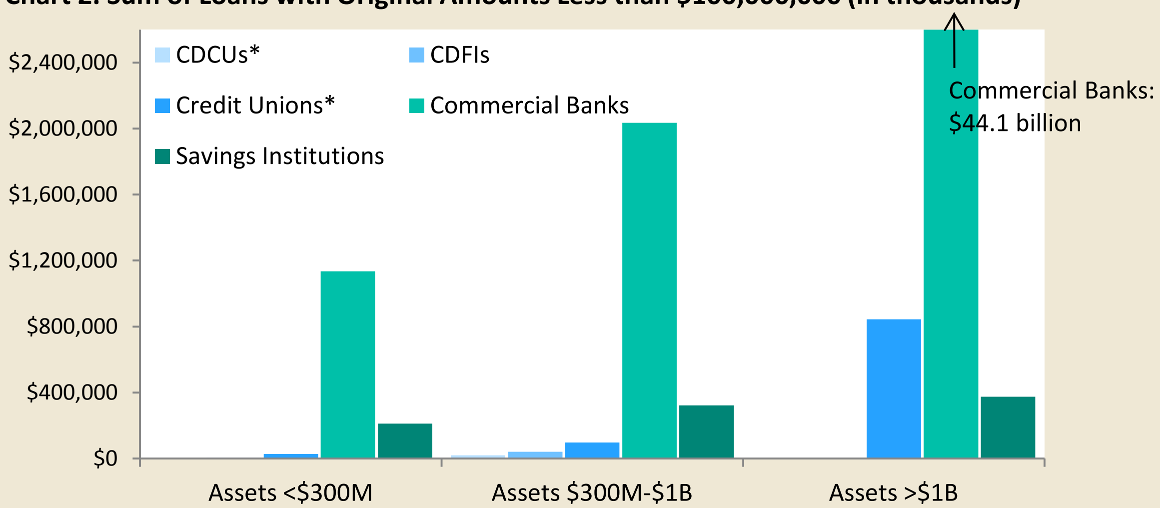


Chart 2. Sum of Loans with Original Amounts Less than $100,000,000 (in thousands)



Sources for Charts 1 & 2:

Federal Deposit Insurance Corporation. Statistics on Depository Institutions. December 2011.
National Credit Union Administration. 5300 Call Report Quarterly Data. December 2011.
CDFI Fund, Community Investment Impact System Program Data, 2010.

*Credit union and CDCU data is for all member business loans (of all sizes) and Small Business Administration Loans.

[3] This data includes lending for small agricultural-related businesses for Commercial Banks, Savings Institutions, Credit Unions, and CDCUs. Agricultural lending data is not available for CDFIs.

This trend is mirrored at the national level, fueled by increased consolidation of banks in recent decades. Between 2004 and 2008, the number of very small banks, with assets less than $500 million, fell 9.2 percent nationally, while the number of very large banks, with $50 billion or more in assets, increased by a third.[4] Because many small firms have credit problems or weak track records, they rely on personal relationships with lenders to secure financing. As banks consolidate, decision-making capacities become centralized, which increases loan officers' reliance on assessments of borrowers based on standardized criteria, rather than more qualitative evaluations. This makes it more difficult for small businesses to obtain a loan.[5]

However, while the volume of small business lending has shifted to larger banks, the share of small business loans in these banks' portfolios has declined. As the Small Business Administration reports, "Lending to small businesses increased steadily in both value and number from 1995 to 2007 except for the smallest loans, which increased extremely rapidly. Nevertheless, the small business loan share of banks' loan and asset portfolios has declined steadily, especially in the smallest loan size category."[6] The share of small business loans held by smaller institutions has at the same time decreased. What this means is that the role of small business lending has shifted to larger financial institutions, while overall fewer small businesses are accessing these loans. According to the Small Business Administration, total outstanding small business loans among the largest banks fell by 1.2% between June and September of 2011, roughly $7.2 billion in just one quarter.[7]

In addition to the loss of local banks on the national level, stricter lending standards have also made it more difficult for small businesses to access capital. The economic conditions brought on by the Great Recession caused mainstream banks to tighten their lending standards, making it even more difficult for smaller businesses—especially those with credit history problems or limited financial management skills—to meet the qualifications. In a survey of small businesses in 2011, the National Federation of Independent Businesses found that while the demand for credit increased (in this case, including credit cards and lines of credit), the number of rejections also increased, indicating that fewer small businesses were able to access the credit they needed.[8] Furthermore, 90 percent of business owners surveyed by the American Sustainable Business Council saw access to capital as a major problem, and 61% of these business owners reported that it is harder to get loans today

