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Small business lending environment is getting worse, fast

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New data from the Federal Reserve underscores how rapidly the lending ecosystem has worsened for business owners.

Small-business loans are becoming both harder to get and more expensive — and that combination is expected to get worse.

While we previously have written about the tightening credit market — driven in part by the Federal Reserve's sustained interest rate increases over the last year — new data from the Fed underscores how rapidly the lending ecosystem has worsened for business owners, with 46% of lenders surveyed saying they were tightening standards for commercial and industrial loans in the second quarter. Less than one-quarter of lenders said the same in the third quarter of last year.

The rates on those loans are rising, too, with 62.3% of large and medium lenders increasing the spread of their loan rates over their cost to get those funds. Those lenders also report a 55.6% drop in overall demand for loans.

For construction loans, 73.8% of lenders were tightening standards.

The banking industry also has suffered through several high-profile collapses this year, most notably that of Silicon Valley Bank, a development that has revealed weaknesses in many banks' balance sheets. Since March 2022, the Federal Reserve has raised its target interest rate from about 0% to about 5% in a bid to tamp down inflation and tame what it saw as a hot job market. Data released last week shows the job market remains resilient.

The latest research from the Fed is sobering and supported by other data, such as S&P Global’s IQ Data Dispatch report that shows delinquency rates at U.S. banks increasing over the latest quarter, said commercial real estate expert David Feider, lead technology product manager at information and software firm Wolters Kluwer.

“One will note that the other periods in the dataset, where we see similar tightening of underwriting standards by commercial lenders, coupled with declining loan demand, are usually during, or just prior to, a recession,” Feider said in an email. “This suggests we are likely to see some challenging months ahead, especially for small businesses that are more dependent on bank lending than their larger counterparts."

Commercial real estate lending under the microscope

While the overall tightening of lending is typical of a normal business cycle, problems are anticipated from attempting to refinance loans at a time of increased remote work — a unique issue that has the potential to make this cycle much more severe, Feider said.

"With respect to the commercial real estate, especially office space, I think it's likely to get worse in the near term, as the factors driving the reduction in demand for office space are not going away anytime soon," he said.

When it comes to residential loans, just 1.9% of lenders said they were tightening standards for government-backed mortgages, while 21.6% were tightening jumbo mortgage standards. Meanwhile, 27.5% of lenders were tightening standards for auto loans, and 23.6% were doing so for consumer loans.

Gary Golden, CEO of BHCU, a Philadelphia-area credit union, said community banks and credit unions are pulling back because of the Federal Reserve activity as well as larger economic factors. Those actions are expected to result in a lending environment that's more challenging for small businesses.

"As for specific segments, such as office space, we will see this trouble coming from both sides," Golden said. "Existing loans will struggle to meet their debt service and increasing default levels, caused by reduced cash flows from much higher vacancy rates. New projects will not have easy access to capital because of the aforementioned tight liquidity and the preponderance of declining values and existing defaults in this arena."

He said his credit union won't look at any office space or retail projects.

Small businesses continue to seek capital

Ultimately, Golden stressed that the banking industry is becoming a microcosm of society, with the largest banks continuing to do very well even as smaller lenders struggle.

Alex Cardona, co-founder and chief operating officer at small-business data-collection and automation firm Codat, said a recent survey done by his firm found 65% of small-business leaders were planning to try to access credit in 2023, with 75% of those doing so as part of a survival strategy, such as paying staff or helping with cash flow.

About 90% of those in need of credit fear their inability to access financing will threaten the survival of their business.

“But the SVB crisis stands to further reduce SMB access to credit," Cardona said. "As they look for more security, businesses are moving their banking relationships to larger banks, where loan approval rates are the lowest and increased regulation and pressure on the operating costs of regional banks (are) set to push the cost of capital higher."

There have been some efforts to boost small-business lending, with the SBA opening its doors to new non-bank lenders for the first time in more than 40 years. That is part of an agency-wide effort to modify its rules and get more loans to smaller businesses.

Small-business owners looking for grants can apply for several right now.

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