COMMUNITY BANKS AND SMALL BUSINESS LENDING

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Introduction

Although small banks do not account for a major share of commercial and industrial lending, they are critically important suppliers of credit to Main Street, the small business sector of the economy that produces nearly half of private GDP and employs half of the private sector workforce. They are also important citizens in the communities that they serve. The National Federation of Independent Business (NFIB) has studied the relationships between small businesses and their banks over the past 40 years.[2] When asked about what was important in a banking relationship, 70 percent of independent businesses said "knows you and your business".[3] Asked about performance, 50 percent of the owners using a small bank rated performance "good" on this dimension, compared to 40 percent of those patronizing a large bank. Over 60 percent said "reliable source of credit" was very important, 52 percent rated their small bank as "good" on this dimension compared to 46 percent for the largest banks. "Easy access to loan officer" was very important to 57 percent, performance was rated "good" by 56 percent of owners for small banks, 44 percent for large. These important dimensions of the banking relationship are clearly better provided by smaller banks than large ones.

The most important product that a community bank provides is credit, loans to support economic activity and job creation in their community that incorporate local and relationship information that scoring models exclude. In the process, banks perform due diligence on every loan application to insure borrowers return the money lent to them by savers. To do this, they collect as much information as is practical to assess the creditworthiness of loan applicants.

However, a recent study released by the FDIC (2018 FDIC Survey) provides important new information about small versus large bank lending to small firms.[4] Using a sample that represents about one-sixth of the bank in the United States, the survey finds that both small and large banks cite relationships and personal attention as a competitive advantage in small

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[2] The National Federation of Independent Business is a member organization with about 300,000-member firms that lobbies on behalf of small businesses in Washington, D.C. and in 50 state capitals. For 45 years, it has surveyed a random sample of its members on their economic condition.

[3] "Small Business and Banks: The United States." (1988) William J. Dennis, William C. Dunkelberg, Jeffrey S., Van Hulle, The NFIB Foundation, Washington, D.C.

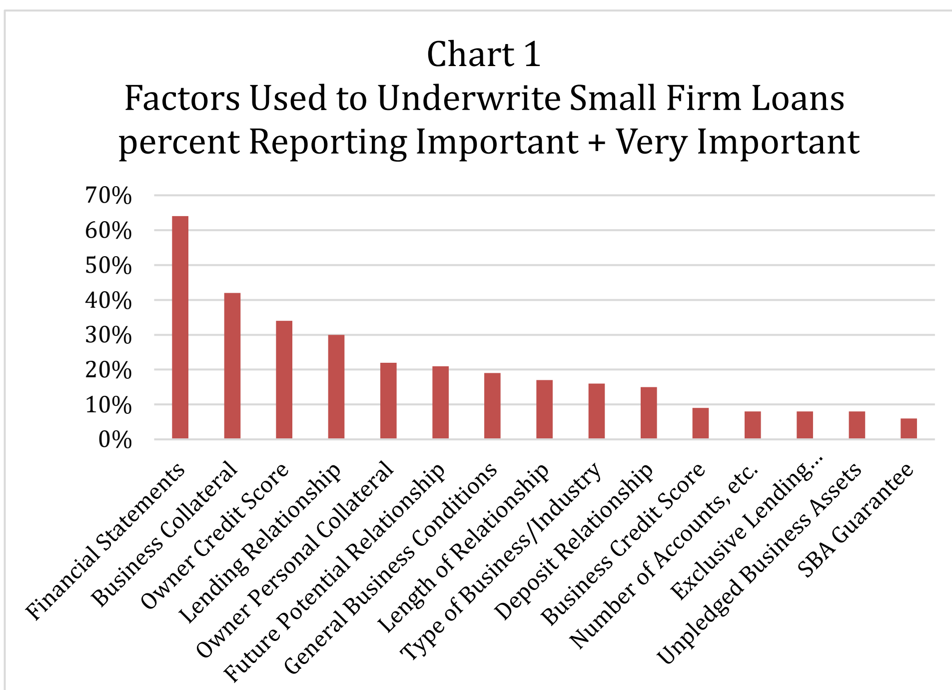
[4] 2018 Small Business Lending Survey, 2018. Federal Deposit Insurance Corp., Washington, D.C.

