FDIC PODCAST

Small Business Lending

BRIAN SULLIVAN: Hey, welcome back to the FDIC podcast, a place to talk about the business of banking. and how banking supports business, most especially small businesses. I'm Brian Sullivan with the Federal Deposit Insurance Corporation, and today we dive into the world of bank lending to small businesses.

The FDIC just released the *2024 Small Business Lending Survey Report*. It's a sampling of U. S. banks that explores their small business lending practices and how these banks are meeting the credit needs of our nation's small businesses. And joining us are two of the report's authors, FDIC economists Nick Frazier and Jacob Goldston. Gentlemen, welcome.

NICK FRAZER: Happy to be here. **JACOB GOLDSON:** Great to be here.

BRIAN SULLIVAN: So, Nick, you first…tell us about this survey, how was it conducted and what does it tell us about banks and the small businesses they lend to?

NICK FRAZER: So, the Small Business Lending Survey, or SBLS, was a nationally representative survey. We ended up surveying about 1,300 banks, which amounts to about a quarter of the banks in the U.S. Doing the survey at that kind of scale allows us to get a comprehensive view of small business lending to make statements about the entire industry, as well as also pick out some differences where they exist, between different types of banks. And this lets us not only make statements about small business lending and understand how banks do it but helps the FDIC and other stakeholders get a better understand how banks meet the credit needs of small firms.

BRIAN SULLIVAN: Nick, it's, it's not a surprise is it that banks lend to small businesses? That's what they've always done, right?

NICK FRAZER: Right. It's not so much…this is something the FDIC has long understood about small banks of all sizes and in the report, we cite that over 90 percent of banks lend to small businesses in a regular, in a typical fashion.
The point of this survey was more to understand the variety and depth of practices that banks do, including things like fundamentals, such as loan underwriting and approval of loans, how they view their markets in competition, as well as new and timely topics that are maybe less studied, like the use of fintech, financial technology, and the role of branches and lending to, certain types of small business borrowers of a particular interest like a startup.

BRIAN SULLIVAN: Well, Jacob, what does this survey tell us about how, or maybe even whether… you say more than 90 percent of banks do this, but how are banks lending to small businesses?

JACOB GOLDSON: So, one of the basic things that we find with the survey which is something that's often assumed but not investigated, is that banks are making pretty large loans to businesses they consider to be small. So, nearly all banks make small business loans of a million dollars, and about half of banks will make three-million-dollar loans to small businesses. Again, this is the businesses that they consider to be small. And one of the other things that we confirmed that I think a lot of people know or at least guess about small business lending is that banks are generally keeping this stuff on their books with the exception of certain government-guaranteed loans that can be sold off. This is not a situation where people are making these loans and then immediately selling them off like their mortgages.

BRIAN SULLIVAN: And what does that tell you when they keep them on their own books…they have faith in their own underwriting I would think, right?

JACOB GOLDSON: Well, it means they've got to be careful about their underwriting and they've got to think pretty hard about that because they're not, they're not just selling them off. They've got to keep them on, they've got to keep servicing them. So, relationships may be playing a more important role here, which is something that we find in more detail.

BRIAN SULLIVAN: Are there any differences between how big banks and small banks lend to small businesses?

JACOB GOLDSON: So, we found a number of what I think of as very interesting differences between large and small banks and how they lend to small businesses. We found that they, especially for smaller loans, acted pretty differently. So, one thing we did when we did the survey is we asked banks, what kinds of information do you gather about different loans…particularly loans of different sizes. We asked about the small loans, like $25,000, medium-sized loans, $250,000, and then big loans of a million or $3 million. We asked them what kinds of information they gathered, stuff like…did you talk, did you ask about business plans? Do you ask about credit scores? Did you ask if a loan officer interview involved in the in the process? And we took these things and we kind of use that to create kind of a score of the amount of information that they use, and particularly a score for their 'soft information,' which is the stuff that's hard to quantify. Like a loan officer interview may be hard to turn into a number where stuff that's sort of easy to quantify, like a credit score.

BRIAN SULLIVAN: Is what you would you call 'soft information' the kind of relationship lending that maybe smaller banks are more involved in than, say, larger banks?

JACOB GOLDSON: Yeah, so that's what we found…that small banks are sort of consistently using more soft information. Which is, I think, is generally what people think of when they think of relationship lending. They think of these small banks being more connected with their borrowers and more embedded in their communities and better able to make sense of this sort of contextualized information. Which is, again, with a credit score, you just have a credit score and it's really independent of any kind of context and you can just put it in a spreadsheet, no problem.

NICK FRAZER: One thing we were really excited about when writing the 2022 survey was to talk about…to take a deeper look into how banks are using technology in their small business lending…especially when you think of larger trends in the industry, such as mobile banking and, for example, the really dramatic increase in remote communication during the pandemic and whether this had kind of permeated into the bread and butter of small business lending. And we found in the survey that this is the kind of industry-level statement we can make: Approximately half of U. S. banks were either using or considering using financial technology in some form for their small business lending. And so we can say things like most banks are using financial technology when they are using it for things that happen after the approval, after money changes hands for things like, uh, portfolio analysis, regulatory compliance, uh, data management. So, it's not necessarily changing the overall underwriting process as much as the kind of reducing the cost after the loan is approved.

BRIAN SULLIVAN: So, this confirms that the act of lending, you know, is still a human pursuit.

