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Emerging Trends in Small Business Financing

The small business credit landscape is shifting, stemming from a combination of factors, some long-standing, some recent, and some newly emerging.

- Although lending standards have eased since the recession and the financial condition of businesses has improved, some credit needs continue to go unmet, particularly among smaller and minority-owned firms.
- Meanwhile, small business lending has declined as a share of assets among both large and small banks. Large banks' share of lending is growing at the expense of community banks.
- These developments have created a space for online lenders to enter the market and provide small-dollar credit. For small businesses, online lenders may be expanding access to credit. However, borrowers have raised concerns about the transparency of terms and rates of some online credit products. Banks have responded by both competing against and cooperating with online lenders.

Data on Borrowers and Potential Borrowers

One theme that is pervasive in small business lending is the lack of detailed and timely data about small business borrowers. In the wake of the financial crisis, information about small business credit demand was limited. The Federal Reserve Bank of New York developed the *Small Business Credit Survey* in 2010 as the result of listening sessions with community stakeholders which highlighted the importance of credit to local businesses and communities. Following the local success of the survey, the Federal Reserve Banks launched a national *Small Business Credit Survey* (SBCS) in 2015. The survey is designed to provide timely intelligence at minimal cost. The survey questions ask about business performance, recent financing needs, credit experiences, and outcomes. The Federal Reserve Banks work with a diverse set of approximately 400 local, regional, and national partner organizations to circulate the survey to small business owners. Typical partners include chambers of commerce, small business development centers, incubators, and government agencies that license businesses.

The SBCS is a convenience sample. Since the sample is not selected randomly, the survey may be subject to biases that are not present in randomly selected samples of firms. We control for potential biases by weighting the sample data so that the weighted distribution of firms in the SBCS matches the Census distribution of small firms in the US.

The 2018 survey,[1] fielded in fall 2018, yielded 6,614 responses from employer firms[2] in 50 States and the District of Columbia. Consistent with the composition of employer firms in the US, the weighted sample of respondents is composed of firms across the spectrum of industries. A third of the firms are fewer than 5 years old, 73% have fewer than 10 employees, and 83% are located in urban areas.

[1] Federal Reserve Banks. 2019. Small Business Credit Survey: Report on Employer Firms. https://www.fedsmallbusiness.org/survey/2019/report-on-employer-firms

[2] Employer firms are firms with full- or part-time staff on payroll in addition to the firm's owner(s).

In addition to top-line findings, the survey provides information on important business segments, including startups, minority-owned firms, women-owned firms, and veteran-owned firms; detailed analysis of these segments can be found in special topics reports that the Federal Reserve Banks published in 2017 and 2018.[3]

Financing Needs of Smaller Revenue Firms and Chief Credit Obstacles

The 2018 SBCS results highlight key challenges and opportunities in small business financing. Fifty-one percent of small firms earn between $100K and $1M in annual revenues. The survey reveals persistent credit gaps for these firms, which are often seeking small dollar credit. Of the applicants in this revenue band, 43% received the full amount of financing sought. 26% of smaller revenue ($100K-$1M) firms applied for $25K or less in 2018, and another 45% sought $25-100K. Because small loans are less profitable for banks than larger denomination loans and credit lines sold to larger businesses, the credit needs of small firms may not be best served by traditional lenders.[4,5]

Furthermore, smaller firms often struggle to meet banks' underwriting criteria. Of the firms with less than $1M in annual revenue that were denied credit, low credit scores and insufficient credit history were most commonly cited as the reasons their applications were denied. Top reasons given by firms with over $1M in annual revenue were different, with pre-existing debt and insufficient collateral topping the list of credit challenges.

Reliance on Personal Credit

Personal credit scores and collateral commonly underpin small business financing, even for larger revenue firms (those with annual revenues over $1M). More than 40% of small businesses report using personal credit scores when applying for business capital. Personal guarantees are the most common means of securing debt for both smaller and larger revenue firms.[6] Personal finances—especially a personal credit score—play an outsized role in how lenders and suppliers determine the terms of credit for small firms—especially newer and typically smaller firms that have not yet established a business credit history.