Small Business in Focus:

James Heckstall, Family Farm in Bertie County

James Heckstall has a long standing relationship with credit unions, which began in the fifth grade when we was introduced to St. Luke's Credit Union (now Generations Community Credit Union) and started saving five cents every week. In the late 1970s, Mr. Heckstall had the opportunity to purchase his grandfather's land, a family farm of 160 acres. While many small and minority farmers have difficulty obtaining loans to either purchase land or expand their existing farms, Mr. Heckstall was able to obtain a loan from the credit union to purchase his grandfather's land. In 2007, Mr. Heckstall began farming full time, growing corn, soybean and peanuts and reserving 100 acres for timber.

[4] Small Business Administration, "Small Business in Focus: Finance." July 2009. Pg 25.
[5] U.S. Department of Treasury, CDFI Fund. "The Relationship Between CDFIs and Conventional Leaders in Finance." October 2009. Pg 4.
[6] Small Business Administration, "Small Business In Focus: Finance." July 2009. Pg 14.
[7] Williams, Victoria. "Small Business Lending: Third Quarter 2011." Small Business Administration. December 28, 2011. http://www.sba.gov/sites/default/files/SBL_2011Q3.pdf
[8] National Federation of Independent Businesses. "Small Business, Credit Access, and a Lingering Recession." January 2012. Pg. 2.

than it was a few years ago.[9] It should also be noted that in this environment, many business owners have turned to small business credit cards, yet these do not include the same protections as consumer credit cards.

The Small Business Administration defines small businesses as those with fewer than 500 employees, but the challenges are even more formidable for *very* small firms, such as those with fewer than 20 employees. In addition to credit impairments, these businesses often do not have enough of their own equity—either personal or business, in the form of retained earnings or available cash—to invest into the business, which is a common stipulation for receiving a business loan. Many banks will also require collateral against the loan, such as business equipment, business real estate, personal real estate, or inventory. Very small businesses struggle to meet this requirement, particularly when they need the loan to build their business in order to then have the equipment or inventory to use as collateral. Banks are especially wary of lending to small start-ups that do not yet have track records or revenues to show. With limited access to alternative sources of affordable financing, these very small businesses end up relying on their personal networks (friends and family) for the funds they need. But, with the recession and consequent loss of wealth among households, the capacity of personal networks has diminished in recent years.

The financial sector in North Carolina has not experienced such widespread bank mergers and consolidations as the nation, and many smaller community-based and local banks are still in operation. Nevertheless, accessing capital remains a challenge for small businesses in the state. A closer examination of the types of loans made by different financial institutions in the state shows that there are significant gaps where the larger commercial banks are not investing in small businesses, particularly in low- and moderate-income areas of the state.

Small Business Lending Gap & the Role of Community-Based Lenders

The wide-angle view of small business lending can obscure the disparities that exist between low-income and upper-income areas of the state. To accurately assess the gaps in small business lending, it is necessary to look at the census tract level, as even the county level can conceal important differences in lending patterns. Table 1 details the spread of small business lending (loans under $100,000) by large banks (those with assets above $1.098 billion) in the census tracts that loans were originated in, by the income level of those census tracts.[10] This table includes only those census tracts where the banks made loans. The volume of small business loans by large banks is concentrated in middle and upper income census tracts. In looking at the volume per census tract, the amount of investment in upper income tracts is 250 percent greater than in lower income tracts.

Table 1. Large Bank Small Business Lending by Income Levels in Census Tracts

Income Group	Number of Census Tracts	Percent of Lending Volume	Volume of Lending Per Tract
Low-Income	66	1.9%	$406,182
Moderate-Income	315	14.0%	$602,841
Middle-Income	888	56.6%	$907,419
Upper-Income	276	27.5%	$1,420,319

Source: Federal financial Institutions Examination Council. CRA Aggregate Data. 2010.

