

Who Is Lending to **Small** Businesses?

The Role of Community Banks

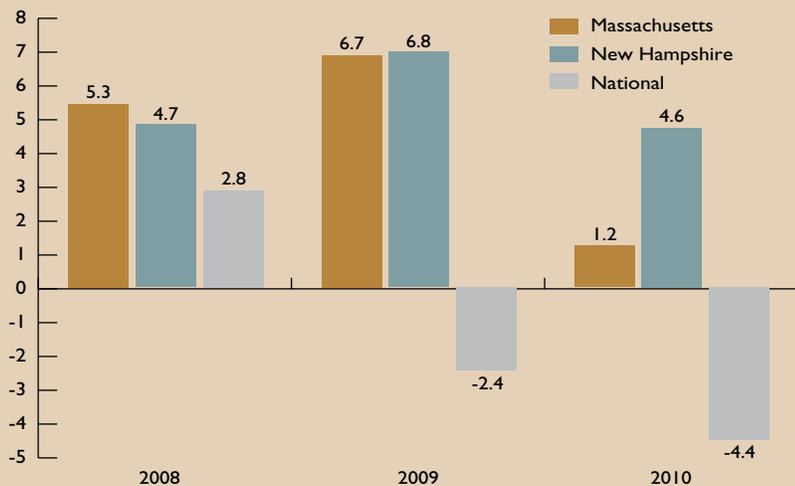


by DeAnna Green, Federal Reserve Bank of Boston

Community banks believe they are special.¹ They argue that their strong ties to local communities—whether rural villages or big city neighborhoods—enable them to make a difference economically, despite their small size. And when it comes to small business lending, three recent reports on New England financial institutions tend to support this belief.

Illustration: Barry Maguire

Percentage Change in Small Business Lending Volume at Community Banks



Source: Massachusetts Bankers Association, New Hampshire Bankers Association.
Note: 2010 data is for nine months ending Sept. 30, 2010.

Since the economic crisis, many observers have documented a decrease in lending to smaller businesses. For example, the U.S. Small Business Administration Office of Advocacy found that lending to small business declined by 6.2 percent from 2009 to 2010. The smallest loans—below \$100,000—dropped by 5.5 percent in 2008-2009.²

But despite those nationwide statistics, which represent lending by all banks, recent lending data seem to indicate that smaller banks in Massachusetts and New Hampshire continued to lend through the recession. Three recent studies found that larger national banks and out-of-state lenders decreased small business lending in Massachusetts and New Hampshire, while local banks stepped up to provide a greater proportion of small business credit.

Complementing the regional reports, national data from the U.S. Small Business Administration, released in February 2011, show a decline in small business loans by the biggest banks since 2009, while lending by banks with less than \$500 million in assets remained remarkably stable. (See “Value of Small Business Loans.”)

Increased Lending

The Massachusetts Community and Banking Council (MCBC) evaluates small business lending trends using Community Reinvestment Act lending data.³ MCBC found that in 2009, for the second year in a row, local lenders increased market share in small business loans—after years of market

share losses to out-of-state lenders.⁴ By far, most small business loans in Massachusetts were underwritten by local lenders. For 2009, local lenders originated \$2.6 billion in loans; credit card lenders, \$488.1 million; other out-of-state lenders, \$564.5 million. Overall in 2009, small business lending that banks reported under CRA lending was down, both in the state and nationwide, according to MCBC.

Another Massachusetts study examined all “small business lending” (for smaller banks, small business lending reporting is voluntary under CRA), not just CRA loans. The Massachusetts Bankers Association (MBA) found that local lenders increased lending consistently throughout the recession, between 2007 and late 2010.⁵ Nationally, small business lending by community banks increased only in 2008 and declined in the following two years. (See “Percentage Change in Small Business Lending.”)

According to the MBA, community banks increased their volume of small business lending by 5.3 percent, 6.7 percent, and 1.2 percent in 2008, 2009, and the first nine months of 2010, respectively. Cumulatively over the two years and nine months reported, community banks increased small business lending by \$1.21 billion.⁶

The New Hampshire Bankers Association also found that community banks in that state increased small business lending between 2007 and 2010. Small business lending volume increased by \$231 million over the three years.

During the same time period, national

credit card banks saw a significant reduction of their lending activity in both states, reducing their market share for the first time in years. The dollar amount of credit card loans to small business was down 67 percent in 2009 and 26 percent in 2008. A March 2010 survey by Greenwich Associates also found evidence of a move away from larger banks. Greenwich found that about half the small and mid-sized businesses it surveyed borrowed from a lender outside the top 20 U.S. institutions.⁷

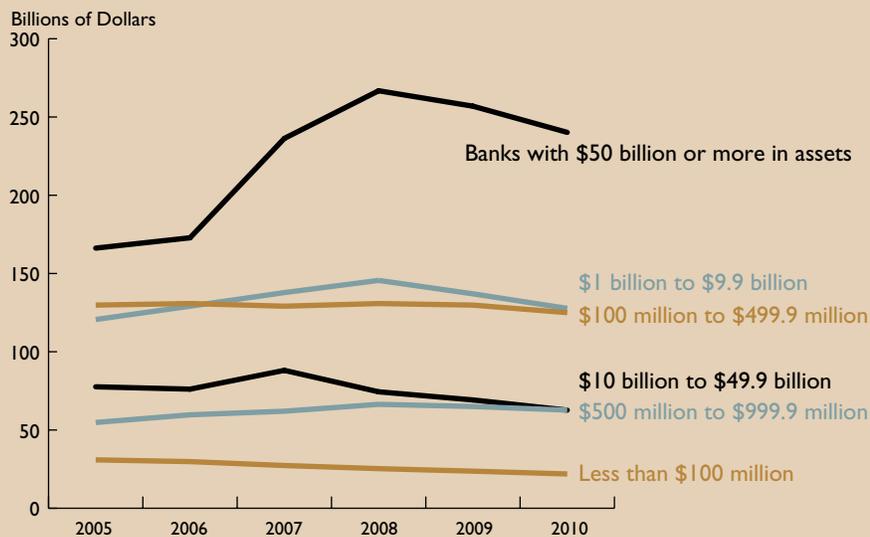
Bruce Clafin, relationship manager in the Boston Fed’s Financial Institution Relations and Outreach (FIRO) group, regularly visits financial institutions to talk about the economy and lending trends. He reports that executives at community banks consistently maintain that their small business lending has not been restricted, changed, or otherwise altered in any way that would affect the supply of credit to borrowers. They maintain that the criteria they have used to evaluate qualified borrowers—character, capacity (cash flow), capital, collateral, economic conditions—have remained the same throughout the recession.

