The SUPPORT CENTER

Your Partner in Small Business Growth

STATE SUPPORT FOR SMALL BUSINESS LENDING:

A Roadmap for North Carolina

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Introduction

Small businesses are the economic engines of our state and local communities. In North Carolina, businesses with fewer than 100 employees make up almost 96 percent of employer firms in the state, accounting for one-quarter of total annual payroll.[1] These businesses are job creators. In fact, very small businesses (those with 1 to 4 employees) were the only businesses that actually created jobs each year between 2007 and 2010—during the height of the Great Recession.[2]

Despite their economic impact, many small businesses have struggled to access the capital they need to start-up and expand. Numerous surveys of business owners rank access to capital as a top concern. Banks have significantly reduced their lending to small businesses, while business owners who are still overcoming hardships from the recession are finding difficulty in meeting the new, stricter lending standards.

In light of this growing gap in financing for small businesses, other alternative means of expanding access to capital have grown. Community Development Financial Institutions (CDFIs), for example, are mission-based lenders that specifically target small businesses in underserved markets. Programs supported by state governments have also played an important role. In fact, North Carolina's two neighboring states—South Carolina and Virginia—have state-supported small business lending programs that have seen growth in the past few years.

The Business Development Corporation of South Carolina (BDC) and Virginia Community Capital (VCC) are both programs that have the explicit aim of serving underserved small businesses that cannot access capital from traditional sources. Both entities were established with significant state support, either through direct funding or through legislative action. And both work closely with the other financial institutions and banks in their states to leverage capital in order to achieve their missions of reaching underserved entrepreneurs. Each of these organizations has had a significant impact on their state economies as a result of the programs and services that they offer.

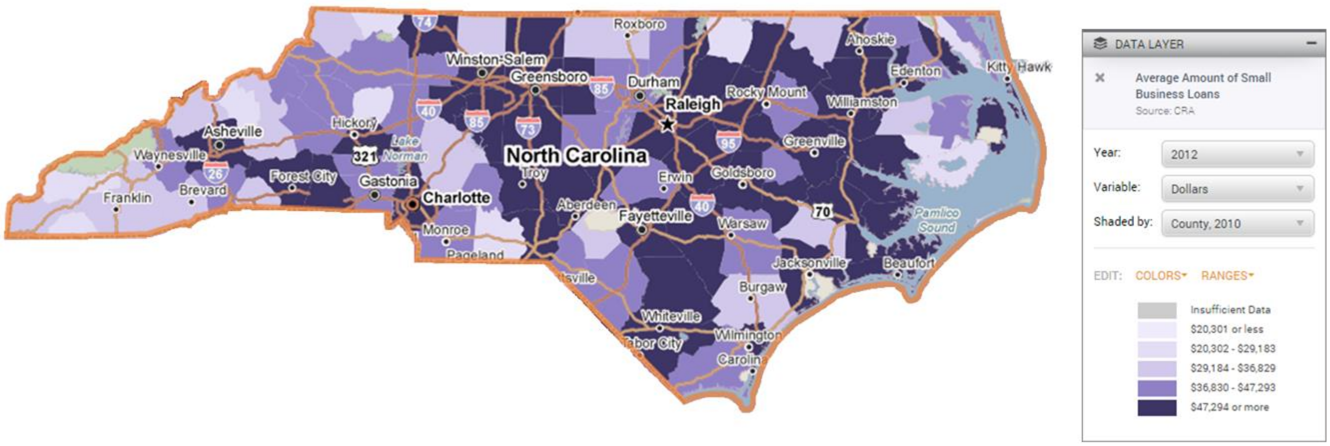
This brief will examine both the BDC and VCC as examples of how state government can play a vital role in supporting small business development and in generating much-needed economic activity within the state.