business lending and are willing to grant exceptions in underwriting policies based on existing loan and depositor relationships. The differences in relationship lending lie in the focus, where small banks tend to focus on community involvement and personal attention, while large banks focus on professional referrals. Both small and large banks use the same underwriting criteria, but large banks are more likely to use business credit scores and more likely to offer business credit cards and standardized products. Finally, small banks have a speed advantage in approving loans.

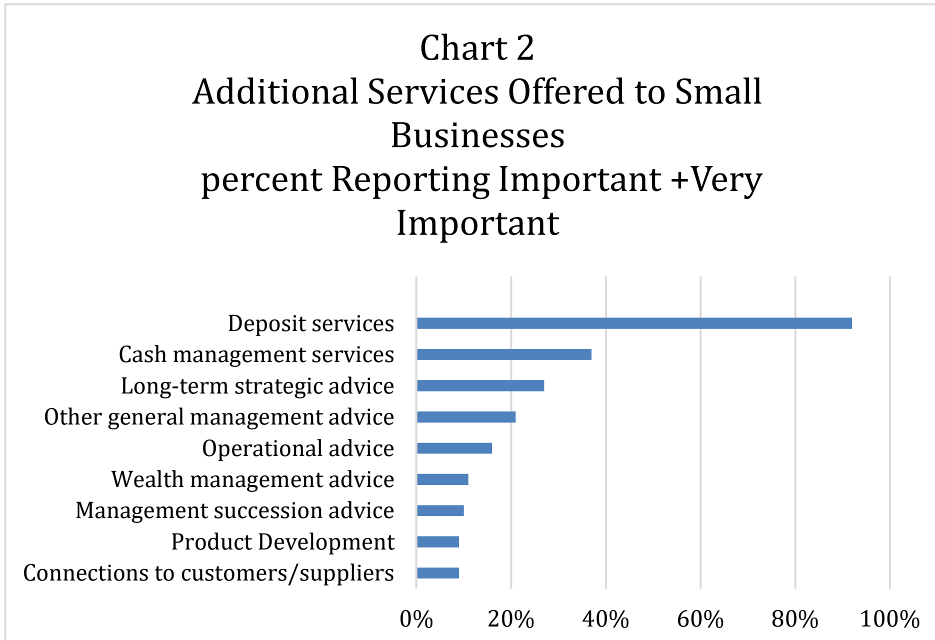
The 2018 National Survey of Community Banks provides insight into the role of community banks and small business lending (almost 96 percent of the respondents report making small business loans). Small banks report the type of information they use in making a small business loan, which provides additional insight beyond the 2018 FDIC Survey into the importance of hard information such as financial statements and soft information such as the lending relationship and length of the relationship for underwriting loans. The banks also report on ancillary service offerings to small firms that again can be either a hard service such as deposit services or a soft service such as strategic or operational advice, which provides insight into the depth of relationships small banks have with small firms. Finally, current and future competition for small business loans is also reported along with what terms are adjusted to other lenders in the market, which gives some insight into changes in the competitive landscape and how small banks are dealing with competition in their home market.

Small Business Loan Underwriting

This survey provides a window into the type of information small banks use when making small business loans where small banks are said to have a strong emphasis on relationship lending. Chart 1 shows the various pieces of information collected by community banks ranked by the percent characterizing the information sources as "very important." While the importance of relationships Not quantifiable) has been emphasized in the literature for small



business lending and community banks, the top two measurable factors are financial statements (reported by 64 percent of the banks) and business collateral (reported by 42 percent). This reliance on hard information is not say that soft information is not important, because bank examiners will pay close attention to traditional metrics for credit underwriting. An historical or current lending relationship is cited by 30 percent of the respondents as a factor in underwriting a loan, along with 21 percent reporting that the future potential relationship is considered and 17 percent the length of the relationship. The only factor that had any association with bank size was business credit score and SBA guarantees, where large banks more frequently reported these factors as important in underwriting small firm loans.

