

FOCUS UNITED STATES

By Christine Altuzarra - writing completed 18 October 2012

SMEs the backbone of the economy?

When public sector job creation runs out of steam, eyes turn to the private sector, which alone seems able to offer a solid basis for recovery in the months to come through investment and the hiring of workers. This article focuses on SMEs, and poses several questions: What actually are the SMEs and in which sectors are they present? Has the 2009 crisis had any after-effects? Can SMEs play a role in recovery in the short-term? And sustain the economy in the medium term? The answers to these questions are crucial since half of American jobs are in SMEs.

We read regularly that businesses are sitting on piles of cash⁽¹⁾. Entrepreneurism is also a strong feature of American culture, the generator, via start-ups, of high value-added jobs. On closer inspection, the reality behind these statements is more nuanced. The pace of business creation has been slowing since the early 1980s while that of triadic⁽²⁾ patents remains at an enviable level but has slowed since 2006. And the spectacular rise in profits almost exclusively concerns big companies. The reality for SMEs seems quite different. In a recent speech Obama emphasised the extent to which the American economy depends on small and medium-sized businesses.

« When our small businesses don't do well, America doesn't do well. We all have a stake in helping our small businesses to grow and succeed. And because small businesses create two out of every three new jobs in America, our economy depends on it »

Président Obama, Woonsocket, Rhode Island, 25 octobre 2012⁽³⁾

For several months political uncertainties have prevented businesses in general and SMEs in particular from implementing clear development strategies. In the short term household consumption could continue its uneven rhythm and employment its too slow recovery. Moreover, discussions concerning the raising of the debt ceiling (the USA could be in technical default in February 2013) and the fiscal cliff⁽⁴⁾ will occur during the Congressional lame duck session⁽⁵⁾, which is not really conducive to problem-resolution. In the medium term, the next term of office will continue to be marked by systematic obstruction on the part of the Republican Party if Obama wins (whether or not he loses his slim majority in the Senate). If Mitt Romney wins (with a majority in both houses) and applies the announced program, tax reductions and increased military expenditure will worsen the fiscal deficit to the detriment of the USA's sovereign rating. Apart from this impact on public finances, cuts in government aid program to the most deprived could lead to social backlash. In both cases, the political context will be tense, the worst of situations for the business world.

(1) The share of cash left in banks by companies rose from 23% in 2006 to 50% in 2012. (Financial Times, July 13, *US companies' dash for cash heralds a painful freeze*)

(2) Triadic patents: Patents registered in the United States, Japan and Europe.

(3) <http://www.whitehouse.gov/the-press-office/2010/10/25/remarks-president-small-businesses-and-economy-woonsocket-rhode-island>

(4) The *fiscal cliff* (of more than \$600bn, or 4% of GDP) refers to the fiscal consolidation provided for in the 2013 Finance Act, which, if it is not renegotiated after the November elections, could lead to a recession of 2.9 per cent in the first half of 2013, according to the analysis of the Congressional Budget Office released August 22, 2012.

http://cbo.gov/sites/default/files/cbofiles/attachments/43539-08-22-2012-Update_One-Col.pdf

(5) *Lame duck session*: period which extends from the November Congressional and Presidential elections until the assumption of office by the new Congress on January 3 and the investiture of the new President on January 20. Some senators and members of the House of Representatives sit even though they have not been re-elected. The president elect, if he is new, possibly may not be informed by the outgoing president of matters in progress.

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HOW WILL SMEs GET THROUGH THE CRISIS?

In this article, we use the US Census Bureau's definition of an SME: an enterprise⁽⁶⁾ with one or more establishments employing up to 500 staff (which excludes micro businesses of which the owner is the only employee).

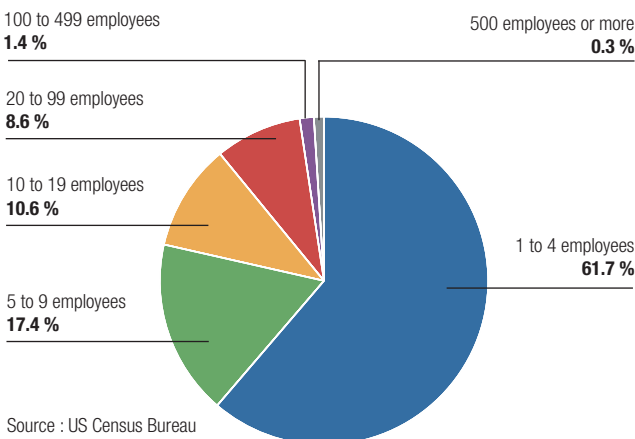
A European SME is defined by the characteristics common to all business sectors. This is not the case in the USA, where the criteria set by the Small Business Administration (SBA) concern either the number of employees or business revenue and vary according to the sector. It is the type of products sold that determines the number of employees and the maximum sales volume whether an enterprise can be described as an SME.

The data on this business typology are limited to those gathered by the US Census Bureau⁽⁷⁾ and by the US Bureau of Labor Statistics⁽⁸⁾ and are based on the year 2010 at best, but more frequently 2009.

SMEs = 46% of GDP and 49% of domestic employment

Ten years ago American SMEs contributed half of domestic GDP⁽⁹⁾. Since then their share has fallen slightly to 46% in 2008 (against a European range of 50% to 70% respectively in the United Kingdom and Italy). The projection made by the economist Kathryn Kobe over 2009 and 2010 shows that this share has probably continued to decline, the post-Lehman shock having further weakened this business category. Nevertheless, it is clear that small and medium-sized businesses constitute a source of employment essential for the economy: 5.7 million businesses, irrespective of size, employed 114.5 million employees (full and part time) in 2009 (most recent figures). Among them, SMEs with less than 500 employees accounted for almost

Distribution of companies in 2009 (number of employees)



(6) An enterprise is a business organization consisting of one or more domestic establishments that were specified under common ownership or control. The enterprise and the establishment are the same for single-establishment firms. Each multi-establishment company forms one enterprise - the enterprise employment and annual payroll are summed from the associated establishments. <http://www.census.gov/econ/susb/definitions.html>

(7) <http://www.census.gov/econ/smallbus>

all of these businesses and employed a workforce of 56.3 million, or 49% of the national total (against 54% in the United Kingdom and 81% in Italy).