Mismatch between Application Sources and Success Rates

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[3] See www.fedsmallbusiness.org

[4] Karen G. Mills. *Fintech, Small Business & the American Dream: How Technology is Transforming Lending and Shaping a New Era of Small Business Opportunity.* Palgrave Macmillan. (2019).

[5] Karen G. Mills and Brayden McCarthy. "The State of Small Business Lending: Innovation and Technology and the Implications for Regulation." Harvard Business School. (2016). Working Paper 17-042. http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf

[6] Federal Reserve Banks. *Small Business Credit Survey: Report on Employer Firms*. (2019). https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/sbcs-employer-firms-report.pdf

The SBCS also provides insight on the credit sources small firms turn to for financing. As noted in prior surveys, and not surprisingly, the 2018 respondents indicated they most often apply for credit at banks. Half of the respondents that sought financing turned to a large bank, and nearly as many firms applied at a small bank. Notably, in 2018 about 32% of applicants submitted credit applications at online lenders, which the survey defines as "nonbank alternative and marketplace lenders."

Despite the higher share of firms applying at large banks, the survey data also indicate that small firms of all revenue sizes experience higher approval rates on average at smaller banks and online lenders than at large banks.[7]

Bank Lending to Small Businesses

Given the continued importance of banks as the source small firms most often turn to for credit, it is important to examine the supply of bank credit. Bank loans of over and under $1M are standard proxies for large and small business lending, respectively. Data from the Federal Financial Institutions Examination Council (FFIEC) show steady growth in large business loans (loans >$1M) since 2010, and a corresponding lack of growth in small business lending (loans <$1M) during the same time period.[8]

Of course, these trends have been driven in many ways by credit demand, but looking back over ten years, there have been other factors at play. During the recession and its aftermath, business financials were weakened, delinquencies rose, and banks tightened their lending standards. Since that time, delinquencies have returned to more normal ranges, and as the Federal Reserve's Senior Loan Officer Opinion Survey indicates, banks' lending standards have eased overall.

Even so, loans to small firms hover near pre-recession levels[9]; and altogether, small loans are shrinking as a share of all commercial loans and as a share of banks' total assets.

Some have suggested small business lending has become less important to banks, driven in part by the limited profit potential of small loans. An analysis of community bank profits shows that business loans and lines of credit are not very profitable in aggregate. Of course, banks likely want to retain these customers because other small business services – including credit cards – do generate stronger returns.[10]

A separate analysis from Bank Administration Institute[11] attributes the lower profits to relatively high fixed costs - for origination, underwriting, servicing, and compliance. Those fixed costs are roughly the same whether the loan is $100K or $1M, and they note the lower net income on smaller loans may not

[7] Federal Reserve Banks. *Small Business Credit Survey: Report on Employer Firms.* (2019).
[8] FFIEC Call Reports, 2018; data include C&I and CRE loans. Small business loans are defined as loans under $1 million.
[9] "Small Business Lending in the United States, 2018," Office of Advocacy, U.S. Small Business Administration. https://cdn.advocacy.sba.gov/wp-content/uploads/2019/04/24110545/Small-Business-Lending-in-US-2016-Report.pdf
[10] Oliver Wyman and Fundera. *Great Expectations: Improving the Loan Application Process for Small Business Borrowers.* (2017).
[11] Bank Administration Institute. "Making Small Business Loans Profitably." (2015) https://www.bai.org/banking-strategies/article-detail/making-small-business-loans-profitably

justify the risk. As other types of lending have become increasingly automated, the process for small business loans has not benefited from the same efficiency gains. These loans are harder to automate – and also difficult to securitize, which limits their appeal for some institutions. While the use of automated processes makes small business lending more standardized, it can limit the types of credit available to small businesses and the types of firms that qualify for credit from traditional funding sources.

Underserved borrowers and potential borrowers

Amid shifts in the credit landscape, some creditworthy small firms remain underserved. As new online lenders have entered the market with promises of expanding credit access, there has been renewed focus on questions about whether creditworthy minority- and women-owned small businesses have access to affordable credit.

