SECTION 4. Competitive Practices and Advantages

This section investigates the overall approaches that small and large banks take to small business lending by looking closely at the competitive practices each type of bank customarily uses and at each type's perceived competitive advantages. The preceding section presents evidence of partial segmentation in the lending market by size: small and large banks often view each other as competitors, but at the same time they rarely view each other as top competitors. This suggests that their customer bases partly overlap, with some small businesses able and willing to borrow from a bank of either size, whereas other small businesses are much better suited to small banks or to large ones.

Therefore, the survey considers the extent to which the approaches of these organizations overlap and the extent to which they diverge, and whether these approaches correspond to the understanding that small banks are relationship lenders and large banks are transactional lenders. The answer to this question is important for small businesses in the context of the recent trend toward fewer small banks. For instance, if small banks approach small business lending in a more personalized manner than large banks, small businesses that need more personalized engagement through the loan application process may lose access to credit if trends continue.

4.1 How Does Your Bank Maintain and Generate Relationships with Small Businesses?

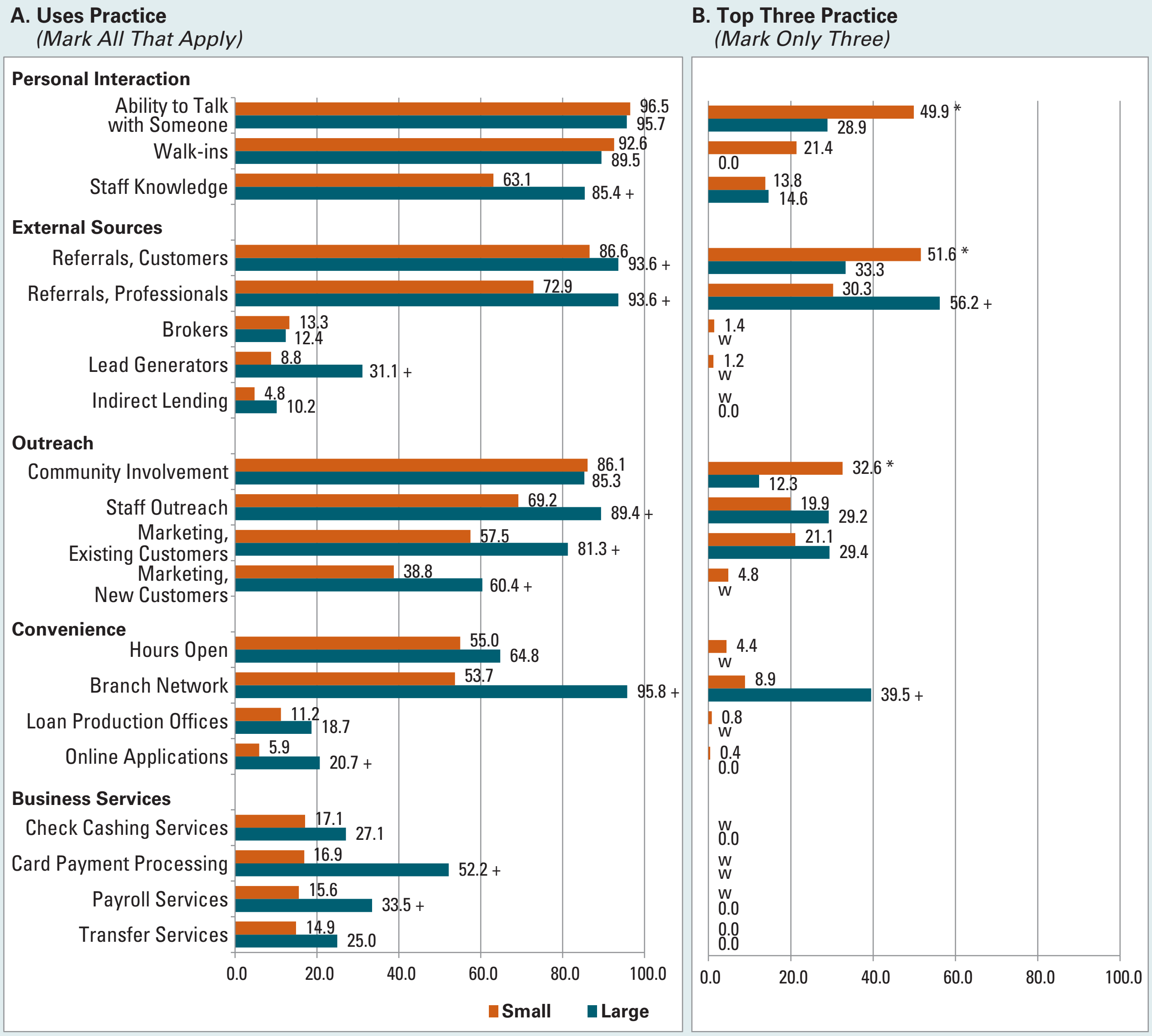
The partly overlapping competition between banks of different sizes that is discussed in Section 3 may be mirrored in an overlapping of practices between small and large banks. However, small and large banks might also be expected to use different practices, with small banks using relationship-based practices that focus on individual contact between staff and potential customers, whereas large banks may take advantage of economies of scale and scope to offer customers a greater range of products and greater convenience.