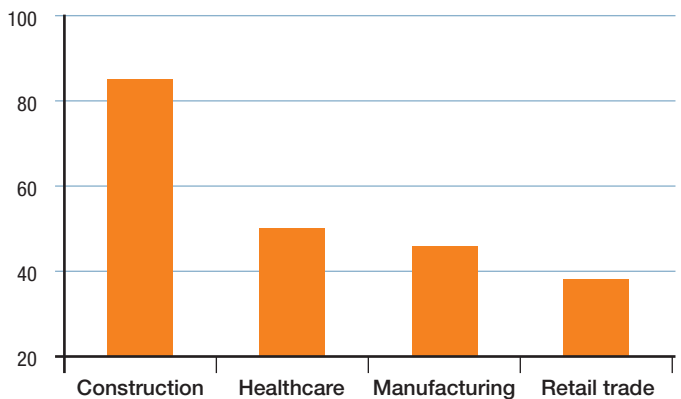
SMEs are therefore a backbone of the American economy.

Construction: the biggest employer among American SMEs

In July 2012, over 83% of domestic private employment was in the services sector, which has grown by 2.6 percentage points since the official onset of the recession. At the same time, employment in the goods sector,⁽¹⁰⁾ to which construction and manufacturing belong fell to account for little more than 16% of the national total.

Main sectors

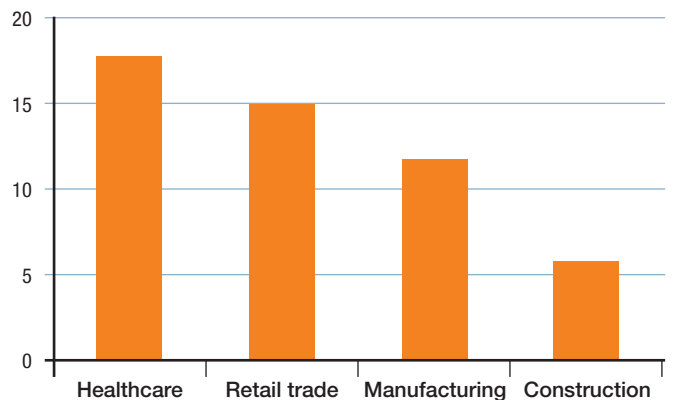
Share of SMEs in national employment by sector in 2009 (percent)



Source : US Census Bureau

Main sectors

Number of employees in SMEs in 2009 (in millions)



Source : US Census Bureau

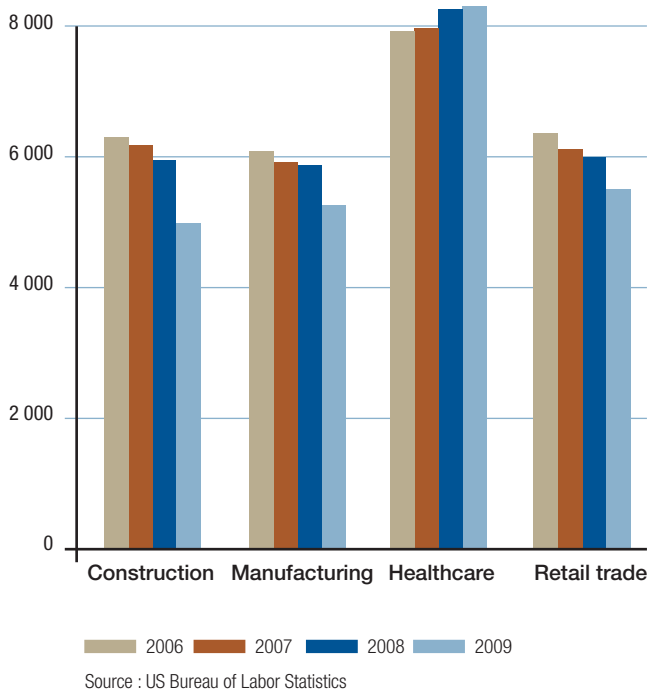
(8) <http://www.bls.gov/>

(9) Kathryn Kobe, Small Business GDP: Update 2002-2012, SBA Office of Advocacy, January 2012

(10) Services: Wholesale and retail trade, services to individuals and businesses, health, education, property, financial, technical and scientific services, hotel and catering business. Goods: manufacturing industries, mining and construction according to the standard classification.

Since SMEs have a strong presence in construction and manufacturing (respectively 85% and over 40% of jobs in each sector at national level -chart above-), they were particularly weakened during the crisis, from 2006 in construction, then, in 2008, in manufacturing industry with the fall in orders that immediately followed Lehman-Brothers bankruptcy. Employment in SMEs plummeted by 17% in both sectors in three years (chart below). Nevertheless, since January 2010 hiring has begun again in manufacturing, unlike construction where employment remains weak.

Evolution of Employment in SMEs by main sectors 2006-2009
(in thousands)



By contrast, the crisis did not interrupt the trend observed for over 30 years in the healthcare sector, where SMEs represent half of the sector's national employment: employment in the sector's SMEs grew by 4% (2006-2009).

The turnover rate is much weaker...

Besides the employment rate, the job turnover rate⁽¹¹⁾ is an indicator of the economy's health. There are no data concerning the share of SMEs in the national turnover rate but this business sector cannot be excluded from the trends observed for the change in job openings, new hirings, employees leaving for new jobs, abolition of jobs and firings (separations). The Canadian TD

Bank⁽¹²⁾ shows that during times of expansion, this rate is high with employees willing to go from state to state to take better paying jobs. This movement thus contributes to additional wealth creation. In March 2012, the National Bureau of Economic Research assessed the impact of the reduction in the turnover rate during the crisis at an annual equivalent of 4% of GDP over a period of three and a half years. The authors of the study⁽¹³⁾ show that before 2006, employment increased every month by 172,000 against a monthly contraction of 421,000 during the worst of the 2009 crisis. The situation has since improved but the turnover rate remains insufficient. Several reasons are preventing an improvement in the employment market: low workforce mobility due to the fall in house prices and the slowdown in business start-ups, which before the crisis had been important providers of employment. The very dynamic pre-crisis turnover rate in rapidly growing businesses with less than 250 employees can, however, be explained by the high level of competition.

... but net job creation is faster in SMEs...

The year of recession was particularly hard on the SMEs. Their number fell by nearly 20% compared with the previous year and their jobs by nearly 6% (against a drop of 5% in number and jobs for big businesses). On the other hand, the contribution of SMEs to new job creation grew by 66%⁽¹⁴⁾ versus +22.5% in businesses with over 500 employees.

