Lael Brainard: Community banks, small business credit, and online lending

Speech by Ms Lael Brainard, Member of the Board of Governors of the Federal Reserve System, at the Community Banking in the 21st Century, The Third Annual Community Banking Research and Policy Conference, cosponsored by the Federal Reserve System and Conference of State Bank Supervisors, Federal Reserve Bank of St. Louis, St. Louis, Missouri, 30 September 2015.

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I would like to thank the event organizers for inviting me to participate in this year's Community Banking Research and Policy Conference. Supporting the health and vitality of America's community banks is an important priority for me. Community banks have long been a central provider of finance to Main Street America. Despite the challenging environment of the past several years, community banks have continued to play a significant role in a number of key market segments.

Today I want to focus on one of the most important of those segments – the provision of credit to small businesses – and to explore how the traditional role of community banks may be affected by the growing role of online lenders. Some view the growth of online platforms as a challenge to community banks in their traditional core businesses. But it is also possible that the very different strengths of community banks and online lenders could lead to complementarity and collaboration in the provision of credit to small business while recognizing there are important risks that must be managed by banks and borrowers. By working together, lenders, borrowers, and regulators can help support an outcome whereby credit channels are strengthened and the possible risks are being proactively managed.

Small businesses, small business credit, and the U.S. economy

Small businesses make up a large and vitally important segment of the U.S. economy. And their vitality hinges centrally on their access to credit.

More than three-fourths of American businesses have fewer than 10 employees and another nearly one-fourth have between 10 and 500 employees.[1] In addition to constituting the vast majority of firms in the United States, small businesses account for about one-half of private-sector employment.[2] And small firms, especially new small firms, are an even greater source of net new jobs in our economy.[3] Thus, ensuring that creditworthy small businesses have access to credit is vitally important.

Discussions of small businesses, along with their credit needs, often fail to appreciate the tremendous heterogeneity that exists among these firms and, consequently, the variation in their credit needs. Small businesses include plumbers and electricians, medical and dental offices, dry cleaners and hair salons, restaurants and bodegas, as well as growth-oriented tech start-ups and small manufacturers. They range in size from having zero employees – which accounts for a very large share of small businesses – to the much smaller share of small businesses with a few hundred employees. Although some small businesses aspire to grow quickly, many others are unlikely to grow much at all. While some have audited

[1] See Bureau of Labor Statistics, "Table G, Distribution of Private Sector Firms by Size Class: 1993/Q1 through 2014/Q1, Not Seasonally Adjusted (.txt)".

[2] See Bureau of Labor Statistics, "Table F, Distribution of Private Sector Employment by Firm Size Class: 1993/Q1 through 2014/Q1, Not Seasonally Adjusted (.txt)".

[3] For more on small firms and net new jobs, see Haltiwanger (2013).

financial statements, most small businesses do not. Some have assets that can be pledged as collateral, but many do not. Some have a long history of solid, profitable performance, while others have short histories or a mixed track record with regard to profitability.

Not surprisingly, there is also considerable variation in the credit needs of small businesses. Some small businesses, particularly very small firms in knowledge or service industries, may have little or no need for credit. Larger small businesses, and those that require a substantial amount of equipment or need to hold sizeable inventories, tend to have greater credit needs. Among small businesses that do need credit, funds may be required for managing cash flow, for purchasing or maintaining property or equipment, for building inventory, or for expanding operations. Depending on the needs, firms may be interested in term loans, capital leases, lines of credit, or credit card loans. The characteristics of a small business and the nature of its credit needs influence the type of lender that is best suited to meeting those needs.

Community banks and small business lending

Community banks have long been a primary source of credit for small businesses and today may continue to have the best business model for fulfilling many small business credit needs.[4] But changing technology has led to increased competition in this product space from both larger banks and, in recent years, alternative lenders.