Accordingly, the survey asked banks to mark which of 20 different practices they use to generate new small business lending relationships and maintain existing ones.[37] The survey also asked banks to designate up to 3 practices as their top practices. The survey results show that there is a core set of practices for small business lending that is common to both small and large banks. Further, this core set contains practices that are high-touch and personal in nature. Figure 4.1, Panel A, presents the shares of small banks and large banks that selected each practice as one that the bank uses. The figure shows that the ability to talk to a live person, acceptance of walk-in customers, community involvement, and customer referrals are practices cited by more than 85 percent of both small and large banks. Conversely, practices that outsource or automate small business lending are relatively unpopular, even among large banks. Brokers, indirect lending, and online applications are used by less than 25 percent of both small banks and large banks, and lead generators are used by only 31.1 percent of large banks and a much smaller proportion of small banks. Together, these results suggest that for both small and large banks, small business lending is inherently relationship-focused.

Beyond these common practices, large banks appear to take advantage of their economies of scale and scope in several ways. Large banks, on average, use 2.8 more practices than small banks, possibly

[37] Banks were also given a write-in option.

Figure 4.1: Percentage of Banks That Use This Practice to Generate New and Maintain Existing Small Business Lending Relationships



Source: SBLS Question 24.

Notes: Entries marked with a "w" indicate that the number of responses falls below the allowable reporting threshold for protecting respondents' identities. At the statistical significance of 10 percent, "*" denotes that small banks are more likely than large banks to use this practice to generate new and maintain existing small business lending relationships; "+" that large banks are more likely than small banks. Banks may select multiple answers; results will not sum to 100.0 percent.

reflecting their greater resources.[38] Nearly all large banks (95.8 percent) use their branch networks to generate new relationships and maintain existing ones, whereas only slightly over half (53.7 percent) of small banks do. This, along with the findings of Section 3 about markets and competitors, underscores the crucial role that physical proximity plays in small business lending, and suggests that having multiple branches is a powerful tool for large banks. Large banks are also more than

[38] The survey finds that small banks use 8.9 different practices on average, whereas large banks use 11.7, which is a statistically significant difference.

20 percentage points more likely than small banks to engage in active marketing to both their existing customers and potential new customers, a divergence that could arise from large banks' greater economies of scale. Finally, large banks are more likely than small banks to use their other business services, such as payroll services and, especially, card processing, to attract small business borrowers, thus leveraging economies of scope to provide customers with greater convenience.

Whereas there is substantial overlap in the practices that small and large banks use, there is less overlap in the practices they prioritize. Figure 4.1, Panel B, presents the shares of small and large banks that selected each practice as one of the bank's top three practices. Small banks are between 18 and 21 percentage points more likely than large banks to prioritize the common high-touch practices—live person, walk-ins, community involvement, and customer referrals.[39] Many small banks also prioritize other practices that rely on strong connections to the community, including professional referrals (30.3 percent), marketing to existing customers (21.1 percent), and staff outreach (19.9 percent).

By contrast, large banks are 30 percentage points more likely than small banks to view the use of their branch networks as one of their most important practices, once again highlighting the importance of location in small business lending. Large banks also rely more heavily than small banks on professional referrals (56.2 percent versus 30.3 percent).