Business start-ups played their role in this performance. The US Census Bureau pointed out last May⁽¹⁵⁾ that without the creation of businesses and the corresponding jobs, the American economy would have suffered much heavier net job losses. Three hundred ninety-four thousand new SMEs created 2.3 million jobs, whereas, in the same period (March 2009 to March 2010), the American private sector as a whole marked up a net loss of 1.8 million jobs. The authors note, however, that the pace of job creations has slowed since the beginning of the 1980s when new businesses represented 12% to 13% of the business fabric. This decline has accelerated since 2006 (11% of the total) to stabilize at 7% in 2010 (latest available statistic). This constitutes an unfavorable element on the subject of employment in SMEs, since the share of new SMEs in job creation fell from 20% in the 1980s to 10% in 2010. The crisis has therefore hit the entrepreneurial spirit hard, with difficulties in obtaining access to credit and devalued collateral indispensable to guarantee finance for the business, probably partially explain this decline in start-ups (see text box on regional banks).

(11) Turnover rate: relationship, expressed as a percentage, between the number of workers who, in the course of a given period, left a company and the average number of workers the company employed during the same period.

(12) TD Economics: Meeting America's Job Challenge Means Growing Small Business, May 15, 2012. http://www.td.com/document/PDF/economics/special/jm0510_small_business.pdf

(13) Beata Caranci, Deputy Chief economist, and James Marple, Senior Economist

(14) US Bureau of Labor Statistics, Employment Dynamics database

(15) John Haltiwanger, Ron Jarmin and Javier Miranda: *Where Have All the Young Firms Gone?* US Census Bureau's Business Dynamics Statistics, May 2012

... and the exporting SMEs have come out of it better

The Obama administration decided, starting in 2010, that supporting SMEs in foreign markets was a priority (see text box: Exports: Obama Administration targets SMEs). Indeed, the US Census Bureau noted in 2010 that 98% of exporting businesses are SMEs but their share in the value of goods exported is only 33.7%. This portion has grown regularly, since it represented only 27% of national exports in 2002 and 31.3% in 2008. Export-oriented SMEs in the manufacturing sector⁽¹⁶⁾, however, contribute only 18.6% of the value exported by the sector on the national level, whereas in the wholesale trade SME's account for 58.6% of the sector's exports.

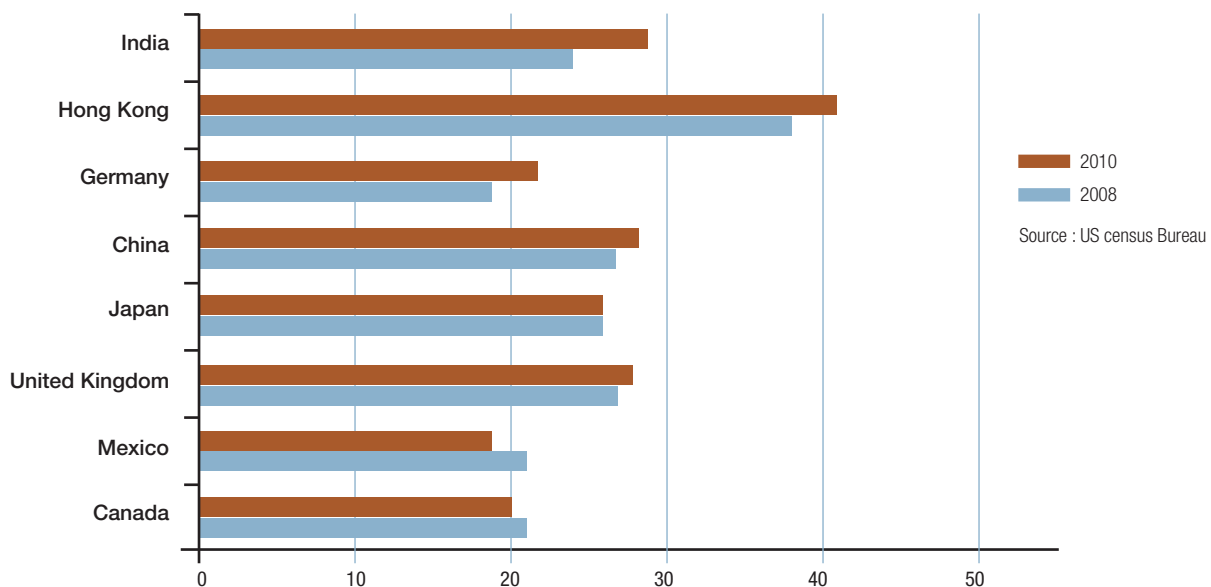
The USITC⁽¹⁷⁾, in its two most recent analyses, estimates that the real contribution of the 287,000 SMEs to export value is higher than is reflected in the official statistics. These cannot take into account either the finished products made by American SMEs and exported by wholesalers or the inputs produced by the SMEs and incorporated in goods manufactured by big exporting firms. Neither can they determine the share of products manufactured by big businesses but exported by SMEs. Consequently, the role of SMEs in exports may be underestimated or, on the other hand, overestimated.

But the fact is that exporting favors employment. In its conclusions, the USITC shows that the sales of exporting manufacturing SMEs grew by 37% (2005-2009), while the sales of non-exporting SMEs of the same sector declined by 7%⁽¹⁸⁾. The gap is even greater in

terms of labor productivity. Over the same period it was 70% higher for exporting SMEs. To a lesser extent exporting SMEs in the services sector performed better than those devoted only to the domestic market. Labor productivity improved by 43% (2002-2007) versus +27% for non-exporting SMEs in the sector. Compared to big firms, SMEs achieved excellent performances: their income grew by 64% (2002-2007) and jobs by 12% against +25% and -0.6 respectively for big businesses.

But SMEs export growth is curbed by the weak geographic distribution of market outlets together with a limited customer base. More than 58% of American businesses that export do so to only one country, the proportion of SMEs coming into this category is the largest. Though Canada and Mexico are the chief destinations of American exporting businesses as a whole, SMEs, without neglecting those countries, find niches where they are very active (chart below). But the limited number of outlets is a weakness that the USITC confirmed in its November 2010 survey on the obstacles to exporting. Manufacturing SMEs cite the search for trading partners, transport costs, foreign customers' preference for local products, high customs duties and the difficulty of getting paid. In services, the greatest handicaps are linked to inadequate intellectual property protection, foreign taxes, American regulation, establishing subsidiaries, obtaining finance and, as with manufacturing SMEs, to payment by customers.

SMEs in American exports 2008-2010
(percent of export value to main destinations)



(16) Electrical and electronic equipment, machinery, chemicals and transport equipment; beverages, tobacco, clothing and accessories, leather goods.

(17) United States International Trade Commission, Small and Medium-Sized Enterprises: Overview of participation in US Exports and Characteristics and performance, USITC publication, January 2010; November 2010.