[9] American Sustainable Business Council. "Opinion Survey: Small Business Owner Opinions on Access to Credit and Proposals to Boos the Economy." January 26, 2012. http://asbcouncil.org/sites/default/files/files/Access_to_Credit_and_American_Jobs_Act_Poll_Report_FINAL.pdf
[10] This includes only small business loans, not farm or agriculture-related loans. This analysis is limited to the loans for which census tracts and income level were reported.

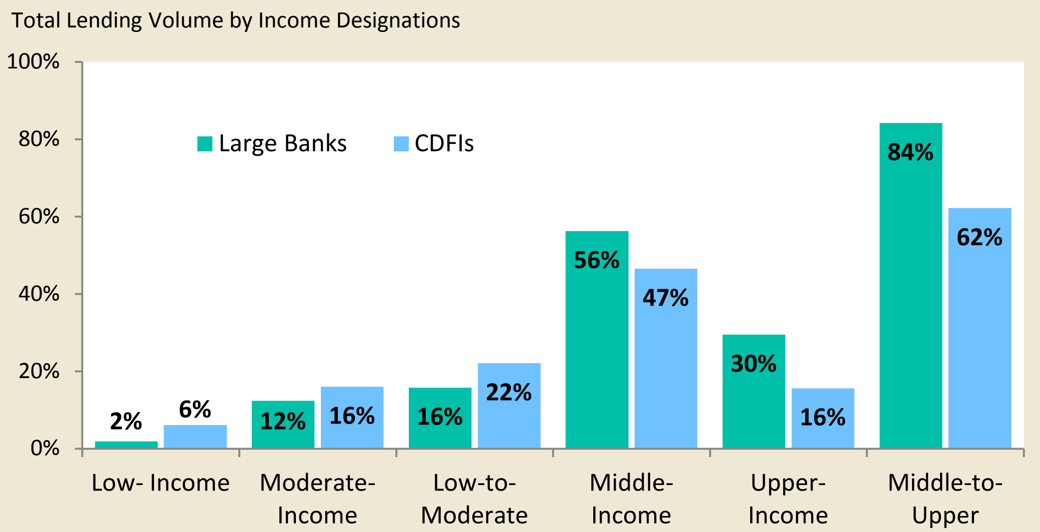
By contrast, small business loans (under $100,000) made by CDFIs (table 2) show a greater relative investment in low- and moderate-income census tracts (again, looking only at the census tracts where CDFIs made small business loans). Although the amounts are far less than the large banks, these data illustrate that CDFIs have a specific focus on meeting the capital needs of borrowers in low- and moderate-income parts of the state, as dictated by their mission. The investment level per low-income census tracts by CDFIs is actually 44 percent greater than it is in upper-income census tracts. In regard to volume, CDFIs focus a greater share of their lending resources on low-and moderate-income tracts, as compared to large banks—22 percent, compared to 16 percent, respectively (see chart 3).

Table 2. CDFI Small Business Lending by Income Levels in Census Tracts

Income Group	Number of Census Tracts	Percent of Lending Volume	Volume of Lending Per Tract
Low-Income	16	6.1%	$87,244
Moderate-Income	71	16.0%	$52,037
Middle-Income	203	46.5%	$52,810
Upper-Income	74	15.6%	$48,689

Source: CDFI Fund, Community Investment Impact System Program Data, 2010.

Chart 3. Percent of Lending Volume to Census Tracts by CDFIs and Large Banks



Sources: Federal financial Institutions Examination Council. CRA Aggregate Data. 2010.
CDFI Fund, Community Investment Impact System Program Data, 2010.

Project-level data is not available for credit unions in order to assess their lending patterns among census tracts of various income levels. As member owned and non-profit institutions, credit unions can offer lower rates and fees, as well as providing localized service and personal connections, which make their products easier to access for small businesses. In particular, CDCUs, as mission-driven institutions, specifically target their services to the underserved, including low-income families and individuals.

On average, the loans made by CDCUs, CDFIs, and credit unions are very small. Taking their entire loan portfolio, the average loan size for CDCUs in North Carolina is $68,500, while for credit unions as a whole the average loan is about $135,300. For CDFIs, the average loan size is $101,700. In fact for CDFIs, 72 percent of all their business loans are under $100,000, and 87 percent are under $1 million. Through these loans, CDCUs, CDFIs, and credit unions are meeting a specific need for very small loans.

