SECTION 1. Introduction

The survival and growth of small businesses depends on access to credit, and banks are the most common source of external credit for small firms.[1] Banks are able to provide this degree of financing because they have a special ability to identify creditworthy small businesses that often lack verifiable evidence of their quality.[2] Yet, despite the importance of banks to small businesses and the importance of small businesses to the larger economy, very little comprehensive information is available about small business lending by banks.[3] In particular, evidence is scarce about how banks define small business lending, what approaches they take to meet the needs of these customers, and whether small banks and large banks approach small business lending in significantly different ways.

The need for such information is important given the trends in the banking industry since the Great Recession. One such trend is consolidation: between 2008 and 2017 the number of small banks in the country dropped by nearly a third and small-bank assets dropped by more than 14 percent, whereas large banks increased their assets by 13 percent (in this report, small banks are defined as those with under $10 billion in assets, and large banks as those with at least $10 billion in assets).[4] Even so, at the end of 2017 small banks, though holding only 17 percent of banking assets, held nearly 53 percent of small loans to businesses (according to the Call Report measure for small business lending).[5] Another trend is the decline in the number of bank branches. In 2017 there were nearly 10 percent fewer branches in operation—for all sizes of banks—than there had been in 2008.

The critical question, then, is how the continuation of these trends is likely to affect the availability of credit to small businesses. The answer to that question requires a many-faceted answer to a different question: how do banks manage their small business lending, and in particular do small banks differ from large banks and are any such differences likely to affect small businesses?

The established understanding of small business lending is that small and large banks *do* differ in the practices they use, the geographic areas they serve, and the types of information on which they

1 On the need for access to credit, see Titan Alon et al., "Older and Slower: The Startup Deficit's Lasting Effects on Aggregate Productivity Growth," *Journal of Monetary Economics* 93 (2018): 68–85, https://doi.org/10.1016/j.jmoneco.2017.10.004; and Thorsten Beck, Asli Demirgüç-Kunt, and Vojislav Maksimovic, "Financial and Legal Constraints to Growth: Does Firm Size Matter?" *Journal of Finance* 60, no.1 (2005): 137–77. On the role of banks, see Federal Reserve System, "Report on Employer Firms," *Small Business Credit Survey*, April 2017. https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf; and Federal Reserve Bank of Cleveland. *2016 Small Business Credit Survey Report on Microbusinesses: Nonemployer and Small Employer Firms.* November 2017. https://clevelandfed.org/global%20search?q=2016+Small+Business+-Survey%3A+Report+on+Microbusinesses%3A+Nonemployer+and+Small+Employer+Firms.+Published+November+2017.+Federal+Reserve+Bank+of+Cleveland.

2 On the advantages of banks relative to other external credit options, see Gregory Udell, "What's in a Relationship? The Case of Commercial Lending," *Business Horizons* 51 (2008): 93–10.

3 On the importance of small businesses to the U.S. economy, see U.S. Small Business Administration, Office of Advocacy, *Frequently Asked Question (2017),* https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2017-WEB.pdf.

4 For a full description of the structural changes in the industry, see Federal Deposit Insurance Corporation, *FDIC Community Banking Study,* December 2012, https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf; and Eric C. Breitenstein and Nathan Hinton, "Community Bank Mergers since the Financial Crisis: How Acquired Community Banks Compared with Their Peers," FDIC Quarterly 11, no. 4 (2017): 41–52, https://www.fdic.gov/bank/analytical/quarterly/2017-vol11-4/fdic-v11n4-3q2017-article2.pdf.

5 The Call Report measure is the sum (reported to regulators) of outstanding small commercial and industrial loans, small commercial real estate loans, and small agricultural and farmland loans. See the box at the beginning of Section 2 for a discussion of the small business lending captured by regulatory Call Reports.

base their decisions (see the box for detail on these differences). One implication is that the continued decline of small banks could have significant adverse effects on access to credit by these banks' small business customers even if large banks continued to operate in the affected geographic area. This concern is most acute for firms that have little quantifiable evidence of their creditworthiness—most notably, start-ups. Although some evidence exists that is consistent with the established view of differences between small and large banks, no nationally representative survey has asked banks of all sizes to describe how they conduct small business lending, making it difficult to understand the possible implications of these practices for small businesses' access to credit in the future.

To fill this knowledge gap, the Federal Deposit Insurance Corporation recently conducted the Small Business Lending Survey (SBLS) to collect

RELATIONSHIP LENDING AND TRANSACTIONAL LENDING

The consensus explanation for banks' centrality to small business finance is that banks have a unique ability to generate information that allows them to identify the high-quality small firm and, by extension, the profitable small business loan.[a] Although all banks are thought to use a variety of methods to identify high-quality small businesses, small and large banks are widely considered to hold distinct advantages in how they generate information. As a result, small and large banks are expected to manage their small business lending programs differently.

Specifically, small banks are regarded as having a comparative advantage in gathering and using "soft" information—knowledge of both the local community and the small businesses within it—which the bank has accumulated over multiple interactions, and which is hard to quantify or transmit. Small banks are typically located within the communities they serve, which therefore lowers the transaction costs of engaging with and monitoring the firm or of gathering knowledge of the local market. Further, small banks are usually closely held organizations with few managerial layers between bank owners and loan officers, so that the loan officer may be more motivated to gather and use soft information when deciding whether to grant a business loan.[b] Small banks are therefore considered more flexible and able to engage with small businesses on a case-by-case basis. It is for these reasons that small banks as a group are believed to specialize their commercial and industrial lending to small businesses and are typically called relationship lenders.