(18) The data on manufacturing SMEs are taken from a survey among 9,000 SMEs conducted in February 2010

Exports

Obama administration targets SMEs

Five years ago, exports of goods and services represented nearly 13% of GDP and 7% of employment (10.3 million), the highest level since the beginning of the '1930s. The loss of 1.8 million export-related jobs during the recession led the Obama administration to promote the *National Export Initiative* (NEI) ⁽¹⁾ in March 2010, aimed at encouraging companies, especially SMEs, to develop their export trade: promotion campaigns, loans to businesses, limitation of export curbs, and stronger commercial regulations. Its aim is to double exports by the end of 2014 to \$3158 billion from \$1579 billion in 2009.

US exports in goods & services
(monthly changes / in \$ billions)



Source : US census Bureau

Entities such as the Ex-Im Bank (*Export-Import Bank of the United States*), the USDA (*US Department of Agriculture*) and the USDOC (*US Department of Commerce*) saw their budget increased - to improve the financing of companies, develop promotion activities, increase the number of consultants for businesses and improve transport infrastructures. An *Export Promotion Cabinet* centralizes operations and reports regularly to the President.

In its first report (after the first six months ⁽²⁾), the Cabinet underlined the importance of export finance for SMEs in a period in which bank credit has become scarce. It also stated that action by the Department of Commerce has to date made it possible to reduce some fifty obstacles to trade with 33 countries.

Referring to a comparative study on the assistance given to SMEs in the United States and in the European Union, the Cabinet illustrated that SMEs in the EU, unlike those in the USA, benefit from facilitated access to various market penetration sources and to greater financial support for participating in trade fairs.

The Cabinet also pointed to the public financial support given by competing governments, particularly those of emerging countries outside OECD structures. The Ex-Im Bank indicated, for example, that between 2006 and 2010, medium and long-term loans supported by Chinese, Indian and Brazilian agencies have more than doubled, rising from \$37 billion to \$72.7 billion, with \$45 billion for China alone in 2010. In the same period, the same loan categories rose by 80% to \$65.4 billion for the G7 countries.

Increasing export credit is one of the Initiative's priorities

With regard to SMEs, the Cabinet recommended that the Ex-Im Bank capitalize on its human and financial resources in order to offer loans at preferential rates to exporting SMEs as well as to sub-contracting businesses that are involved in the supply chain but are not necessarily direct exporters (*Supply Chain Finance Guarantee*). The program also introduced a reinsurance product to help SMEs to obtain credit insurance cover against commercial and political risks in countries where the Ex-Im Bank ceilings are reached (*Export Credit Reinsurance*) as well as specific insurance coverage for SME exports in the renewable energy sector (*Renewable Express*).

Increasing export credit is the NEI's fifth-ranked priority. There are several reasons for this:

- Conditions for access to credit for SMEs are unlikely to become significantly easier, with the banks and in particular the regional banks still seeking to adjust their balance sheets as well to improve their capital adequacy ratio (Basle III);
- Prudent regulation is driving the banks to resort more to government agencies, among them the Ex-Im Bank, in order to reduce, through guarantees, the risks that they hold in their portfolios;
- The objective set by the NEI of doubling exports is likely to intensify reliance on public sector resources.

(1) <http://www.whitehouse.gov/blog/issues/white-house>

(2) http://www.whitehouse.gov/sites/default/files/nei_report_9-16-10_full.pdf

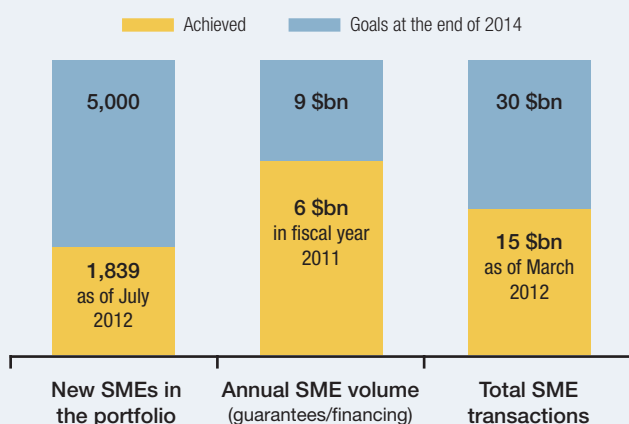
It is in this context that the Ex-Im Bank has seen its capacity for intervention broadened. Among the 175 countries to which the agency is open, the emerging countries of Mexico, Brazil, Colombia, India, Indonesia, Vietnam, Nigeria, Turkey and South Africa have been targeted. Sectors as well as businesses with development potential have been identified (medical technology, industrial machinery, conventional and renewable energy, transport). And the mandate given by Congress to the Ex-Im Bank aims for 20% of the bank's commitments to be made to SMEs.

What are the results today?

By financing or guaranteeing 3,600 businesses for a total of \$32 billion in 2011 (+50% since 2009), of which 85% is devoted to SMEs, the Ex-Im Bank (3) has supported \$40 billion of export contracts and 290,000 related jobs.

As far as SMEs are concerned, Ex-Im Bank has announced that it has achieved a significant proportion of its objectives (chart below) and that in 2015 it will have supported \$58 billion of SME export contracts. In this connection, the agency has set up the *Export Express Program*, an approach slanted towards SMEs that provides for a simplification of the bank's procedures through the use of digital technology.

Ex-Im Bank: Goals and achievements



Source : Ex-Im Bank

With regard to the objective of doubling exports in five years, we observe that exports grew by more than 14% in 2011 to \$2,100 billion. They had grown by almost 17% in the previous year and slowed in the first eight months of 2012 (+5%) to \$1459 billion, but remained dynamic to Canada and Mexico (about 33% of exports of goods), the rest of Central and South America (12%) and to China (7%). This is expected to compensate over the remainder of the year for the slowdown in sales to Europe, to the open economies of emerging Asia (9%) and to Brazil. Assuming a similar momentum over the whole year, by the end of 2014 the value of exports will have increased by 40% since 2009 (a year in which they had fallen by 14%).

Can the bet be taken up?

Coface predicts strong growth in Canada and Mexico and good resilience in the emerging countries, which have implemented fiscal policies in support of domestic consumption.

Exports are therefore not expected to slow markedly in 2013. There are, however, elements that could negate this prediction. First is the economic integration between the United States and Mexico. The latter plays an increasing role as an assembly platform for American firms that export intermediate products to Mexico to be incorporated into finished products re-exported to the United States. The Mexican economy thus depends in large part on the health of the United States.