NICK FRAZER: It very much is, and so we see, in a different question, we ask 'how do you take applications?' And so, for instance, it might be at a branch, it might be at a site visit and it could be online. And so we find very very few banks will let you do an entire small business application entirely online.

BRIAN SULLIVAN: So does that also mean that the bank branch is still alive and well out there?

NICK FRAZER: I think that's a strong finding from the survey is that the bank branch is still kind of a central concept, a central defining mark…

BRIAN SULLIVAN: …for small business lending.

NICK FRAZER: For small business lending. Eighty percent of banks define their small business lending market, the place where their customers are generally located as somewhere around their small business, or sorry, somewhere around their bank branches.

BRIAN SULLIVAN: Right. Well, okay. So Jacob, technology has, you know, changed the nature of banking generally, but we've also seen this rapid growth of non-banks since you did your survey in 2016. How has this competitive landscape changed how banks approach small business lending?

JACOB GOLDSON: Well, we certainly see a lot more competition coming in from non-bank competitors. I would say particularly fintechs, we saw a definite rise in the number of banks that think that fintechs are a big competitor to them. We're not seeing technology supplant all these practices that you think of or associate with, uh, small business lending. For instance, we're not seeing, that banks that use technology are less likely to do sort of face-to-face human contact.

NICK FRAZER: I think a strong finding of the survey report is that technology seems to be supplementing rather than supplanting the role of humans in small business lending. It's still very much… there's needs to be a local branch, there needs to be some relationship with the customer through a long-term relationship between staff and the customer. These things remain critical; it remains the critical competitive edge of banks when they talk about what makes them better at small business lending than their competitors. Also it’s very important for retention, generating and maintaining these small business lending relationships.

BRIAN SULLIVAN: Well, what about banks’ lending to startups? Do you find that small banks are more likely to lend to startups than, say, larger banks?

JACOB GOLDSON: So small banks are a bit more likely to lend to startups than larger banks, but not…the difference is maybe 10 percentage points. So, it's not a huge gap. What's actually more interesting is the *way* in which small banks and large banks lend to startups, which is, we found very different strategies. Okay. Uh, so large banks tend to really focus on government guarantees, particularly the SBA (Small Business Administration). So we found that if you're a large bank and you're not an SBA lender, there's only a 25 percent chance that you lend to a startup, something like that. And if you do lend, if you do, if you are an SBA lender, it's much, much higher.

BRIAN SULLIVAN: So, banks are looking for some sort of government backstop to that loan before they'll make it?

JACOB GOLDSON: Large banks are looking for that.

BRIAN SULLIVAN: I see.

JACOB GOLDSON: So, we think startups are kind of a risky loan, and they're know, they're hard to underwrite because they don't necessarily have a long track record of being in business, sort of by definition. So, we found that it makes sense that large banks would seek some sort of guarantee. Now, what we found with small banks is they didn't seem to really require an SBA guarantee. That wasn't something that they were particularly looking for. Instead, we found with small banks, there was actually one very interesting behavior that was pretty common in small banks, which is having the small business owner meet directly with a decision maker in the bank. This is maybe beyond just meeting with a loan officer or a business banker. This is somebody who is going to have authority over the loan itself, over whether or not the loan gets funded. And we found that that seems to be a key to their making startup loans. So small banks that don't have these individual meetings are much less likely to make startup loans than the small banks that do have these meetings. And that's different from large banks; large banks, that behavior is less common and also less important for determining whether or not they make small business or sorry, startup loans.

BRIAN SULLIVAN: Well, I'll ask you both, where there are any surprises in this survey, especially as it compared to the one that you did back in 2016?

NICK FRAZER: Yeah, I guess I'll go first. We did talk about how technology really hasn't changed the nature of small business lending but it has kind of changed the nature of competition in the small business lending market, and in particular, as Jake hinted at earlier, the rise of these fintech lenders. So these are non-bank, uh, online firms that are…while they're not a main competitor of banks…they are a certainly in the market and something banks are very aware of. And when we ask them banks about the competitive advantages of these fintech lenders, they're fairly diverse. It's not just something like pricing, which is the common competitive advantage of credit unions. It's things like their back-end technology, their flexibility in lending, and other types of variety of advantages that fintech lenders bring to the market.

JACOB GOLDSON: One of the things that I found surprising was these meetings with decision makers. First of all, we found that 90 percent of small banks do this, have these meetings with decision makers, but only 40 percent of large banks. And that was a pretty, that was a much bigger drop off than we were expecting. And what's in one thing that's sort of interesting is that we broke it down into more, finer gradations. And it really seems to be a, sort of a smooth relationship with size. So the really, really big banks do this very, very rarely. And the really, really small banks do it extremely often.

BRIAN SULLIVAN: Is it an overstatement to say that banking still is a people business?

NICK FRAZER: I think at least in terms of generating and maintaining these relationships, there's lots of in-person competition. I think the only place where we see some differences across the industry is where Jake was just talking about using that soft information when you're making a loan decision, whether you're using the information generated in that relationship through the long-term contact to underwriting the actual credit worthiness of the application.

BRIAN SULLIVAN: Thank you gentlemen both! Nick Frazier and Jacob Goldston for joining us on the FDIC podcast. It was a great conversation. Thank you so much and congratulations on your survey.

NICK FRAZER/JACOB GOLDSTON: Thank you so much.