CDFIs, credit unions, and CDCUs can evaluate borrowers on a broader range of criteria to expand access to credit for those businesses that are unable to get loans from banks. For example, CDFIs can be more willing to lend to start-ups if the business owner has management experience or previous industry experience. Programs such as The Support Center's Small Business Development Loan Program, supported by state funding, help CDCUs make small business purpose loans to business owners who may not have enough collateral. The funds are deposited into the CDCUs to serve as a guarantee against those loans. Finally, CDFIs and CDCUs can extend opportunities for financing by providing training and education to increase business owners' financial and business management skills, making them stronger businesses and more credit-worthy in the long-run.

Building Capacity for North Carolina's CDCUs and CDFIs

Given these gaps in lending, it is important for the state's financial sector to be diverse, flexible, and be able to meet the broad range of business' capital needs. Particularly in this economic context, the state needs to use all avenues for supporting job creation and economic development—especially in the most underserved communities. Smaller, local financial institutions, which are becoming an increasingly important source of capital for many small businesses, are a key player in North Carolina's local economies. As reported in the NFIB survey, even though only a small number of businesses rely on credit unions for capital, that number had more than doubled (from 3 percent to 7 percent) between 2009 to 2011.[11] Support in the form of investments, policy, and grants can enable CDCUs and CDFIs to expand their lending capacity, reach more potential borrowers in underserved markets, and get more North Carolinians to work.

Investments

Investments in CDCUs can be made in a few ways. Deposits would enhance CDCUs' portfolios, allowing them additional capital to then lend out to small businesses in the low- and moderate-income areas that they serve.

Small Business in Focus:
Jackie Green, Sweet Cheeks Bakery

Jackie Green had been operating her bakery business out of her home, using her conventional oven. As her business grew, orders increased—especially after she secured contracts from Whole Foods and Ben & Jerry's. Ms. Green needed to purchase a commercial oven to keep up with her orders, but was turned down by her bank. She was introduced to Generations Community Credit Union, which was able to provide her a $40,000 loan to finance the new commercial oven to expand Sweet Cheeks Bakery.

[11] NFIB, Pg 11.

Secondary capital, or a subordinated loan to a CDCU, can increase the net worth of a CDCU, which would also allow the CDCU to increase its lending activity. Unlike a deposit, secondary capital can be counted as assets toward meeting the minimum requirement for a credit union to participate in lending. Both deposits and investments will ultimately increase CDCUs' portfolios and allow them to leverage more funds for lending to small businesses.

Policy

CDCUs and CDFIs impact their local communities by strengthening the core of local small businesses, increasing community wealth, and creating jobs. State and local policy is instrumental in creating a supportive environment for CDCUs, CDFIs, and the individuals and businesses they serve to grow and thrive. Currently, CDCUs, like all credit unions, can only make business loans of up to $50,000 without gaining approval from the National Credit Union Association (NCUA). This hampers the efficacy of CDCUs' small business lending. In addition, credit unions are currently only able to loan up to 12.25 percent of their total assets, which also constrains the amount of lending credit unions can do. Lifting the $50,000 maximum would enable credit unions to more quickly and efficiently make more small business loans, and increasing the 12.25 percent cap would allow credit unions to increase their business lending volume.

Policy can also help to increase the presence of CDCUs and CDFIs throughout the state. Although CDCUs fall under the same regulations as credit unions, they have specific needs, challenges, and advantages—as do the communities they serve. Working together with CDCUs and CDFIs, state and local policy can be shaped to best meet these needs and help remove impediments to the growth of this vital segment of the financial services sector. With proper incentives, more credit unions would seek low-income or CDCU status, thus expanding access to financial services to more underserved communities.

Grants

Operating capital is vital for CDCUs and CDFIs to grow and expand their reach. CDCUs and CDFIs provide financial education and training and engage in outreach and marketing to gain new members. In addition, to move increased lending capital requires internal capacity, in the form of tellers, loan officers, support staff, and branch locations. Grants to CDCUs and CDFIs would support these necessary operations, giving the institution the adequate internal capacity to move their financial services and products out into the community.

Conclusion

Small businesses play a key role in North Carolina's economy. As job creators and generators of economic development, they are vital to creating a sustainable and broad-based economic recovery. However, as long as accessing capital remains a challenge, many entrepreneurs will be unable to build and grow their businesses. Especially in low-income and underserved areas of the state, these small businesses create wealth and opportunity at the community level, and as such it is necessary to try and reach as many potential borrowers as possible.