Secondly, intensification of the crisis in the eurozone (13% of the exports of goods) would lead to a decline in American direct and indirect sales.

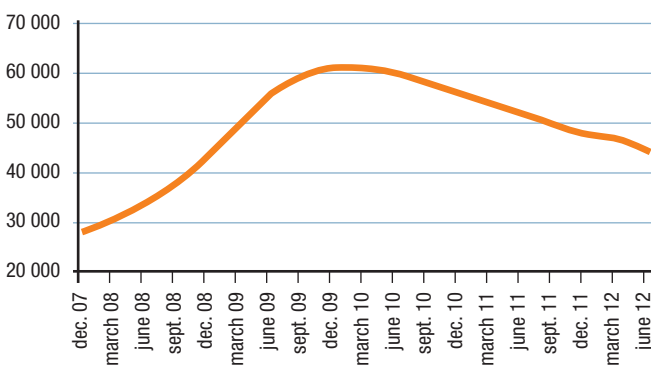
(3) <http://www.exim.gov/smallbusiness/>

The number of SME bankruptcies is declining and returning to the pre-crisis level...

There are no statistics on the bankruptcies of small and medium-sized businesses employing fewer than 500 people. There is an index published by the information provider Equifax that takes into account the use of chapters 7 and 11⁽¹⁹⁾, traditionally used to track business bankruptcies at national level (chart below) and also of chapter 13 which covers payment plans. Equifax also covers businesses with fewer than 100 employees that are nearly all SMEs (chart below).

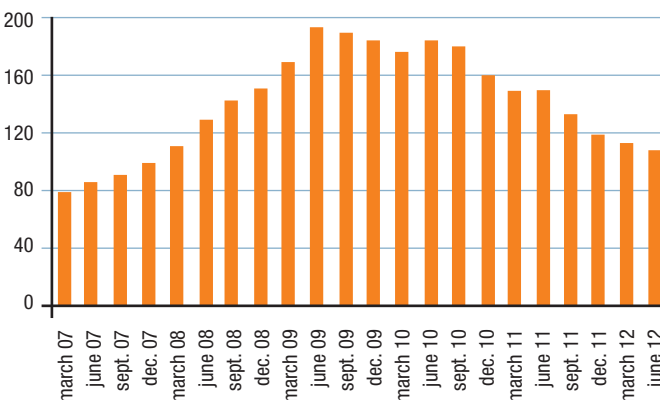
In both cases, the trend is identical but we observe that bankruptcies of SMEs with fewer than 100 employees peaked in March 2009, while at the national level this peak was reached several months later, in December 2009. The rate began to slow very regularly from the first half-year 2010. The improvement is continuing in 2012 but nationally the level will remain above that of before the crisis, while the Equifax data indicate that the December 2007 100 index has been reached.

American business bankruptcy evolution / all sized-firms
(chapters 7 and 11 / national level)



Source : US Courts

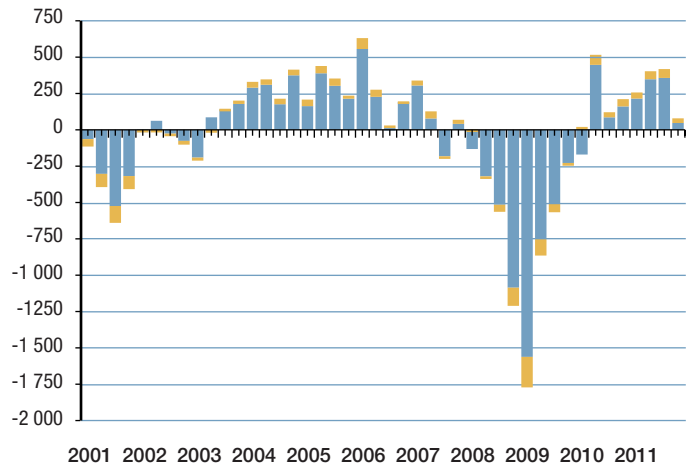
Index of 100 employee-sized businesses under chapters 7, 11 and 13: Evolution
(100 index: December 2007)



Source : Equifax

The evolution of employment in SMEs with less than 500 employees (chart below) confirms that the shock was severe until March 2010, when businesses again began to create jobs.

Net job changes in SMEs (in thousands)



250 to 499 employees firms
1 to 249 employees firms

Source : US Bureau of Labor Statistics

... while employment in construction is expected to pick up again

The prospects for employment from 2010 to 2020 presented by the Bureau of Labor Statistics⁽²⁰⁾ in its January 2012 monthly letter are encouraging for SMEs in construction. Based on annual growth of about 3% over the period studied and a return to near full employment, the BLS shows that employment in construction would regain some of the ground lost during the crisis at about +3% a year, sustained by infrastructure renovation. The outlook for manufacturing industry is less promising. The number of jobs is expected to decline by -0.1% annually as a result of higher gains in productivity than in production. This is no surprise, considering the previously mentioned trend that the services sector is expected to show a rise of 1.5%, driven by services linked to healthcare, education and to businesses where SMEs account for half the jobs.

(19) Chapter 11 of the American Federal Code defines the rules applying to bankruptcy. Chapter 11 sets out a reorganization procedure to assist the debtor in difficulty: A request by the debtor or one of his creditors to begin proceedings leads automatically to the suspension of actions by creditors. The activity of the business continues with the debtor remaining in control (*debtor in possession*). Chapter 7 governs the placing of a business under administration for liquidation: The business ceases its activities, and a trustee sells all its assets and distributes the proceeds to the creditors.

(20) Dixie Sommers and James C. Franklin: Employment Outlook: 2010-2020, *Overview of Projections to 2020*, Bureau of Labor Statistics, Monthly Labor Review, January 2012. The authors show that these projections are based on the assumption of full employment in 2020, a 3% annual growth rate and a 2% annual increase in productivity, taking into account the 2009 recession and the weak level of recovery, with prospects starting at a low point and moving towards an ambitious objective.