Studies show that some women- and minority-owned businesses do face barriers to accessing credit. For example, in 2016 Experian looked at the use of credit among minority business owners as compared to US-small business as a whole.[12] They concluded:

- Minority owned businesses receive fewer commercial loans and are more likely to turn to consumer credit to fund their businesses;
- Although there are slight differences in their credit scores and payment histories, Experian notes that these minority business "should qualify as viable prospective borrowers;" and
- This study adds to a number of others dating back over two decades suggesting there are minority-owned, creditworthy small businesses that are likely underserved.

Data from the SBCS special report on Minority-Owned businesses[13] show:

- Minority-owned firms are more likely to say they sought financing than non-minority-owned firms;
- Minority-owned firms are 21% less likely to cite sufficient financing as a reason for not applying for financing in the past 12 months
- Notably, 28% of minority non-applicant firms did not apply because they were discouraged compared to 15% of non-minority non-applicant firms

Online lenders and credit access

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[12] Peter Bolin and Raymond Anden. *Study reveals opportunities for minority-owned business lending*. Experian. (2016).

[13] Alicia Robb, Mels de Zeeuw, and Brett Barkley. "Mind the Gap: How Do Credit Market Experiences and Borrowing Patterns Differ for Minority-Owned Firms? Federal Reserve Banks of Atlanta and Cleveland. (2018).

Minority-owned firms are less likely to receive financing, and when they are approved, they are approved for less of the amount sought - - even when controlling for borrower credit score.[14,15] Data from SBCS can be used to compare small businesses that applied to credit from traditional banks only and those that made at least one application for credit to an online lender. Comparisons show that the groups more likely to apply to online lenders are:

- **Smaller firms** -- *revenues under $1 million*
- **Younger or newer firms--** *in business less than 5 years*
- **Minority-owned**

While certainly not definitive, this survey evidence suggests that online lenders may be increasing credit access for certain borrowers. Results from the 2018 SBCS indicate that medium- and high-credit-risk applicants seeking loan or line of credit financing were *as likely* to apply to an online lender as to a large bank (54% and 50%, respectively), and *more likely* to apply to an online lender than to a small bank (41%), CDFI (5%), or credit union (12%).

Applications to online lenders continued to trend upward: 32% of applicants turned to online lenders in 2018, up from 24% in 2017, and 19% in 2016. This growth occurred despite lower applicant satisfaction with online lenders compared to satisfaction levels with large and small banks.[16]

While online lenders may expand access to credit -- they also raise a set of concerns. A series of focus groups with small firms[17] conducted by the Federal Reserve Board of Governors and the Cleveland Fed illuminates some of the issues. The focus groups, conducted online, asked small firms about their awareness and impressions of online products and lenders and their understanding of the credit products offered.

Small business owners were asked to look at actual websites of online lenders as if they were shopping. Participants were presented with mock products with costs and features modeled on those actually in the market – one of which was a merchant cash advance. The firms were asked to estimate the effective interest rate. Even though firms were presented with exactly the same information, their answers varied considerably, ranging from 5% to over 50%.[18] However, when asked specific questions, many owners expressed uncertainty or answered incorrectly, particularly on cost. When asked what recommendations they would make to the industry, they said: "*Just make the loan descriptions simple and easy to understand*."

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[14] Robert Fairlie, Alicia Robb, and David T. Robinson. "Black and white: Access to capital among minority-owned startups." *Stanford Institute for Economic Policy Research discussion paper* (2016): 17-03.
[15] Alicia Robb, Mels de Zeeuw, and Brett Barkley. "Mind the Gap: How Do Credit Market Experiences and Borrowing Patterns Differ for Minority-Owned Firms? Federal Reserve Banks of Atlanta and Cleveland. (2018).
[16] *Small Business Credit Survey: Report on Employer Firms* (2019).
[17] Defined as "mom & pop-sized"—owner plus 1-20 employees and <$2 million in revenues.
[18] Barbara J. Lipman and Ann Marie Wiersch. "Browsing to Borrow: 'Mom & Pop' Small Business Perspectives on Online Lenders." *Board of Governors of the Federal Reserve System* (2018).
https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf

The 2018 SBCS findings underscore this point. Among applicants that were successfully funded – satisfaction was considerably lower for online lenders than for large and small banks. When asked why, the common responses were lack of transparency and high interest rates.