Overview of Small Business Lending in North Carolina

Harvard Business School recently released a working paper on the state of small business lending in the U.S., illustrating the decline in small business lending by the major banks over the past several years.[3] The Great Recession hit small businesses particularly hard, causing financial hardships for many small business owners. At the same time, banks, which had already started to pull back from small business lending prior to the recession, have become more risk averse and less willing to extend credit to smaller firms. Post-recession changes in the regulatory environment have further accelerated banks' retreat from making smaller business loans. This "perfect storm" has meant that small businesses face significant barriers in accessing bank credit, which has historically been a critical source of capital for their start up and expansion.

The story in North Carolina is the same. Looking at loans originated by the large banks that must report according to the Community Reinvestment Act, both the total number of loans and total volume of small dollar loans (those originated at amounts under $1 million) had decreased between 2007 and 2012—by 26 percent and 41 percent, respectively.[4] Additionally, the loans that are being made are primarily concentrated in and around the state's more metropolitan areas, as shown in the map below. Darker purple indicates a higher average amount of small business loans within those counties. Small businesses in underserved markets remain largely outside the financial mainstream.

Average Amount of Small Business Loans by County, 2012



Courtesy of Policy Map, www.policymap.com

The Support Center conducted a market analysis of small business lending in North Carolina in 2014, which provided further evidence for the growing lending gap. The analysis found that while banks have recently started re-entering the small business lending market, their focus is on larger dollar loans, in particular those above a threshold of about $250,000 to $300,000. Their lending criteria remain strict and many small businesses are still unable to access their resources. As such, there is a critical gap in lending for businesses seeking loans between $50,000 and $250,000.

State Investments in Small Businesses

Many states have enacted programs to help address the growing demand for small business loans. Following are examples of successful state-supported small business programs from two of our neighboring states, South Carolina and Virginia.

Business Development Corporation of South Carolina[5]

The Business Development Corporation of South Carolina (BDC) was established in 1958 by state legislation as a non-governmental agency to expand access to capital to businesses that are not served by traditional lenders. Though not funded by a state appropriation, the BDC was funded through the sale of stocks and was assisted in this process by the lieutenant governor at the time.[6] The legislation allowed banks to become members of and extend lines of credit to the BDC, which would then use the funds to make loans to small businesses. Currently there are 39 member banks, which elect two-thirds of the Board of Directors of the BDC.

The BDC specializes in the Small Business Administration's 7(a) loan guaranty program, which provides loans for start-ups and existing small businesses. Under this program, the BDC provides loans up to $5 million with up to an 85 percent guaranty. In order to assist businesses that have been declined for loans by banks, the BDC also operates a program called the Second Look Program. Under this program, the BDC will conduct an analysis of a business' loan request to review the bank's underwriting and perform any additional due diligence, identify and arrange for any technical assistance for the business, and provide an explanation for why the loan request was declined and recommend any improvements. Loans may be submitted for this program by the banks after they have denied a loan request, or by the businesses that have been denied. If the BDC recommends approval of the loan after going through the Second Look Program, the BDC will process the loan request with the bank, obtain an SBA guaranty (if applicable) and will advance the loan.

The BDC also operates a Capital Access Program (CAP), which allows financial institutions to make business loans that are considered to be more risky and may not meet their typical underwriting standards. For each institution that participates in the CAP, a reserve fund is set up to cover any potential future losses in that institution's portfolio. The reserve funds are managed by the BDC, but are provided and owned by the State of South Carolina. In this way, participating institutions can also meet their Community Reinvestment Act requirements.

In 1994, an affiliated organization was established, the Certified Development Corporation of South Carolina (CDC), as a statewide, certified development company focusing on the Small Business Administration's 504 lending program, which provides financing for major fixed assets such as real estate (purchase and improvement) and equipment.

Over the past several decades, the BDC and CDC have approved over 1,927 loans, totaling over $716 million. The CDC has approved more than $350 million in financing for 700 businesses, which led to the creation or retention of more than 7,000 jobs.