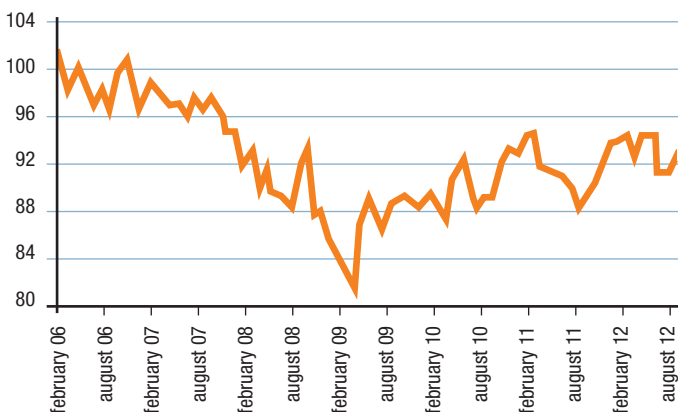
SMES AWAIT GREATER CLARITY

NFIB ⁽²¹⁾ SURVEY OF SEPTEMBER 2012

Sharp decline in SME confidence

Before the summer of 2007 which marked the start of the financial turmoil, the SME confidence index oscillated between 96 and over 100. During the recession it fell its lowest level in March 2009 (81), but remained above 90 since spring 2010 when job creation took off again. The curve (chart below) turned down sharply twice, corresponding to political tensions: loss of confidence in the ability to refloat the economy in 2010 and repercussions of the political stalemate concerning the raising of the debt ceiling, which resulted in the downgrading by Standard & Poor's and the loss of the USA's triple A rating. Added to this in 2011 were the poor sales numbers.

SMEs' confidence index evolution



Source : NFIB

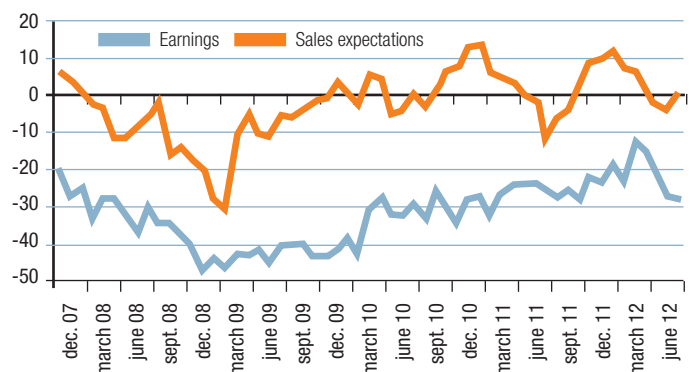
On the employment side, the survey highlights an improvement in hirings (past and expected). The downside is that more than a third indicated that they had failed to find qualified staff for the positions offered. The Federation considers that this is a good sign for employment and augurs well for a fall in unemployment. This rate did indeed decline slightly in August and more markedly in September (7.8%). We do not believe that the gap between labor supply and demand is likely to reduce unemployment. As indicated above, the problem probably arises more from the deterioration of labor mobility and the increasing number of unskilled long-term unemployed workers. The fall and then the uneven rise in the unemployment rate results in part from the dejection felt by a fraction of these unemployed workers who give up their search for employment and then began to search again, just when an improvement in the unemployment rate was reported, as well as to the growing proportion of part time jobs.

But the indicator of SMEs' hiring intentions (10% net ⁽²²⁾) is evidence of a perceptible improvement compared with the situation a year earlier. However, the intentions, already favorable a year ago, are not really reflected in the facts: job increases have remained practically nil over a year.

This tenuous improvement is clouded by the state of the other indicators that make up the overall confidence index: sales remain depressed around zero (the net percentage between the "highest" and the "deteriorated further" is 1 versus an average of 14 in 2007) and profits are continuing their fall (-28 versus -19). As can be seen, the reality experienced by Main Street is far from the results achieved overall by American businesses since the start of the crisis. Admittedly, since May 2010, the change in the profits of SMEs responding to the NFIB survey shows a smaller deterioration, still chaotic and very distinctly below the equilibrium line. There is, nevertheless an improvement. This curve turned sharply down in June. Since profits are the main source of finance for their investments and hirings, SMEs are expected to maintain a prudent wait-and-see stance, especially since they state that the rise in regulatory costs and taxes reduce their room for manoeuvre and their profitability.

Sales expectations and earnings

net percent ("higher" minus "lower")
last three months compared to prior three months



Source : NFIB

(21) *Small Business Economic Trends de la National Federation of Independent Business* (publication de septembre 2012) : <http://www.nfib.com/research-foundation/surveys/small-business-economic-trends>

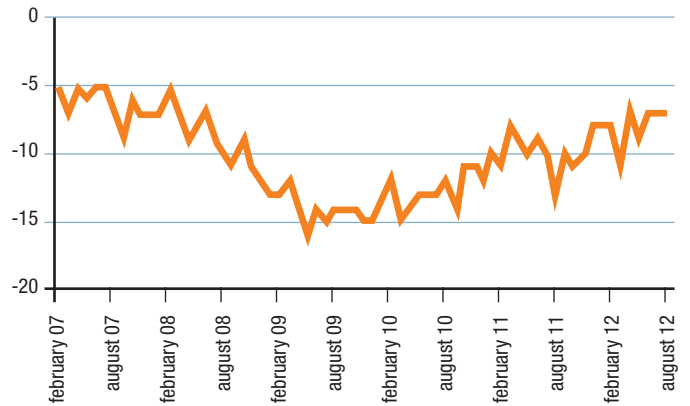
(22) This concerns the difference between hiring intentions on the rise and those that are declining.

Wait-and-see policy when confronting economic and political uncertainties

This wait-and-see policy is also shown in the indicator related to access to bank credit (-8 average since January 2012 versus -6 in 2007), the latter being of key importance for SMEs since, unlike their big counterparts, they cannot make use of the bond markets. The indicator has been very stable since April: SMEs believe conditions for obtaining credit are less restrictive but a majority nevertheless declares that they do not wish to borrow (see boxed text on *American Regional Banks*).

Credit conditions

Loan availability compared to three months ago



Source : NFIB

American regional banks

Their difficulties have repercussions on the credit offered to SMEs

By Nina Delhomme (writing completed on 18 October 2012)

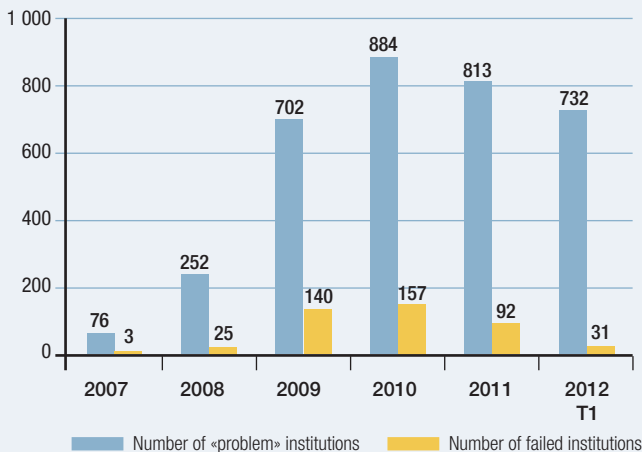
The financial tribulations of the big Wall Street banks were the object of great attention during the financial crisis - the regional banks less so. They are however essential partners for SMEs. Before the crisis the regional banks were very involved in the delivery of mortgage loans and in financing major projects for property development companies. The bursting of the property and credit bubbles shook them greatly. Will restructuring their balance sheets and their ability to meet many challenges be likely to make access to credit easier for SMEs? Where do they stand?