In terms of similarities, both small and large banks prioritize staff outreach and marketing to existing customers at similar rates, and although large banks do use their other business services to attract borrowers, they rarely consider the provision of these services to be crucial practices.[40] Overall, both small and large organizations do tend to prioritize different practices, with small banks using high-touch practices somewhat more intensively than large banks; but for banks of both sizes, relationships are important.

4.2 What Are the Competitive Advantages of Your Bank and of Your Number One Competitor?

In order to gain more insight into the priorities of banks of each size and the potentially different types of value they provide to their customers, the survey focused on how banks of both sizes view themselves and how other banks view them. The understanding that small banks are relationship lenders and large banks are transactional lenders could lead one to expect that each size has distinct advantages in small business lending. For example, small banks might be better at customer service and at customizing their approach for different customers, whereas large banks might offer more convenience and lower interest rates. The similarities discussed in the preceding section, however, allow the possibility that the two sizes of banks may in fact not have strongly distinct advantages.

The survey asked banks to list both their own competitive advantages and the competitive advantages of their top competitor.[41] In both cases, banks selected from a list of 18 possible advantages, and designated up to 3 as top three advantages.[42] The results are broadly consistent with the findings of the previous subsection that, even for large banks, small business lending is rarely fully transactional.

Figure 4.2 groups into six broad categories the individual advantages that banks selected, and shows that an overwhelming majority of both types of banks—86.5 percent of small banks and 83.5 percent

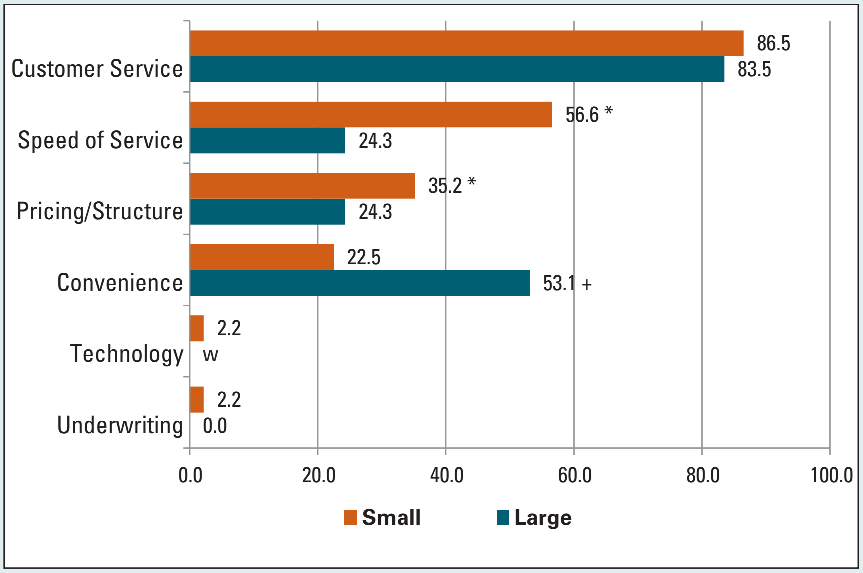
[39] The number of large banks reporting walk-ins as a top three practice fell below the reporting threshold for protecting respondents' identities.

[40] The number of small and large banks that report card processing as a top three practice fell below the reporting threshold for protecting respondents' identities; the number of large banks that report check cashing and payroll services also fell below the threshold.

[41] Top competitors for small business lending are discussed above in Section 3.3.

[42] Banks were also given a write-in option.

Figure 4.2: Percentage of Banks That Consider Themselves to Have a Top Three Competitive Advantage in This Category



Source: SBLS Question 18.

Notes: Entries marked with a "w" indicate that the number of responses falls below the allowable reporting threshold for protecting respondents' identities. At the statistical significance of 10 percent, "*" denotes that small banks are more likely than large banks to consider themselves to have a top three competitive advantage in this category; "+" denotes that large banks are more likely than small banks. Banks may select answers in multiple categories; results will not sum to 100.0 percent.