Large banking organizations ramped up their small business lending between 2003 and 2008. Although they pulled back from this market segment in the wake of the financial crisis, their small loans to businesses have been gradually rising since 2011. Meanwhile, community banks experienced very modest growth in small loans to businesses during the pre-crisis period, followed by a decline from 2009 through 2013 and a subsequent leveling-off. Consequently, community banks' share of the dollar volume of outstanding small loans to businesses at commercial banks has declined over the past decade.[5] Despite this decline, community banks continue to hold about 50percent of outstanding small business loans at commercial banks, far in excess of their20 percent share of commercial banking assets and deposits.[6]

To understand the continued strong role played by community banks, it is helpful to look at the differences in small business lending between large and small banks. Although large banks and small banks now provide about equal dollar volumes of small loans to businesses, they tend to provide different types of loans to different types of borrowers, using different underwriting methods. On the one hand, large banks generally have some advantages in the provision of transaction-based lending – that is, lending that relies on hard or quantitative information such as financial ratios, collateral, or credit scores. Small banks, on the other hand, have advantages in the provision of relationship-based lending – lending based on context-specific or qualitative information, such as the owner's character and reliability and the needs of the community.

When we use Call Report data to break down commercial banks' loans to businesses by loan size, it is striking that most of the erosion in community banks' share over the past decade has been concentrated among the very smallest loans – those with initial principal amounts less than $100,000. Among these so-called micro loans, the share held by large

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4 For purposes of this talk, I define a community bank as a bank with less than $10 billion in assets, which is either independent or part of a banking organization that also has less than $10 billion in assets.

5 Small loans to businesses are loans to businesses with initial principal amounts of less than $1 million.

6 Data on bank assets, deposits, and small loans to businesses were compiled from Consolidated Reports of Condition and Income, also known as Call Reports, that banks file with the Federal Financial Institutions Examination Council. Data on banks' small loans to businesses are widely used to proxy for bank loans to small businesses because data on the latter are not collected.

banks grew from 42 percent in 2005 to 67 percent in 2015. In contrast, large banks' share of larger outstanding small loans to businesses – those with initial principal amounts between $100,000 and $1 million – grew much more modestly, from 39 percent to 43 percent, over the same time period. Business micro loans are typically underwritten based, primarily or exclusively, on credit scores because the small loan size makes it unprofitable to produce such loans using more costly traditional underwriting methods. Thus, the growth in large banks' share of micro business loans is likely attributable to their ability to benefit from economies of scale in credit-score-based lending.

Business loans with principal amounts between $100,000 and $1 million are generally not underwritten solely on the basis of credit scores – probably because lenders are not willing to incur the risk associated with larger loan amounts without the benefit of a traditional underwriting approach. For these larger loans – and for smaller loans where the borrower does not qualify based on credit score alone – community banks are often the lender of choice. Their local knowledge and close ties to the communities they serve enable community bankers to establish a deep understanding of local businesses that allows them to prudently provide credit to borrowers who might not otherwise be considered creditworthy. A number of empirical studies confirm that relationships are important factors influencing both the availability and the terms of loans to small businesses.[7]

Similarly, when we slice the Call Report data to separate commercial and industrial (C&I) loans from commercial real estate loans, we see that while community banks' share of outstanding small C&I loans dwindled from about 54 percent in 2005 to 40 percent in 2015, their share of small commercial real estate loans has remained relatively stable, moving marginally from 66 percent to 63 percent. Community bankers' intimate knowledge of their communities and their familiarity with local economic conditions provide an advantage relative to large, geographically dispersed banks in underwriting commercial real estate loans.

Since large banks are unlikely to become as knowledgeable about local economic conditions or as adept at small business relationship lending as community banks, there may be some limits to their expansion in this segment of lending.

Online alternative lenders

In recent years, online alternative lenders have also made inroads into small business lending. There has been a lot of speculation about the effect of this sector on traditional banks: Will it disrupt their activities, broaden their reach, or maybe a little of both?

Focusing specifically on nonbank alternative online lenders or online marketplace lenders, it is important to underscore that the online space is highly dynamic, with a number of business models emerging and evolving. I will touch on two business models in particular, recognizing that as these business models are tested, it is likely that some will prove more successful than others, and that some may adapt in ways that will cause us to revise our segmentation of online alternative lending.[8] First, online balance sheet lenders generally use their own

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7 Examples of such studies include Petersen and Rajan (1994), Berger and Udell (1995), Cole (1998), Berger and others (2005), and Cole and others (2004).