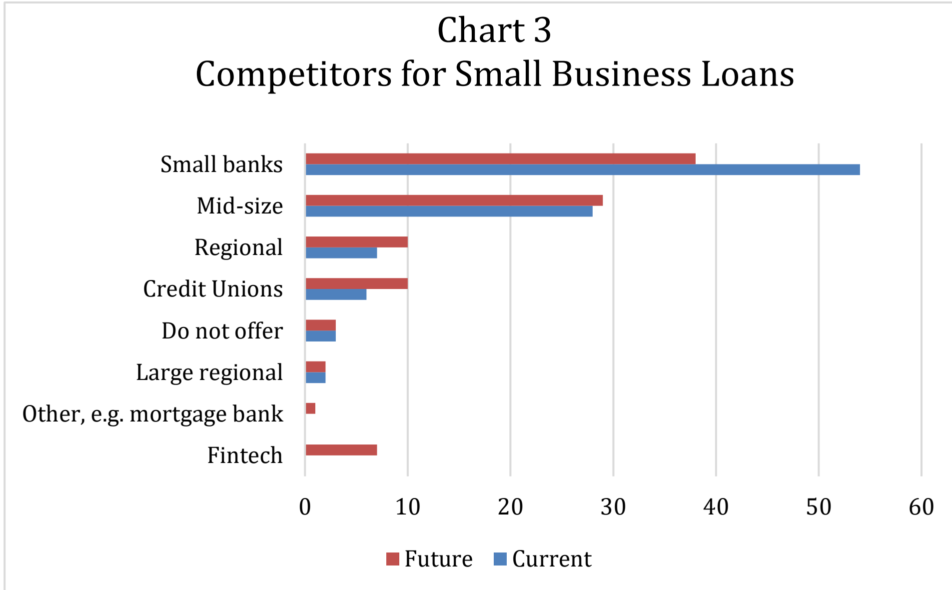


Ancillary Service Offerings

Banks offer other important services, often tied into a loan agreement, to gain or keep valued customers and deepen their relationship. For many businesses, community banks are an important source of management advice and market information. The 2018 National Survey asks the respondents to report on nine additional services beyond lending and the results are shown in Chart 2. Deposit services are most frequently reported (92 percent) followed by cash management services (37 percent). Many other of the soft services are reported less frequently. Bank size is strongly associated with some of these services. Larger banks (over $800 billion) more frequently offer cash, strategic management advice, wealth management advice, and other general management advice. Thus, it appears that some scale is required for small banks to offer a number of these soft services to their small business customers, because providing these often requires the acquisition of high fixed cost assets (e.g. a lawyer or investment specialist) that cannot be spread over a large customer base.

Competition for Small Business Loans

Small business lending does not occur in a vacuum. Community banks most frequently report (54 percent) other community banks (assets less than $1 billion) as their primary competitor. The next most frequently reported competitor is mid-size banks ($1 to $10 billion) at 28 percent. If a broader definition of community banks is used that includes banks with assets up to $10 billion, then the primary competition for 82 percent of the respondents is other community banks. Urban versus rural location plays a predictable role in whether a small community bank or mid-sized community bank is viewed as primary competition: in non-urban areas it is the small bank, while in urban areas it is the mid-size community bank.



Looking ahead, small banks see a notable shift in the competitive landscape. Only 67 percent of the respondents report that competition will come from their peers. Increased competition is reported from regional banks, 7 percent to 10 percent, and credit unions, 6 percent to 10 percent. The biggest change is with fintech, where no small bank sees fintech as a primary competitor today, but 7 percent do in the future. Location is associated with the reporting of future competition, with community banks in MSAs more likely to report fintech and other non-depository institutions as their future primary competitor, while those in rural areas are more likely to report credit unions and large banks as future primary competitors.

