Economic Analysis

The Changing Landscape of Small Business Lending

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- **Online lenders to small businesses use innovative methods to gauge creditworthiness**
- **Banks can leverage their big data capabilities to more effectively serve customers**
- **Small businesses customers heavily favor face-to-face interaction, making the retail bank indispensable**

"The long game is to use data and software to chew up and revolutionize the financial ecosystem."
-Max Levchin, co-founder of PayPal[1]

"Behind every small business, there's a story worth knowing."
-Representative Paul Ryan (R-WI)[2]

The Problem: Information Asymmetry

The 28 million small businesses in the U.S.—enterprises with fewer than 500 employees—accounted for 48% of total employment in 2012 and 54% of all sales.[3] Given their vast cumulative impact, there has been much government and economic focus on the development of small and medium-sized enterprises (SMEs). Unlike larger businesses, SMEs have experienced a slower and more uncertain rebound after the recession. In addition to demand and supply-side factors, SMEs were also hit by tightening lending standards and depressed collateral values, which reduced the number of creditworthy borrowers.[4]

A sluggish economy and heavy regulation have strained the relationship between small businesses and the banking industry. SMEs typically seek financing for any or all of the following reasons: starting up the business, increasing inventories and expanding the business. The small business loan ratio, which shows how well small business borrowers compete for loans against larger firms, has steadily declined since the onset of the recession, falling from 71.5% to 66.9% between 2008 and 2013.[5] Of particular concern is the decline in the ratio of outstanding microloans (< $100,000) as a share of banks' total loan portfolio as these are often in demand by SMEs. The portion of lenders' assets allocated to commercial and industrial microloans declined from 2.6% to 1.8% between 2008 and 2013, representing the largest decline of all small business loan categories.[6]

The relationship between larger banks and SMEs is even more contentious. Most small businesses (41%) apply for loans at large regional banks but only 45% of them get approved there; whereas, 34% of SMEs apply at community banks with a 59% approval rate.[7] The root of this problem lies in information asymmetry, wherein the borrower tends to know more about his/her financial condition and projected performance than the lender. For banks that are unable to collect and analyze mass amounts of applicant data, the presence of information asymmetry can lead to two types of market failure: adverse selection and moral hazard. Adverse selection

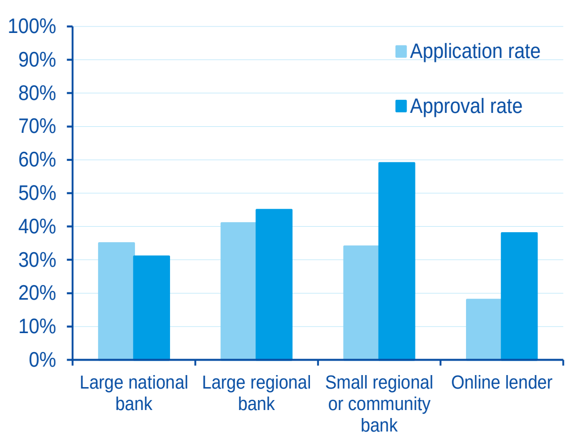
[1] The New York Times, http://goo.gl/nCECnz
[2] NPR, http://goo.gl/CSGi5O
[3] U.S. Census Bureau, http://goo.gl/a6m0Eu, Small Business Administration, https://goo.gl/FRFO4W
[4] Small Business Administration, https://goo.gl/Nzk0zt
[5] Ibid.
[6] Ibid.
[7] Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia, http://goo.gl/WZRWvK

occurs when the lender offers average interest rates and thus unknowingly attracts riskier borrowers, as those with better risk seek lower rates. On the other hand, moral hazard is the possibility that the borrower will not use the funds as intended or may take unnecessary risks.

Community banks and smaller regional banks have a competitive advantage in their ability to create close relationships with their customers, and thus possess more information about their ability and willingness to pay back a loan. In addition, online lenders, such as Kabbage, and equity-based crowdfunding platforms, such as Lending Club, have emerged and gained prominence, boasting faster funding turnarounds using comprehensive algorithms that encompass thousands of data points.