8 As the industry has evolved, alternative online lenders have increasingly been referred to as marketplace lenders, a term that helps emphasize the growing institutional investor base of the sector. So while peer-to-peer lenders initially allowed individual borrowers to connect with individual lenders, individual lenders increasingly are being replaced by institutional investors who are turning to online marketplace lenders for investment opportunities. Because some balance sheet lenders are now originating small business loans for institutional investors to purchase, balance sheet lenders are also often referred to as marketplace lenders. In the Treasury Department's recent Request for Information, they defined online marketplace lending as "the segment of the financial services industry that uses investment capital and data-driven online platforms to lend either directly or indirectly to small businesses and consumers." (See U.S. Treasury, 2015, p. 6.)

capital to fund small business credit products that are originated either directly on their platforms or indirectly through brokers or referral partnerships.[9] Credit products offered by these lenders are usually short term and include loans, lines of credit, or cash advances.[10]

Second, peer-to-peer lending platforms, by contrast, act as intermediaries to connect borrowers with lenders and to assist investors in identifying and purchasing loans that meet their investment criteria. These lenders can be individuals, banks, or institutional investors.[11]

Although data are limited on this sector, the data that are available suggest that the various types of online alternative lenders have captured a small but rapidly growing share of lending since the financial crisis. In aggregate, the outstanding portfolio balances of these lenders have doubled every year since the mid-2000s.[12] It is estimated that online alternative lenders originated $12 billion in 2014, with unsecured consumer loans representing $7 billion and small business loans accounting for approximately $5 billion.[13] While this amount represents only a small fraction of U.S. unsecured consumer and small business lending overall, the rate of growth is notable.

Much of the growth in online alternative lending has been supported by innovative uses of technology that allow lending platforms to streamline and automate loan applications, expedite underwriting and quickly price risk, and provide loan applicants with quick loan decisions and access to funds. Online alternative lenders use algorithms to provide rapid decisions on loan applications, often taking into account information from a wide range of sources that are not typically involved in bank underwriting of loans. For example, aggregated information for small business underwriting may include data on online banking, accounting, bookkeeping, credit card, shipping, supplier, and social media. So, while traditional banks often focus on personal credit scores for underwriting consumer loans and the majority of small dollar, small business loans, online alternative lenders may analyze a broader variety of data to develop different metrics to measure and price loan risk. Currently, the largest platforms typically offer online or mobile applications that allow consumers and small business owners to easily submit information and aggregate vast amounts of data to complete loan applications.

Although rates vary by platform and borrower characteristics, when taking into account origination fees and repayment periods, the average annual cost of borrowing, or APR, associated with loans and credit products offered by online alternative small business lenders tend to be higher than those associated with traditional bank products.[14] Reports suggest that some borrowers are willing to pay a higher price in exchange for an easy application process, a quick decision, and rapid availability of funds.[15]

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9 Online balance sheet lenders include companies such as OnDeck, Square Capital, Fundation, CAN Capital, Kabbage, and PayPal Credit.

10 Cash advances, sometimes known as merchant cash advances, capital advances, or business cash advances, are credit products that allow businesses to convert future credit card or payment account receivables into capital (Lipman and Wiersch, 2015).

11 Peer-to-peer lending platforms include companies such as Prosper, Lending Club, and Funding Circle.

12 See Mills and McCarthy (2014, p. 42).

13 For information on online alternative lenders, see U.S. Treasury (2015, p. 6); for more on unsecured consumer loans and small business loans, see Morgan Stanley Research (2015).

14 For example, Mills and McCarthy (2014, p. 44) note that many alternative lending platforms charge yields ranging from 30 to 120 percent of the loan value, depending on the size, term duration, and risk profile of the loan. Several alternative online lenders advertise lower rates, but industry sources note that lending is rarely done at those rates.