Table 4.1: Percentage of Banks That Consider This Competitive Advantage One of Their Own Top Three

Category	Advantage	Small Banks	Large Banks
Customer Service	Relationship	58.6	57.1
	Personal attention	58.2*	42.7
	Staff quality	29.6	32.5
Speed of Service	Decision speed	48.6*	24.3
	Funding speed	20.3	w
Pricing or Structure	Loan structure flexibility	24.7	20.3
	Fees	8.0	w
	Interest rates	4.3	w
	Term	0.8	0.0
Convenience	Convenient location	11.0	16.3
	Credit products	7.8	18.4+
	Other services	5.4	24.5+
	Number of locations	1.6	22.3+
Technology	Mobile banking	1.8	w
	Remote deposit	0.5	w
Underwriting	Collateral requirements	0.9	0.0
	Debt service coverage	0.9	0.0
	Loan-to-value	0.7	0.0

Source: SBLS Question 18.

Notes: Entries marked with a "w" indicate that the number of responses falls below the allowable reporting threshold for protecting respondents' identities. At the statistical significance of 10 percent, "*" denotes that small banks are more likely than large banks to list this as a top three competitive advantage; "+" that large banks are more likely than small banks. Banks may select multiple answers; results will not sum to 100.0 percent.

of large banks—list some aspect of customer service as one of their own top advantages. Table 4.1 breaks out the categories into their specific individual advantages and presents the proportion of small and large banks that selected each individual advantage as one of their top three. The table shows that a majority of both sizes of banks consider established relationships with their borrowers to be their most important competitive advantage (58.6 percent of small banks and 57.1 percent of large banks), making it the most commonly selected advantage for both groups. Further, there is a set of self-reported top advantages that are common to both small and large banks, mirroring the results from Section 4.1. After established relationships, three of the next four most common top advantages of small banks are also among the next four most common top advantages of large banks: personal attention from the bank, decision speed, and staff quality.[43]

Yet, while small banks and large banks both perceive their customer relationships to be their own most important advantage, their competitors are much more likely to view small banks as having superior customer service. Table 4.2 presents banks' views of the top advantages for their number one competitor, be it a small bank, a large bank, or a credit union.[44] The table shows that nearly half (47.5 percent) of those who compete with small banks view customer relationships as one of small banks' top advantages, compared with 16.2 percent of those who compete with large banks. Figure 4.3 shows that this pattern continues into the broader measures of advantage—the categories within which the individual advantages are grouped. The figure shows that a majority (58.8 percent) of the banks competing with small banks consider them to have an aspect of customer service as a top advantage, compared with only 17.3 percent of those that compete with large banks. This suggests that small banks do have some advantages in relationship lending, consistent with the higher emphasis they place on the components of customer service relative to large banks, as shown in Section 4.1.

The clearest advantage of small banks, however, across both internal and external evaluations, is speed. Figure 4.2 shows that a majority of small banks (56.6 percent) consider an aspect of speed of service—either decision speed or funding speed—to be one of their own top three advantages, compared with slightly less than one-quarter of large banks (24.3 percent). Further, small banks are viewed as similarly advantaged by their competitors. Figure 4.3 shows that over one-quarter (26.2 percent) of small banks' competitors view speed as one of small banks' top advantages, compared with only 7 percent of large banks' competitors.

This speed advantage for small banks is particularly noteworthy because one might expect large banks, using quantitative data, to have a more standardized decisionmaking process resulting in quicker decisions. In practice, however, it appears that the flatter organizational structure of small banks, with fewer layers of management separating loan officers from bank owners, allows for faster decisionmaking and loan processing.[45] The importance of this advantage should not be underestimated, because funding speed is often an important consideration for small business borrowers.[46] This advantage also suggests, however, that if technological advances

43 The fifth most common top advantage of small banks—loan structure flexibility—is the seventh most common for large banks, but the difference between small and large banks is small and statistically insignificant (24.7 percent of small banks compared with 20.3 percent of large banks). The fourth most likely advantage for large banks is other services offered, and large banks are much more likely than small banks to list this as a top advantage (24.5 percent of large banks compared with 5.4 percent of small banks).

44 As shown in Section 3, almost all banks selected one of these organizations as their number one competitor. Banks that did not select one of these organizations as their number one competitor are excluded from this analysis.

45 As discussed in Stein, "Information Production," both capital allocation and loan quality decisions are made locally at small banks, whereas at large banks capital allocation decisions are made at a distant central office, although loan quality is determined locally. The overall speed of small business loan decisions appears to be due partly to lack of distance between the officials who determine resource allocation and those who determine loan quality.