Loan Terms and Response to Competition

Community banks operate in competitive markets and even long-time customers will try to negotiate better terms, especially later in a business cycle. Sixty-three percent of the banks in the 2018 National Survey reported reducing terms “half the time” or “Usually/Always” in response to competition to make a loan transaction. Fifty-one percent reported that the pressure came from banks headquartered in their market. Although competition is a headache to the management of a community (or any) bank, it is essential to the health of the banking industry and the economy.

A number of possible terms can be adjusted in negotiations to close a loan deal in a competitive market. Only 5 percent reported having to make adjustments “usually” or “always” and 5 percent reported making no adjustments in 2017. Thirty-three percent reported “rarely” or “never” making adjustments in order to close a loan. The most frequently adjusted term, no surprise, is the interest rate charged, followed closely by loan fees. Collateral requirements (the second way out of a loan) were rarely altered to close a loan.

TERM	Rarely Never	Half the Time	Usually Always
Lower rates	43 %	37 %	20 %
Extend maturity	75 %	18 %	5 %
Reduce collateral required	91 %	5 %	3 %
Lower fees	53 %	31 %	15 %
Allowing more leverage	81 %	14 %	4 %
Fewer covenants	83 %	11 %	5 %

Larger community banks are more flexible on loan terms. The percent "usually" or "always" adjusting one or more loan terms to close a loan rises with bank size, from 5 percent for the smallest (under $200 million in assets) to 12 percent for the largest banks (Table 1). Looking at particular terms, the percent willing to adjust collateral "usually" or "always" rises from 2 percent for the smallest to 7 percent for the largest (Table 2). Fee reductions are also more frequent among the larger banks (Table 3). Covenant reductions (Table 4) show the same pattern. It is not clear what causes these bank size differences. No strong association is present for loan term adjustments and urban versus rural location. Larger banks tend to be in more urbanized markets and more likely to see more potential competitors, heightening their willingness to negotiate.

Table 1: COMPETITIVE LOAN TERM ADJUSTMENTS

BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks
Usual/Always	5	4	7	11	12	7 %
Rarely/Never	84	90	91	83	81	86 %

Table 2: ADJUST COLLATERAL REQUIREMENTS

BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks
Usual/Always	2	2	2	4	7	3 %
Rarely/Never	84	90	91	83	81	92 %

Table 3: LOWER FEES						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks
Usual/Always	10	14	14	21	16	15 %
Half the Time	11	30	40	40	36	32 %

Table 4: FEWER COVENANTS						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks
Usual/Always	2	4	4	6	7	5 %
Half the Time	8	8	12	13	16	11 %

Conclusion

Relationship lending is a comparative advantage for community banks. Their loan committees know the local market, often know the loan applicants, and possess information that is not used by branches of larger competitors where loan decisions are centralized, often based on point scoring models that cannot incorporate loan committee knowledge. This is an important niche in financial markets that is filled by a decreasing number of community banks, a concern for small business. All banks rely on roughly the same hard data, but only small banks are better suited to incorporate relationship information in the credit decision process.

Small banks can deepen their relationship with small firms through offering ancillary products and services. Deposit services are most frequently offered by community banks but fewer community banks offer soft services such as advice on strategy, product development, operations, and management succession. Larger community banks are more likely to offer these soft services because they operate in larger markets that offer enough potential customers for these services to economically amortize the higher costs of providing them.

Community banks generally view other small banks as the primary competition for small loans to businesses but in urban areas it is the larger community banks (between $1 and $10 billion in assets), while in rural areas it is the smaller community banks (under $1 billion). Looking ahead, community banks see fintech firms becoming more important as primary competitors for small firm loans, but this threat is more frequently seen by banks in urban areas.

Longer term, internet-based services will reduce the need for brick and mortar locations that are typically used by community banks. However, technology deployed over the internet will make it easier for community banks to compete effectively with larger banks, providing increasing convenience, safety and financial management tools comparable to even the largest banks. Further deregulation will also reduce the regressive compliance burden faced by community banks, allowing them to compete more effectively and profitably in the future.