15 For example, see Clark (2014), Cortese (2014), Crowley (2015), and Mills and McCarthy (2014, p. 46).

While some see online alternative lenders as a disruptive threat to traditional lenders, banks increasingly are finding ways to partner with online alternative lenders, including through loan purchases and referral agreements. Loan purchases by community banks of loans originated by online alternative lenders have been focused on unsecured consumer debt. As the percentage of unsecured consumer debt outstanding held by community banks has been declining in recent years, several banks have partnered with online alternative lenders to grow and diversify their portfolios of unsecured consumer debt.[16]

In contrast to the consumer loan activity, the small business partnerships that have developed so far are largely fee-based referral partnerships. In these partnerships, banks refer to online alternative lenders some of their small business customers who are usually seeking loan amounts that the referring banks may see as too costly to underwrite and service, particularly in the size range below $100,000.[17] For example, in 2014, OnDeck announced small business loan referral partnerships with BBVA Compass and with the ProfitStars Lending Network, part of the Independent Community Bankers of America Preferred Service Provider program.

Another type of partnership that has been announced recently involves alternative online lenders and Community Development Financial Institutions (CDFIs) that seek to provide loans to low-income and underserved borrowers and neighborhoods. These partnerships may enable the CDFI to use the online lender's technology platform at no cost or for a reduced cost in order to make underwriting decisions faster and more cost effective.[18] These partnerships are still in the early stages.

Risks and opportunities

Across the Federal Reserve System, we are actively following developments in the alternative online lending space and have engaged with several alternative online lenders over the past few years to learn more about the industry, the technology, and the business models as well as engaging with bankers to understand how these developments are affecting their markets.[19] Most recently, several alternative lenders have participated in

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[16] In 1994, banks and thrifts with less than $10 billion in assets held about 69 percent of U.S. consumer loans, according to an analysis of regulatory filings by SNL Financial. That share dropped to 19 percent in 2004 and 9 percent in 2014 (Tracy, 2015). Recently, BancAlliance, a consortium of approximately 200 community banks, has partnered with Lending Club to purchase consumer loans originated on Lending Club's platform and the Western Independent Bankers, a consortium of more than 160 independent and community banks, have entered into a partnership with Prosper to encourage member banks to use Prosper's platform to facilitate consumer loans for their customers. Also, Lending Club and Citi Community Capital, the community development lending and investing division of CitiGroup, recently announced a partnership to facilitate up to $150million in consumer loans designed to provide more affordable credit to underserved, lower-income borrowers in low- and moderate-income communities.

[17] As an indication of the demand for small dollar loans on the part of small businesses, the Joint Small Business Credit Survey conducted in 2014 by the Federal Reserve Banks of New York, Atlanta, Cleveland, and Philadelphia found that more than one-half of small business loan applicants sought $100,000 or less in credit. (For more information, the survey report is available at www.newyorkfed.org/smallbusiness/SBCS-2014-Report.pdf

[18] For example, in June 2015, Lending Club and the Opportunity Fund, a California-based CDFI microenterprise lender, announced a partnership intended to provide $10 million in loans over a period of five months to 400 small businesses in underserved areas of California (for more information, see www.opportunityfund.org/media/blog/clinton-announces-partnership-between-opportunity-fund-and-lending-club). In 2012, the Association for Enterprise Opportunities (AEO) launched the TILT Forward platform, an online lending platform that is powered by OnDeck's technology and can be used by AEO's network of nonprofit community lenders and other community-based organizations to reach underserved entrepreneurs (more information is available at www.tiltforward.com).

[19] In April 2014, the Federal Reserve Bank of New York hosted "Filling the Gaps: Summit on Small Business Credit Innovations." and the Federal Reserve Bank of San Francisco will be hosting the Consumer Financial Services Revolution in November 2015.

events where we have joined with community development finance experts to discuss ways to adopt platform lending technology to better serve low- and moderate-income borrowers and small business owners.[20]

We want to better understand the opportunities presented by technological advances that may bring new data to bear and help lenders make available credit to a more diverse set of small business borrowers. In some cases, partnerships between community banks and online platforms may help expand access to credit for consumers and small businesses, and help banks retain and grow their customer base.