Virginia Community Capital (VCC)[7]

VCC is a statewide CDFI operating throughout the Commonwealth of Virginia, providing affordable housing, community development, healthy foods, and small business loans. VCC also provides advisory services to small businesses, non-profits and government agencies on a range of topics, including financial forecasting, project feasibility, networking, and asset building. Its mission is: *To offer innovative, flexible financial products designed to support housing and community development ventures, increase jobs and build sustainable communities.* The loan products and services that VCC offers are targeted to have a positive impact in low to moderate income communities in underserved markets.

VCC was established in 2006 with a $15 million capital infusion from the state. VCC had also acquired two other entities, which further expanded its capital and ability to focus on community development statewide. One was a smaller micro-lender that had been focused on small businesses owned by low to moderate income people, and the other was an Industrial Development Authority savings program.

Currently, VCC has over $100 million in assets and averages $50 to $60 million in lending every year. It seeks funding from banks, foundations, corporations, individuals, and government agencies, including the U.S. Department of Treasury's CDFI Fund. VCC has also been rated by Aeris, the comprehensive rating agency for CDFIs, receiving a strong AA rating (highest being a AAA rating) on its impact performance, and a 2 rating (highest being a 1 rating) on its financial strength and performance. It is also a certified B Corporation, which indicates that it strives to make a positive impact while also turning a profit.

In 2008, VCC established a subsidiary bank called the Community Capital Bank of Virginia (CCB), which was the Commonwealth's first regulated bank with the mission of community development financing. CCB serves as a vehicle for traditional banks to make investments that meet Community Reinvestment Act (CRA) guidelines, which are then reinvested into low and moderate income communities.

In its eight-year history, VCC has originated over $140 million in loans, and for every dollar invested by VCC in a community almost $1.90 of additional funding is leveraged from other sources. VCC has had a significant impact through its lending and other activities, including:

- 4,056 total new and rehabilitated affordable housing units
- Over 928,000 square feet of new or rehabilitated commercial real estate
- Over 3.8 million square feet of new or rehabilitated housing real estate
- Total deposits of $42.5 million
- Over 4,900 hours of advisory services provided
- 1,293 jobs created or retained

Implications for North Carolina

North Carolina is home to 819,038 small businesses, more than both South Carolina and Virginia. Over 1.5 million of our workers are employed by small businesses—half of the state's private workforce.[8] And yet, our economy continues to lag. The unemployment rate remains persistently high—6.7 percent in North Carolina, compared to 6.6 percent in South Carolina and 5.5 percent in Virginia.[9] Since the Great Recession, we have seen more people unemployed for longer stretches of time, compared to previous recessions. Concentrated poverty has increased statewide.[10] Our rural communities are increasingly distressed, as economic opportunity shifts toward metropolitan areas.

Entrepreneurship is a pathway toward economic prosperity, and there is great potential in North Carolina for small businesses to lead the way. Businesses that can grow and thrive have ripple effects in their local economies. Small businesses invest in their communities and employ people, who then become active participants in the economy—buying goods and services, saving and building wealth, and generating revenue for the state. As such, supporting small business development should be a key component of our state's economic development strategy. Expanding access to capital is the first place to start.

Policy Recommendations

There are a number of ways that the State of North Carolina could increase its support and investment in our state's small businesses. The key challenge for small businesses is accessing affordable capital to start up, grow, and thrive. These policy recommendations focus on solutions to meet that need.

1. **Establish a state fund for small business lending.**
   Through a direct appropriation, the State could provide the seed funding for a state-level small business revolving loan fund. Additional funds could be leveraged by private foundations, banks, corporations, and other investors. These funds could then be accessed by banks, CDFIs, and other lenders to make small business loans specifically in underserved markets. This type of fund would help banks meet their Community Reinvestment Act requirements and would help CDFIs and other community-based lenders in their mission-driven lending efforts.

2. **Pilot a State Small Business Guaranteed Lending Program.**
   A loan guarantee provides lenders with the ability to make loans that may be outside their typical lending criteria and reach small businesses in new markets. A state level guaranteed lending program would help to mitigate the risk taken on by lenders—banks, CDFIs, and others—when making loans to businesses that are in underserved communities. It allows lenders to meet the needs of borrowers that

may not otherwise be able to access credit such as those who may need to be evaluated on a broader set of underwriting criteria, or who may need more flexible loan terms.