Balance sheets are improving...

The Federal Deposit Insurance Corporation (FDIC) ⁽¹⁾ identified 732 banks in difficulty at the end of March 2012 (chart) or 10% less than three months earlier. This trend reflects ongoing balance sheet restructuring, essentially due to the reduction in the proportion of nonperforming loans in their portfolio. These loans have reached their lowest level in three years, but it still remains high.

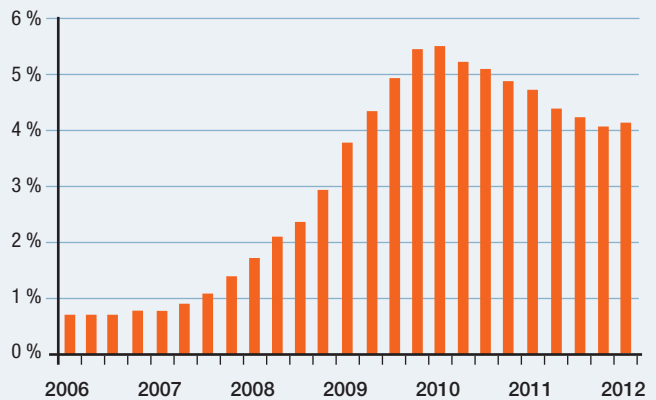
It also reflects the improvement in the capital adequacy ratio.

Number of failed and «problem» institutions released by the FDIC



Source : FDIC

Reduction of nonperforming loans by regional banks



Source : FDIC

(1) Created in 1933, the Federal Deposit Insurance Corporation (FDIC) is an independent Federal agency responsible for bank deposits and managing bank insolvencies.

... but the sluggishness of the property sector is slowing down balance sheet restructuring

The Standard and Poor's/Case-Shiller ⁽²⁾ index confirmed the rise in property prices for July (+1.2%) although prices remain 30% below the July 2006 peak. Our scenario assumes that the property market will not strengthen significantly in the coming months (stock level ⁽³⁾, household and business caution with regard to heavy investment) despite a slight easing in the residential sector in the 3rd quarter. The improvement in the regional banks' situation will probably be long and slow considering the large proportion of mortgages in their loan portfolio (55%), of which 6.6% are listed as non-performing loans.

While the regional banks have improved their balance sheets, businesses continue to be under pressure: credit contracted by 0.8% in the first quarter of 2012 compared with the previous quarter.

Other challenges could worsen the conditions for granting credit

- The FDIC's *Temporary Liquidity Guarantee*, which guarantees senior unsecured debt issued between October 2008 and October 2009 by the banks, ends on December 31, 2012.
- The March 2012 report of the *Government Accountability Office* (the state body auditing the public accounts) states that many medium- and small-sized regional banks (351) are still not able to leave the banking sector recapitalization program (or *Capital Purchase Program*) in the framework of the TARP ⁽⁴⁾.
- The biggest regional banks have to cope with the financial compensation that they will likely have to pay as a result of the legal proceedings against them for abuse of procedures on property repossessions initiated in 2009 and 2010 (US Bancorp, PNC Financial Services and SunTrust Bank).
- Last January the FDIC announced, on the basis of the Dodd-Frank ⁽⁵⁾ law, that the institutions it insures and those that have more than 10 billion dollars in assets, must pass an annual stress test. The concerns raised by this announcement were reinforced by the failure of two big regional banks (with more than 50 billion dollars of assets) in the Fed's annual stress test in March 2012. This led the FDIC to postpone the implementation of the tests for its own banks until September 2013.

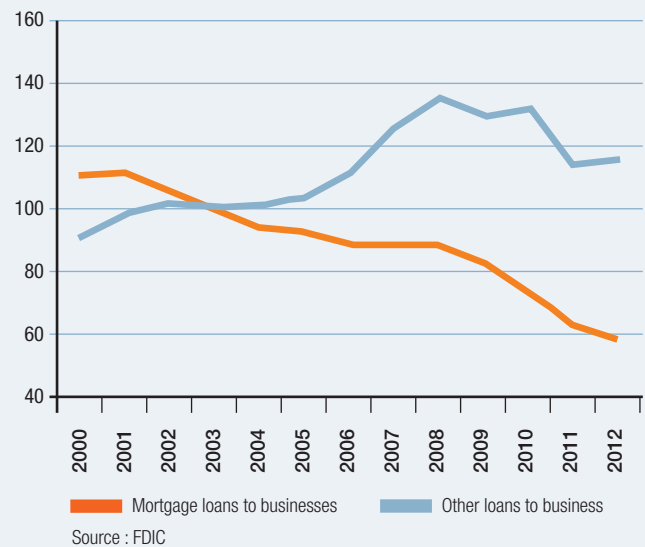
- Between now and 2019, regional banks with more than 500 million dollars in assets ⁽⁶⁾ will have to conform to the Basel III requirements, in particular by increasing their capital to cover part of the risks to which they are exposed.

Could the September quantitative easing 3 be a life-saver for the banks?

The liquidity banks will receive in exchange for the transfer of their MBSs (Mortgage Backed Securities) will help regional banks meet their obligations. Nevertheless, for banks in great difficulty, this manna is unlikely to lead to a sustainable recovery. In this context we believe that the regional banks are unlikely to make their credit offering more flexible in the coming months.

Loans to SMEs

(value less than \$100 000 / 100 basis in 2003)



SMEs, which have been facing credit deterioration since the beginning of the crisis (above) could be led to make use of *shadow banks* ⁽⁷⁾, and thus expose themselves to higher interest rates. And even though the NFIB survey on the main difficulties met by SMEs places access to credit in the last third of the list, the deterioration of margins as a result of a slowdown in profits and higher production costs could lead businesses increasingly to seek the support of banks.

(2) The S&P/ Case-Shiller index aggregates the markets of 20 large American towns.
 (3) 2.6 million property repossessions between March 2011 and April 2012 against 900,000 houses sold.
 (4) To meet the liquidity needs of financial institutions during the crisis, the Administration implemented a public assistance programme, the TARP, of which the CPP is part. The CPP aims to recapitalise the banks through capital injection (preferential shares).