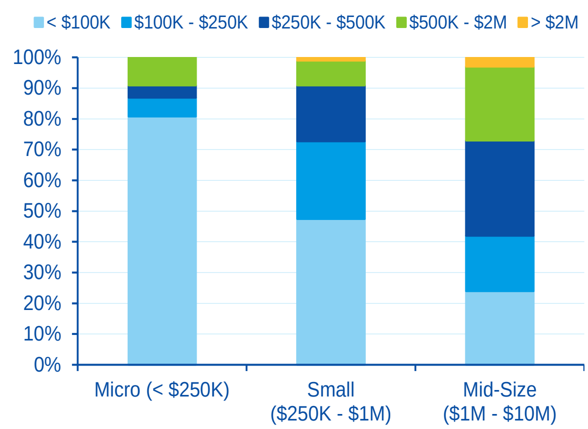
The optimal way for larger banks to reduce information asymmetry is to amass and review as much material about the borrower as possible—a feat that has become infinitely more achievable with the advancement of big data. However, most banks still rely on standard scoring models or personal credit scores. In order to effectively compete against emerging credit sources, such as online lenders, and institutions traditionally popular with SME borrowers, such as community banks, larger banks can utilize the full array of data they possess in order to increase their SME loan portfolio. Big data can provide an alternative means of evaluating creditworthiness and can also allow the bank to offer new value propositions to SME customers.

Chart 1
Credit Sources of Small Businesses
%



Source: Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia

Chart 2
Amount of Financing Sought by Firm Size
%



Source: Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia

The Solution: Know Your Customer

For small businesses with limited history in need of larger amounts of financing, several online lenders and peer-to-peer lending platforms have emerged claiming to incorporate a wider breadth of factors into their credit analysis. The software behind these emerging services makes effective use of all customer data available, such as social media activity and spending patterns, in order to evaluate both the customer's ability and willingness to pay back their loan.

Cash Flow: As financial institutions reconsider their overreliance on a small business owner's personal credit score, the business's sales performance and financial management have emerged as some of the most predictive measures of creditworthiness. The model of OnDeck, a BBVA Compass partner, evaluates small businesses based on their cash flow and direct deposits by analyzing their online banking, payment processing and accounting information, via sources like Quickbooks. With an increased emphasis on cash flow however, small businesses that have been in operation for less than a year and don't meet a minimum annual revenue are cut off from consideration.

Social Media: Online lenders are looking to social media activity on Facebook and Twitter along with financial information from the applicant's friends and followers to predict the likelihood that a borrower will pay back a loan. Social media has the potential to reveal more about the character of the small business owner based on his/her posts on a personal or business account. By looking at customer ratings and reviews as well as replies to customers' inquiries, the performance and customer service ability of the business can also be substantiated during the application process.

The buzz about using social media to evaluate creditworthiness escalated last month after Facebook was granted a patent on a technology that would allow lenders to check the credit scores of an applicant's friends.[8] The logic behind using this technology is that if loan applicants associate with financially responsible people, they are more likely to pay back their loan. Customers of Kabbage can opt to provide access to their Facebook and Twitter accounts in order to increase their loan amount based on the seller rating and customer service activity on these social media outlets. Some lenders also link to borrowers' eBay, PayPal and Amazon accounts in order to gauge customer traffic, customer service and online sales.

Behavioral Analytics: The availability of data on hand allows alternative lenders to assess creditworthiness from even the most insignificant-seeming features. For example, Kreditech looks at how often a customer uses capital letters and at the speed with which the applicant moves his/her mouse during the application process. Other online lenders even look at the amount of time spent reviewing terms and conditions during the application process. Some platforms incorporate mobile phone data to measure creditworthiness, using data such as the length of calls and the time of the day and location at which calls were made. Several banks and online lenders look at the individual's history of paying utility bills, rent and other monthly obligations in order to estimate the likelihood of loan repayment. Behavioral data on small businesses and their owners could be another asset in developing a well-rounded picture of their willingness and ability to pay back loans.

Can We Compete?