As regulators, we also want to help the various stakeholders anticipate and carefully manage the associated risks. Of course, third-party and vendor risks are factors that banks should always take into account when introducing new products and services. Taking the time to identify and mitigate risks is a prudent step that banks can take to avoid unintended consequences when entering into partnership agreements with alternative online lenders. In addition, banks should consider whether the partnerships provide new opportunities to diversify their portfolios if they are purchasing loans, and whether the partnerships provide opportunities to offer new products that are a good strategic fit for their bank and their customers.[21]

It is also important for banks to carefully consider regulatory compliance. When purchasing consumer loans originated by online alternative lenders, banks should examine whether fair lending or unfair or deceptive acts or practices issues result from the origination and underwriting methods used by online alternative lenders.[22] To the extent that the underlying algorithms used for credit decisionmaking use nontraditional data sources, it will be important to ensure that this does not lead to disparate treatment or have a disparate impact on a prohibited basis.

Aside from these risks, banks should consider a variety of others, including the implications of credit risk stemming from the purchase of loans and reputational risk if referrals to online alternative lending platforms end badly.

The risks I have described so far have primarily been from the perspective of banks considering partnerships with online alternative lenders. Another important set of concerns are focused on the small business borrowers who may be considering online alternative loans. Some have raised concerns about the high APRs associated with some online

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20 For example, in March 2014, the Board and the Federal Reserve Banks of New York and San Francisco convened a small group of thought leaders for a discussion on the challenges and opportunities presented by crowdfunding investments as a significant source of capital for the community development industry; and in March 2015, we cohosted the Financial Innovations Roundtable with the University of New Hampshire's Carsey School of Public Policy and brought together representatives from banks, CDFIs, mission-driven lenders, and small business online alternative lenders to talk about opportunities for collaboration, the challenges of scaling up small business lending, and potential consumer and safety and soundness regulatory issues facing partnerships between regulated financial institutions and alternative online lenders. As the sector grows and evolves, we will continue to monitor the development of online alternative lenders and the risks and opportunities that they may have for a range of stakeholders.

21 If a bank is considering a referral partnership, the following questions could help identify potential risks: Do existing customers have a need for the product or are there less expensive products that would better serve borrower's needs? Are the features, risks, and terms of the products offered through the referral program explained clearly and conspicuously, or are they buried in a lengthy document full of "legalese" that makes it difficult for borrowers to make a truly informed choice? Finally, are the products offered through the referral partnership consistent with what would be recommended to a family member? (See Curran, 2013.)

22 There are several regulatory compliance-related questions that banks should consider. For example, have the loans offered or the lending platform to be partnered with been reviewed for compliance with applicable federal and state laws? Have the loans originated by the partnering lending platform been reviewed from a consumer fairness standpoint? When assessing referral partnerships, have any issues been identified that would lead to disparate treatment of customers if banks selectively refer customers to online alternative lending partners? (See Federal Reserve System Community Banking Connections Advisory Board, 2014).

alternative lending products. Others have raised concerns about the risk that some small business borrowers may have difficulty fully understanding the terms of the various loan products or the risk of becoming trapped in layered debt that poses risks to the survival of their businesses. Some industry participants have recently proposed that online lenders follow a voluntary set of guidelines designed to standardize best practices and mitigate these risks.[23] It is too soon to determine whether such efforts of industry participants to self-police will be sufficient. Even with these efforts, some have suggested a need for regulators to take a more active role in defining and enforcing standards that apply more broadly in this sector.

No doubt, ongoing technological advances and the evolving competitive lending landscape will continue to present both challenges and opportunities for community bankers who are deeply committed to the provision of credit to small businesses. I remain confident that community bankers will continue to play a vital role in the small business lending landscape as the respective business models of online platforms and community banks evolve. The advantage that comes from close relationships with their customers and intimate knowledge of their communities that lie at the heart of community banking will continue to provide a powerful advantage in serving the vital banking needs of small businesses, even as the use of nontraditional sources of data and electronic processing platforms may permit faster loan decisions, especially for smaller loan amounts, to a broader set of borrowers.

Thank you, again, to the conference organizers for inviting me to this important event and for the opportunity to speak to you today.

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[23] For example, see www.responsiblebusinesslending.org.

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