As large banks recede from small business lending, the other lenders working to step in—CDFIs, CDCUs, and credit unions—should be supported in their efforts to fill the gap. They are able to reach borrowers that would otherwise be left out by the financial mainstream. Targeted investments and grant funding would increase the capacity of community-based lenders, while carefully crafted public policy would facilitate a more efficient regulatory environment to increase small business lending. In this economic context, North Carolina must use all avenues for creating jobs, improving local economies, and building wealth in our communities.

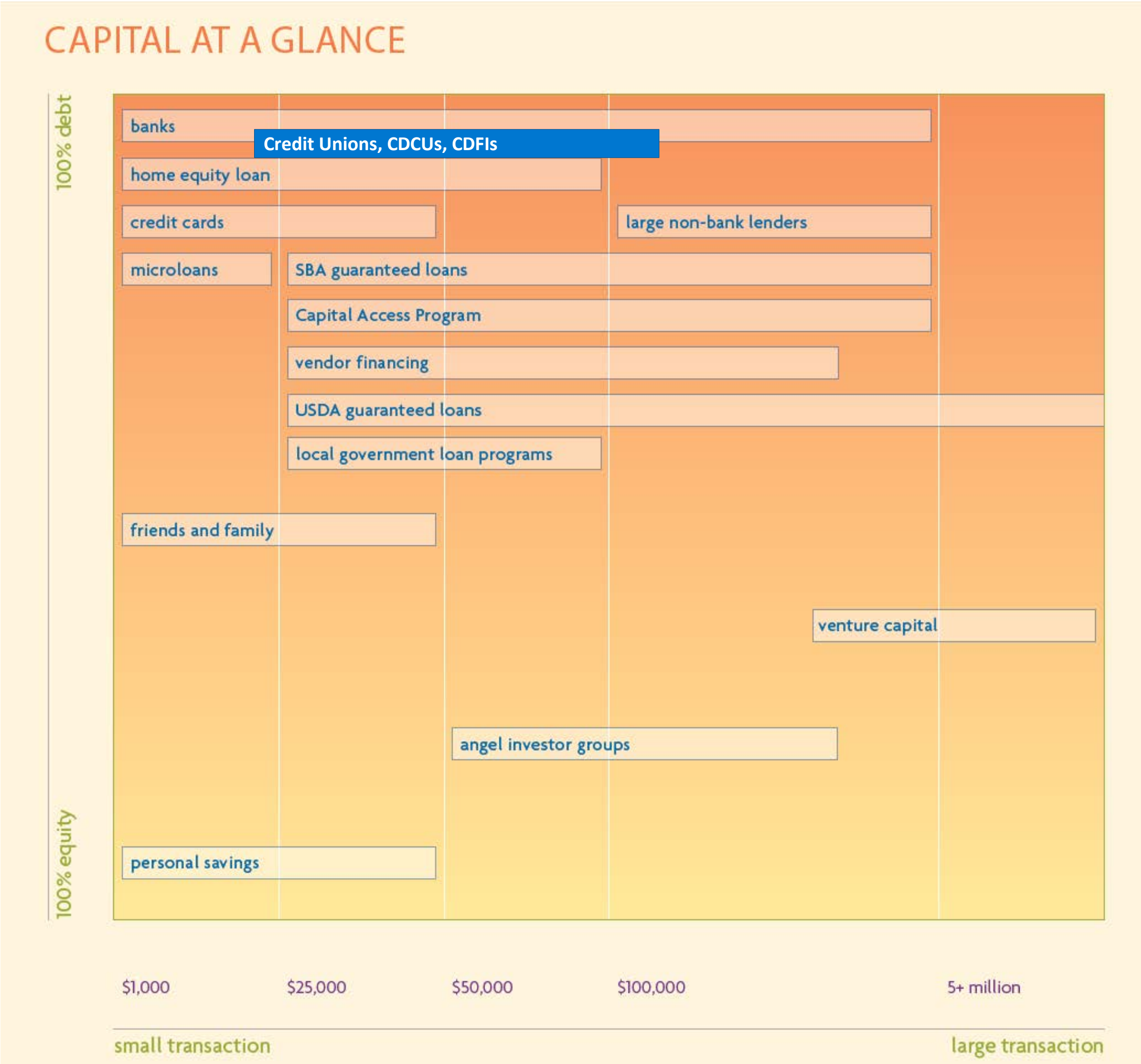
Appendix A: Lending Programs for Small Businesses in NC