3. **Establish a Business Development Corporation modeled after the South Carolina BDC.**
The South Carolina BDC is an example of how legislative action can harness existing resources to meet a distinct need. By creating a structure that allows banks to make investments in small business lending, the State would be helping to expand access to capital in markets that need it most. A BDC-type model would also increase partnerships between banks and the State, and could be expanded to include other types of organizations such as CDFIs, community development corporations, and others.

4. **Create a state Healthy Foods Financing Fund to create new markets for local, healthy foods.**
North Carolina currently has 349 "food deserts" across the state, or areas in which residents lack access to fresh, healthy foods. These communities also suffer from a range of health problems, such as obesity, diabetes, and heart disease. Not only does this impact individuals and communities, it impacts the economy as a whole. A healthy workforce means lower health care costs, and a healthier bottom line for businesses. However, businesses across the healthy foods supply chain—from producers to distributors to retailers—face barriers in accessing capital and accessing local markets. A state-level fund targeted to expanding access to capital for healthy foods-related businesses would help strengthen the local food system, bolster local businesses, and improve health outcomes across the state. One place to start is by helping small retailers such as corner stores and convenience stores expand their selection of healthy foods. A fund that would provide small loans to local retailers that offer healthy food options would serve both an economic development and a nutritional need in many communities. These funds could be used for purchasing equipment to store healthy foods, to upfit stores to accommodate new displays and equipment, for marketing, and for community education about nutrition and healthy foods. The Support Center has been working with a diverse coalition of health advocates, economic development groups, farmer support organizations, and others on providing education on this critical issue, toward establishing a healthy foods financing fund for small retailers in North Carolina.

Conclusion

Research and experience show that though the impact of small businesses on the economy of our state is great, they continue to face significant barriers to accessing vital resources. The Great Recession exacerbated these challenges. Though banks have recently reentered the small business lending landscape, their focus has been on large dollar loans, leaving many entrepreneurs and business owners still outside the financial mainstream.

But as our neighbors to the north and south have shown, there are ways that the state can help alleviate these barriers. South Carolina and Virginia have both used the legislative and budgetary authority of the state to make proactive investments in small businesses, particularly those that are underserved by traditional lenders. The BDC and VCC are prime examples of how state governments can support small business lending in a climate of limited access to capital. Both programs have shown the significant economic impact that states can have by creating new vehicles for lending to small businesses.

North Carolina, which has a more robust small business presence than either of our neighbors, can also make an investment—one that best suits this state's economy and business climate. With the right policies and programs, we can foster relationships and partnerships between government, banks, and community lenders to provide capital to businesses of all sizes and in all communities. The example of other state programs shows that innovation in how we approach small business development can have long-term, positive impacts for businesses and the economy.

[1] U.S. Census Bureau, Statistics of U.S. Businesses, 2011.
[2] U.S. Census Bureau, Statistics of U.S. Businesses, 2011.
[3] Mills, Karen Gordon and Brayden McCarthy. "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game." Harvard Business School. Working Paper 15-004. July 22, 2014.
[4] Federal Financial Institutions Examination Council, CRA Aggregate Reports. 2007-2012.
[5] Unless otherwise noted, information on the Business Development Corporation was obtained from www.businessdevelopment.org
[6] Lesley, Edwin O. Email communication. August 6, 2014.
[7] Information on Virginia Community Capital was obtained from www.vacommunitycapital.org
[8] Small Business Administration, Office of Advocacy. 2013 Small Business Profiles for States and Territories. North Carolina Small Business Profile. 2014.
[9] Bureau of Labor Statistics. Local Area Unemployment Statistics. September 2014 Unemployment Rates, Seasonally Adjusted.
[10] Bishaw, Alemayehu. "Changes in Areas with Concentrated Poverty: 2000 to 2010." US Census Bureau, American Community Survey Reports. June 2014.