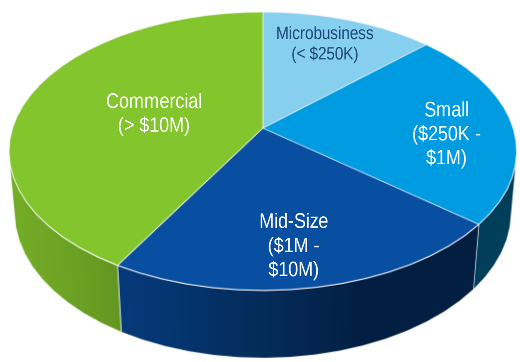
As banks compete against new online lenders and against each other, they can use their retail banking services and experience to expand the value proposition they offer to SMEs. Larger banks in particular can take advantage of their physical scale, advanced software and big data capabilities in order to further attract SME customers. The big data that larger banks possess is a competitive advantage against smaller regional banks that might be considered more cognizant of local market conditions. For larger banks, going beyond just collecting big data and into simple data analysis could facilitate the decision-making process of SME customers. For example, one use of big data in the small business space would be to analyze the spending of bank customers in order to advise SMEs on where to concentrate their business activities.

Although partnering with an online lender and offering additional perks to SME customers could be effective acquisition/retention strategies, perhaps the most essential value proposition that banks can offer is face-to-face customer service at the branch. Unlike consumer banking trends where branch volume is dropping and mobile banking is quickly becoming the norm, small business banking still appears to be mainly centered around the physical branch. A recent Deloitte study found that small businesses prefer face-to-face channels, with 53% reporting that going to a branch is important, 70% conducting business banking activities in the branch and only

[8] U.S. Patent and Trademark Office, http://goo.gl/K6qivT

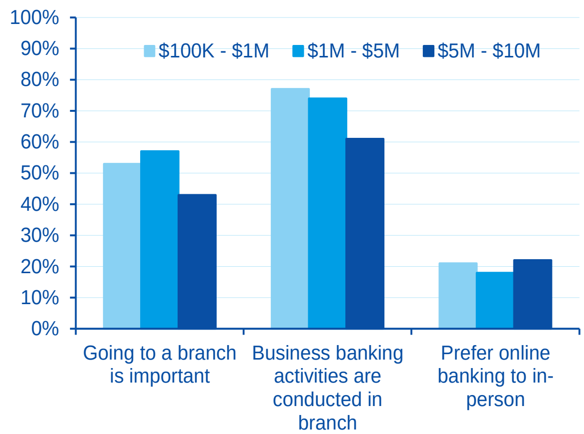
20% preferring online to in-person banking.[9] In addition, only a quarter of small businesses are comfortable with using a mobile device for banking transactions. Due to the complexity entailed with starting and financing a business, the personal engagement and specialized knowledge that branch employees can offer SME clients are inherent competitive advantages that banks possess versus purely online providers. Although small businesses seem to heavily favor more traditional banking channels, their technology usage indicates some adoption of digital banking services. The study found that 68% of small businesses have used online banking and 36% used online bill pay offered through their primary financial institutions.[10] Based on this data, providing a seamless multichannel experience with roots at the branch level is the key to better supporting small business customers.

Chart 3
Credit Application Rate in 1H14 by Firm Size
%



Source: Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia

Chart 4
How SMEs Interact with Their Banks
%



Sources: Deloitte, BAI Research

Bottom Line

The increasing economic contributions of small businesses can provide a substantial revenue opportunity for financial service providers. The needs of today's SMEs are continuously evolving and new digitally-based services have emerged to help these customers finance their growth. However, small businesses heavily favor face-to-face interaction, thereby giving banks with physical locations an inherent advantage. To protect this meaningful customer base, banks must utilize all the data available about loan applicants, such as social media activity and spending patterns, in order to more accurately gauge both their ability and willingness to pay back the loan. By utilizing their existing big data and software capabilities along with the branch infrastructure, banks can deliver both superior customer service and a differentiated experience to SMEs to further bolster acquisition and retention.

[9] Deloitte Consulting, BAI Research http://goo.gl/DVQTG7
[10] Ibid.

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