In North Carolina, in addition to CDFIs, credit unions, and CDCUs, there is a range of lending programs available to small businesses seeking capital. Resources for small businesses can be found through a variety of organizations, lenders, intermediaries, and agencies across the state and across sectors. The Small Business and Technology Development Center (SBTDC) of North Carolina published a thorough guide for small businesses seeking capital in the state, "Capital Opportunities for Small Businesses" (accessed here: http://www.sbtdc.org/resources/publications/capital-opportunities/). Compiled in conjunction with the Small Business Administration and the North Carolina Rural Center, this guide provides a comprehensive overview of all the lending programs available in the state.

The Capital Opportunities guide provides detail on the kind of loans made by a range of providers, including the following:

- **Financial institutions and agencies**, including the banks and credit unions analyzed in this report
- **Lending programs through federal government agencies**, such as the Small Business Administration, U.S. Department of Agriculture, and the U.S. Department of Commerce
- **Lending programs through state government agencies**, such as the state Department of Commerce and the NC Agricultural Finance Agency
- **Lending programs through local government agencies**
- **Equity capital sources**, such as angel investors and venture capital funds
- **Lending programs through private, non-profit institutions**, such as the NC Rural Economic Development Center and the NC Biotechnology Center

The chart on the following page, adapted to include credit unions, CDCUs and CDFIs, provides an overview of the types of lending programs and the markets they serve. As shown, the majority of loans made by credit unions, CDCUs and CDFIs occupy the space between roughly $20,000 and about $150,000. The programs targeted toward smaller loans will be playing a larger role in small business lending, as more businesses continue to seek alternate means of financing.



Source: Adapted from "Fueling Your Business in North Carolina" 2010: http://www.ncprojectgate.org/docs/migration-files/fueling-your-business-2010.pdf?Status=Master

Appendix B: Data Sources

Loan amounts for commercial banks and savings institutions were obtained from the FDIC Statistics on Depository Institutions data, as of December 31, 2011 (http://www2.fdic.gov/sdi/index.asp). This data does not include the total number of all outstanding commercial and industrial loans for commercial banks and savings institutions. Institutions were searched by asset size and loan amounts were obtained for small business loans, which includes the following:

- Total loans secured by non-farm residential properties of $1,000,000 or less
  - Total with original amounts of $100,000 or less
- Total commercial and industrial loans to U.S. addressees of $1,000,000 or less
  - Total with original amounts of $100,000 or less
- Total loans secured by farmland (includes farm residential and other improvements) of $500,000 or less
  - Total with original amounts of $100,000 or less
- Total loans to finance agricultural production and other loans to farmers of $500,000 or less
  - Total with original amounts of $100,000 or less

Loan amounts for credit unions and CDCUs were obtained through the National Credit Union Administration 5300 Call Report Quarterly Data, as of December 31, 2011 (http://www.ncua.gov/DataApps/QCallRptData/Pages/default.aspx). This data is not available at the project level. The following data on credit unions was compiled:

- Loan balance for total member business loans
- Number of member business loans
- Amount of SBA loans
- Number of SBA loans
- Total assets
- Credit union information, such as name, city, state, county, zip code, etc.

Loan amounts for CDFIs were obtained from the CDFI Fund Community Investment Impact System (CIIS) Program Data for 2010 (http://www.cdfifund.gov/news_events/CDFI-2011-37-CDFI-Fund-Releases-Most-Comprehensive-CIIS-Data-to-Date-FY-2004-2010.asp). The following data was compiled for CDFI funded projects in North Carolina:

- Project Information such as county, city, and census tract
- Original loan amount
- Loan purpose. For this analysis, the following purposes were included (data on farm or agricultural loans is not available):
  - Business
  - Microenterprise
  - Commercial
  - Commercial Rehabilitation

Data on small business lending by census tract and income level were obtained from the Federal Financial Institutions Examination Council CRA Aggregate Reports, for 2010 (http://www.ffiec.gov/cra/craflatfiles.htm). Data was obtained from Table A1-1, “Small Business Loans By County – Originations.” This census tract data was joined with the project-level data from CDFI for the analysis of CDFI loans by census tract and income level.

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