(5) The Dodd-Frank law, passed on July 21, 2010, is a national regulatory reform of the United States financial and banking sector. In particular it lowered the threshold for the application of annual stress tests from 50 billion to 10 billion dollars in order to make all the banks improve their risk management.
 (6) In the United States, the Basel I and II requirements apply to banks with assets of more than 1 billion dollars.
 (7) Shadow banks are not required to comply with the banking sector regulations and therefore do not benefit from any public guarantee.

Access to credit is not identified by SMEs as their most important problem. Between 20% and 30% of them point to regulation and taxation as the main handicaps at the same level as sales prospects. This matches the last NFIB survey on SMEs' problems and priorities, published last August ⁽²³⁾, in which SMEs cite the difficulty of obtaining long-term credit (over five years) in 56th place and short-term (less than 12 months and revolving) in 58th place out of 75. The Federal Reserve's monetary policy has affected the ranking positively, as interest rates level have been relegated from 32nd to 62nd place.

On the other hand, in the top 10 places, SMEs rank nine problems linked to regulation (notably social security costs, ⁽²⁴⁾ which has been placed first for 25 years, federal as well as state taxes, the complexity of the tax system, frequent changes in tax rules and laws, land and property taxes) and also to political management of the economy (inconsistency of the regulations introduced by the government and uncertainties linked to economic conditions). The problem of high energy costs slipped to third place. These responses are practically identical to those made four years earlier, with, however, the appearance of two new issues: the uncertainties linked to the new economic situation (2nd) and to government actions (4th). Among the uncertainties cited, we note property values (29th place), a handicap when an entrepreneur has to provide property as a security for a loan. In this area, the September ⁽²⁵⁾ third quantitative easing (QE3) could result in a rise in property prices (through a fall in mortgage rates). But the experience of the first quantitative easing (QE1) shows that households and businesses have not fully benefitted from the fall in rates applied to MBS (Mortgage Backed Securities) ⁽²⁶⁾.

Also included in the list of difficulties are those of finding skilled labor (32nd place) and payment delays (46th place).

In this context, prospects for expansion continue to decline significantly. The percentage of businesses stating that the period now beginning is favorable to their development fell to 7 on average this year versus 14 in 2007. The crisis has lasted nearly five years and is far from having stabilized, unlike previous recessions, which were followed by a significant growth rebound.

Despite the uncertainties, SMEs remain the backbone of the economy

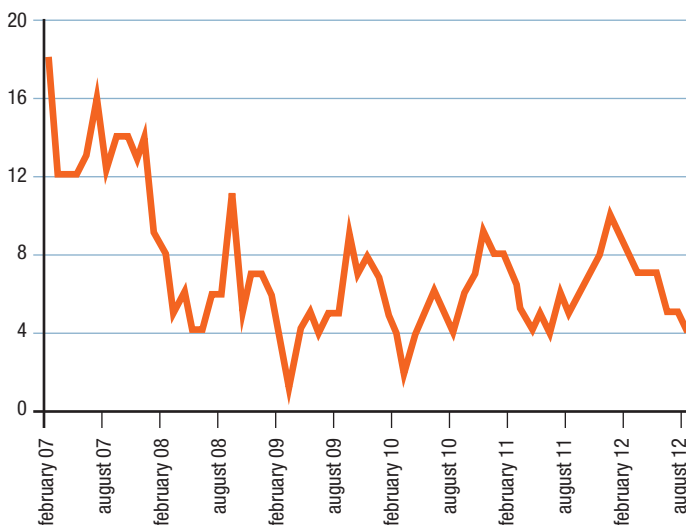
In the NFIB's monthly survey, SMEs express concerns about their environment in the months to come. They have been joined in this by big firms, which have announced a slow-down in profit growth over the year as a whole ⁽²⁷⁾.

But in 2013 American growth is expected to be around 1.5%, which marks a slowdown compared with 2004-2006. But when it was growing by 3%, the American economy did this by depending in part on a frenzy of borrowing, which led to the credit bubble bursting and recession. Household consumption is still making a positive contribution to growth and accounts for 70% of GDP. But what gives the USA its structural strength are its businesses and especially the SMEs. Since 2010, these have created jobs, have managed their finances and investments prudently and have adapted to economic turmoil. They seem to be in a stronger position today to play their full role in the recovery, even if this will remain weak.

However, the short term political uncertainties that the SMEs have put at the top of the NFIB survey are well-founded. The absence of a compromise between Republicans and Democrats for reducing the impact of the fiscal cliff on the economy could, according to the Congressional Budget Office, ⁽²⁸⁾ lead to a recession of 2.9% in the first half of 2013. But on this topic we prefer to assume general agreement to at least give fiscal support to growth. On the other hand, in the medium term, whoever is elected President must give strong indications of his intention to consolidate public finances in 2013, but also beyond 2013, so that businesses can work out their growth strategies and stabilize their expectations. Washington's political polarization will be a handicap to restoring what has been the country's strength throughout its history, i.e., a cooperative political system enabling the executive to act efficiently and pragmatically.

Outlook

Percent next three months «Good Time to Expand»



Source : NFIB

(23) Holly Wade, Small Business Problems & Priorities, NFIB Research Foundation, August 2012: 75 problems that the SMEs consider to be handicapping their development (3,856 businesses responded to the 2012 survey) are listed in descending order. http://www.nfib.com/research-foundation/priorities?utm_campaign=Research&utm_source=PDF&utm_medium=VanityURL&utm_content=pnp2012

(24) The author of the survey cites an increase of 103% in the cost of social security for SMEs over 10 years, above the rise in wages and inflation.

(25) QE3 provides for the purchase by the Federal Reserve of \$40bn per month of Mortgage Backed Securities, for an unlimited period until employment prospects improve. The Fed's action is aimed at bringing down mortgage rates, which should lead to a recovery in mortgage applications by households and a corresponding effect on house prices. This would support the construction sector and employment.

(26) Study conducted by San Francisco Federal Reserve <http://www.frbsf.org/publications/economics/letter/2012/el2012-16.html>

(27) *Earnings in the United States Are beginning to Feel a Pinch*, Nelson D. Swartz, New York Times, September 17, 2012.

(28) Craig K. Elwell: Double-Dip Recession: Previous Experience and Current prospects, Congressional Research service, June 19, 2012 <http://www.fas.org/sgp/crs/misc/R41444.pdf>