They explain that they make their decisions differently from large banks. For example, although they do want to know borrowers’ credit scores, that may not be the first consideration during the application process. A 2004 study found that, when deciding whether or not to make a loan, the smallest community banks (under \$1 billion in assets) relied more on a borrower’s character. Larger institutions were more likely to use standard criteria obtained from financial statements.⁸

Coming out of the recession, New England community bankers are saying that they perceive a lower overall demand from established businesses. Their observation is supported by a January 2011 National Federation of Independent Business (NFIB) survey, in which 91 percent of respondents said either that credit needs were met or that they were not interested in borrowing. Greg Tewksbury, president and CEO of Savings Bank of Walpole in Walpole, New Hampshire, says, “We have a tremendous desire to lend, but there is still a perception that bankers are being tightfisted. For stronger borrowers it’s a buyers’ market.”

Community bankers note that applicants struggling with recent credit issues or low sales will naturally find it difficult to borrow. Their anecdotal evidence parallels the results of a 2010 Boston Fed survey.⁹

Value of Small Business Loans by Institution Size June 2005 – June 2010



Source: Federal Deposit Insurance Corporation, Statistics on Depository Institutions, June 2005 through June 2010.

The survey asked community bankers to rank reasons for turning down credit applications. Seventy-four percent of banks ranked as their first reason insufficient borrower income, cash flow, or credit score. The same reasons were ranked either first or second by 90 percent of respondents.

Additionally, the National Federation of Independent Business survey found that 73 percent of small businesses using a small bank got the credit they sought in 2010, compared with 48 percent of those using a large bank.¹⁰

Knowing the Customer

The survey information shows that in difficult economic times, local control and small size can make a difference. As Ben S. Bernanke, chairman of the Board of Governors of the Federal Reserve System, says, “Banks whose headquarters and key decision makers are hundreds or thousands of miles away inevitably lack the in-depth local knowledge that community banks use to assess character and conditions when making credit decisions. This advantage for community banks is fundamental to their effectiveness.”¹¹

Brian Clarke, the Boston Fed relationship officer who visits community banks in southern New England, says that executives describe their local roots as key to their decision making. “Community banks often describe themselves as local businesses, employing local residents and serving the financial needs of their community,” Clarke

says. “They interact with their borrowers inside the bank and around the community. They see the results of their loan decisions in the formation of businesses and creation of jobs in their communities every day.”

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Endnotes

- Community banks are institutions with less than \$10 billion in assets. They typically have a small number of branches within a narrow geographic area.
- Small Business Lending in the United States, 2009-2010* (Washington, DC: Office of Advocacy, U.S. Small Business Administration, February 2011), http://www.sba.gov/sites/default/files/files/sbl_10study.pdf.
- Small Business Lending 2006-2009* (Boston: Massachusetts Community and Banking Council, 2010), <http://www.mcabc.info/PSBL2010Report.pdf>.
- MCBC defines local lenders as “lenders that are either headquartered in Massachusetts or have a substantial branch network in the state.”
- The Massachusetts Bankers Association defines community banks as state or federally chartered banks with one or more branches in Massachusetts (most are under \$4 billion in assets). It calls larger banks with branches in the state “large and regional banks.”
- Funding Economic Recovery: Trends in Small Business Lending in Massachusetts* (Boston: Polecon Research for Massachusetts Bankers Association,

April 2011), https://www.massbankers.org/uploadedFiles/MassBankers/PDFs/Hot_Topics/finalSmallBizStudy.pdf.

- “Credit Conditions (Finally) Normalizing for U.S. Small Businesses,” http://www.greenwich.com/WMA/in_the_news/news_details/1,1637,1952,00.html?vgnvisitor=eKiXmZ+Lm5k=.
- Rebel A. Cole, Lawrence G. Goldberg, and Lawrence J. White, “Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks,” *Journal of Financial & Quantitative Analysis* 39, no. 2 (June 2004): 227-251.
- Jihyeon Jeon, Judit Montoriol-Garriga, Robert K. Triest, and J. Christina Wang, *Evidence of a Credit Crunch? Results from the 2010 Survey of First District Banks* (public policy brief 10-3, Federal Reserve Bank of Boston, 2010), <http://www.bos.frb.org/economic/ppb/2010/ppb103.pdf>.
- William J. Dennis Jr., *Financing Small Business: Small Business and Credit Access* (Nashville, Tennessee: NFIB Research Foundation, January 2011), <http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-Access-NFIB.pdf>.
- Ben S. Bernanke, “Community Banking in a Period of Recovery and Change” (speech, Independent Community Bankers of America National Convention, San Diego, California, March 23, 2011). <http://www.federalreserve.gov/newsevents/speech/bernanke20110323a.htm>.

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