46 The 2016 Small Business Credit Survey found that small businesses cite long waits for loans as one of their most frequent issues when receiving bank loans. See Federal Reserve Bank of Cleveland, *2016 Small Business Credit Survey Report on Microbusinesses: Nonemployer and Small Employer Firms,* November 2017, https://clevelandfed.org/global%20

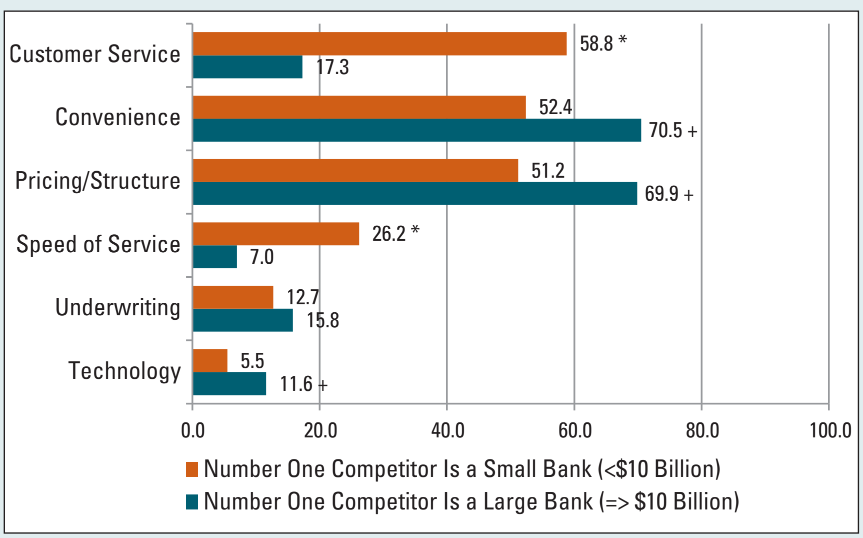
Table 4.2: Percentage of Banks That Consider This Competitive Advantage One of Their Number One Competitor's Top Three

		Top Competitor is a ...		
Category	**Advantage**	**Small Bank**	**Large Bank**	**Credit Union**
Customer Service	Relationship	47.5*	16.2	w
	Personal attention	26.1	w	0.0
	Staff quality	12.1	w	0.0
Speed of Service	Decision speed	21.7*	6.0	0.0
	Funding speed	9.7*	5.0	0.0
Pricing or Structure	Loan structure flexibility	24.2	22.7	40.8ϕϕ
	Fees	7.0	6.5	13.1
	Interest rates	29.6	59.3+	85.1ϕϕ
	Term	8.0	22.6+	39.1ϕϕ
Convenience	Convenient location	25.9	28.2	w
	Credit products	15.4	23.8+	w
	Other services	15.8	21.7	w
	Number of locations	17.8	33.7++	17.7
Technology	Mobile banking	3.5	7.7+	0.0
	Remote deposit	3.0	w	0.0
Underwriting	Collateral requirements	6.9	10.9	18.5ϕ
	Debt service coverage	3.2	2.4	w
	Loan-to-value	5.4	5.6	w

Source: SBLS Questions 16 and 17.

Notes: Entries marked with a "w" indicate that the number of responses falls below the allowable reporting threshold for protecting respondents' identities. At the statistical significance of 10 percent, "*" denotes that small banks are more likely than large banks to be considered by their competitor banks to have this competitive advantage as one of their top three; "+" that large banks are more likely than small banks; "++" that large banks are more likely than both small banks and credit unions; "ϕ" that credit unions are more likely than small banks; "ϕϕ" that credit unions are more likely than both small and large banks. Banks may select multiple answers; results will not sum to 100.0 percent.

Figure 4.3: Percentage of Banks That Consider Their Number One Competitor to Have a Top Three Competitive Advantage in This Category



Source: SBLS Questions 16 and 17.

Notes: At the statistical significance of 10 percent, "*" denotes that small banks are more likely than large banks to be considered by their competitor banks to have a top three competitive advantage in this category; "+" that large banks are more likely than small banks. Banks may select answers in multiple categories; results will not sum to 100.0 percent.

allow large banks or FinTech firms to increase their decision speed, small banks may face more competitive pressures in the future.