Large banks are regarded as taking advantage of economies of scale to gather and use large amounts of quantifiable, or "hard," information about the borrower. This reliance on hard information requires that bank management specify the types of data used as well as the metrics for determining small business quality, usually well before any business applies for a loan. Further, since the information used by large banks is quantifiable, it can be submitted and shared electronically, which may reduce the need for the large bank decisionmakers to be in close proximity to the small business. This structure facilitates a high-volume small business lending model, and is often referred to as transactional lending.

[a] Udell, "What's in a Relationship?"

[b] Allen N. Berger and Gregory F. Udell, "Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure," *Economic Journal* 112, no. 477 (2002): 32–53; and Jeremy C. Stein, "Information Production and Capital Allocation: Decentralized versus Hierarchical Firms." *Journal of Finance* 57, no. 5 (2002): 1891–921, https://doi.org/10.1111/0022-1082.00483.

high-quality data on the small business lending practices of a large, nationally representative sample of U.S. banks. The survey had a sample response rate of 60 percent, with approximately 1,200 banks, or more than one-sixth of all banks in the country, responding. The answers given to the questions have been weighted to reflect the whole population of U.S. banks. There are currently few other surveys of small business lending that survey banks, and these other surveys include convenience samples of only small banks, which prevents comparison between different-sized banks; these other surveys also cover fewer topics.[6] The SBLS is the only survey able to provide nationally representative findings that reflect a broad view of the practices of the entire industry, including both small and large banks.

The survey instrument was developed in consultation with experts at the U.S. Census Bureau and benefited from suggestions by more than 40 banks of all sizes across the United States; these banks agreed to provide feedback on draft versions of the survey in one-on-one interviews throughout 2015.[7] The survey, which was conducted between June 2016 and January 2017, captured information about banks' experiences in the calendar year 2015.

The survey questions covered the following subject areas:

- Banks' characterizations of their small business borrowers
- The volume of C&I lending to small businesses that is not captured in current bank reporting to regulators
- Banks' market area and their competitive environment for small business lending
- Competitive practices and advantages
- Loan products offered and underwriting practices, including for loans to start-ups.

The answers given in the first two areas allow the survey to make a particularly significant contribution to the measurement of small business lending. As explained in Section 2 of this report, the standard loan-size measure for small business C&I lending does not fully correspond to banks' own definitions of what is a small business and what is small business lending, and therefore the standard measure is unable to capture substantial portions of such lending. The survey has made it possible to quantify two missing portions. Thus, the findings from the survey provide policymakers, bankers, and academics a better understanding of aspects of small business lending by banks that is currently understated.

[6] See Federal Reserve System and Conference of State Bank Supervisors, Community Banking Research and Policy Conference, October 4–5, 2017, *Community Banking in the 21st Century 2017*, https://www.communitybanking.org/~/media/files/cb21pub_2017_book_web.pdf; and Jeff Bajek, "RMA Survey: Trends in Small Business Lending at Community Banks," *RMA Journal*, March 2017, https://www.rmahq.org/ProductDetail.aspx?productid=491302131. Both publications report on surveys that use convenience sampling rather than random sampling. An exception is the Federal Reserve Bank of Kansas City's newly launched *KCFed Small Business Lending Survey*, April 2, 2018, https://www.kansascityfed.org/~/media/files/publicat/research/indicatorsdata/smallbusiness/2018/1stquarter/smallbusinesslendingsurvey04-02-18.pdf?la=en, which uses a nationally representative sample that includes large banks but has a narrower focus on the terms of lending offered by banks to small businesses. There are also current surveys of small business owners about their credit needs and experiences, which use either convenience samples or focus on a small set of firms. For examples of a small business owner surveys, see Federal Reserve System, "Report on Employer Firms," *Small Business Credit Survey*, April 2017, https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf or DesRoches, David and Potter, Frank and Santos, Betsy and Sengmavong, Ae and Zheng, Yuhong, "Kauffman Firm Survey (KFS) Seventh Follow Up Methodology Report," June 28, 2013, https://ssrn.com/abstract=2286725.

[7] The survey development phase involved three rounds of interviews with institutions in both rural and urban areas and in ten states. See Appendix A for details on sampling methodology, survey development, and survey validation; see Appendix B for a discussion of the extrapolation methodology used to generate estimates, presented in Section 2, of small business lending by banks that is understated in current regulatory reports; see Appendix C for the full survey instrument.

The answers given in the remaining areas all relate to the approaches that banks take toward small business lending, and provide direct evidence on the differences between small and large banks. Sections 3, 4, and 5, each in its separate subject area, provide evidence in support of the established understanding, but they also show that, in practice, the differences between the approaches taken by the two sizes of banks involve many nuances. Although small and large banks do emphasize distinct aspects of small business lending, a core set of practices centering on locally-based personal interactions characterizes much of small business lending regardless of bank size.

Sections 3, 4, and 5 report the survey findings in detail, by bank size, with Section 3 focusing on the environment for banks (market areas and competitors), Section 4 looking both within and without (competitive practices and perceptions of advantages), and finally, Section 5 focusing on the bank itself (loan products offered and underwriting practices). Each of these sections specifies the topic to be addressed and its rationale, describes the survey findings, and concludes by briefly discussing implications for small businesses' future access to credit.