In contrast to small banks, large banks are viewed both internally and externally as offering greater convenience to their customers, with a broader range of services offered and a larger number of branches. Figure 4.2 shows that slightly more than half (53.1 percent) of large banks believe some form of convenience to be one of their own top advantages, compared with slightly less than a quarter (22.5 percent) of small banks. Similarly, Figure 4.3 shows that more than 70 percent of large banks' competitors view them as having convenience advantages, compared with just over half (52.4 percent) of small banks' competitors. These convenience advantages include number of locations. Table 4.1 shows that 22.3 percent of large banks consider number of locations to be one of their own top three advantages, whereas the comparable figure for small banks is only 1.6 percent. Table 4.2 shows that 33.7 percent of large banks' competitors view number of locations as one of large banks' top three advantages, compared with 17.8 percent of small banks' competitors for small banks' advantages. This once again shows the importance of physical branches in small business lending.

As for price advantages, evaluations vary depending on whether banks are rating themselves or whether competitors are rating them. Table 4.1 shows that very few banks of any size consider interest rates or fees to be one of their own top advantages. However, many banks do view interest rates as being a top advantage of their number one competitor. This is especially true for the competitors of large banks. As Table 4.2 shows, 59.3 percent of the competitors of large banks view interest rates as a top advantage of their large-bank competitor. By a large margin, this is the most common perceived top advantage for large banks, and large banks are twice as likely as small banks to be perceived as having this advantage. The frequency of this perception suggests that large banks do possess some advantages in pricing, but the evidence is surprisingly mixed, given the important role pricing usually plays in competitive markets.

As discussed in Section 3, few banks have a nonbank as their number one competitor. Nevertheless, it is possible to make some observations about banks' perceptions of credit unions, for the latter are listed as the number one competitor by 4.5 percent of banks (overwhelmingly small banks). Table 4.2 shows that the top perceived advantages of credit unions are pricing (85.1 percent) and, to a lesser extent, other elements of loan structure. This perception of advantages likely stems from the perceived tax-advantaged status of credit unions. Although pricing and loan structure are advantages more commonly associated with large banks rather than small banks, it appears that credit unions are more likely than large or small banks to be perceived as having advantages on these dimensions. Furthermore, despite their community focus and small average size, credit unions are viewed as having very different advantages from the ones small banks are perceived to have.

4.3 Conclusions

The survey finds that relationship lending practices are highly important for both small and large banks—a finding that suggests that small business lending is, to some extent, inherently relationship focused. With near universality, both small and large banks report using relationship lending practices, and they believe that their customer relationships, and their customer service in general, are among their top advantages.

Small banks, however, appear to focus more heavily on these practices and are more likely to view them as their most important practices. Small banks are also more likely to be viewed by their competitors as having advantages in customer relationships and in customer service in general. In addition, small banks consistently perceive themselves and are perceived by others as having a significant advantage in decision and funding speed. Given that large banks are thought to make lending decisions based on evaluating quantifiable data against preset

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limits, one might assume that they would be able to analyze the data and come to decisions faster. Large banks' advantage of relying on quantifiable data, however, is evidently less important than the flatter organizational structure of small banks, where fewer managerial layers separate loan officers from bank owners. The importance of this speed advantage may be considerable, for speed in decisionmaking and funding is one of the top concerns of small businesses.

Large banks, by contrast, provide more convenience, both by offering a greater variety of products and services and by having a larger number of branches. Branches are consistently shown to be among the most important advantages of large banks, with branch networks serving as small business lending hubs. The advantages large banks derive from these networks further emphasize the importance of physical presence and proximity in the practice of small business lending (as discussed in Section 3). Large banks are also viewed as being able to offer lower interest rates than their competitors, although large banks themselves do not view this as an important advantage.

Overall, the results of the survey confirm the widely held belief that small banks focus on relationship lending practices and view their relationships with their clients as essential to their business model. Somewhat contrary to expectations, however, large banks are also heavy users of relationship lending practices when lending to small businesses. But small banks are shown to focus more intensively on relationship lending than large banks do, and this finding suggests that small banks' approach to small business lending is distinct from the approach of large banks. If that is the case, the decreasing number of small banks in the country may disadvantage the small businesses that prefer a less transactional approach.