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Economic Letter

Small-Business Lending Languishes as Community Banking Weakens

by Kelsey Reichow

ABSTRACT: Community banks are key providers of loans to small businesses, which are important contributors to the local economy and international trade. While regulatory burden on small banks and its impact on lending has received attention, it is difficult to isolate the most significant driver of sluggish small-business lending.

America's small businesses have struggled securing credit since the end of the financial crisis in 2009. Small-business loans at U.S. commercial banks have declined 15 percent from their precrisis high, while total business loans increased 33 percent (*Chart 1*).

As a result, small-business loans' share of total bank loans is down 13 percentage points. The trend extends beyond the crisis, as small-business loans —those with original amounts of less than $1 million—have shrunk from almost 40 percent of the overall business loan portfolio in 2004 to 20 percent in 2016.

This is particularly worrisome because small businesses, defined as those with fewer than 50 employees, are significant job creators. Small businesses employ about 120 million people, roughly half of the nation's private-sector workforce. New firms in particular—almost all of which are small—are responsible for a majority of total net job creation.[1] Moreover, the Federal Reserve Bank of Cleveland's 2015 Small Business Credit Survey found that 95 percent of all firms employed fewer than 50 people.[2]

A less-heralded role small business fills is that of driving innovation. Relative to larger enterprises, small business develops more patents per employee, with the smallest firms (fewer than 25 employees) producing the greatest number per employee.[3] More broadly, small businesses contribute significantly to private nonfarm gross domestic product and to international trade, comprising more than 97 percent of exporters and importers and roughly one-third of export and import value.[4]

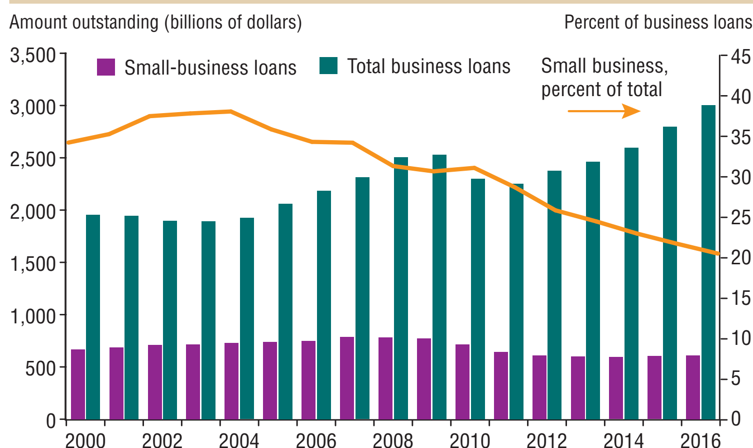
Community Banks and Lending

Community banks, those with less than $10 billion in assets, are a key local source of credit, particularly for small businesses. While small-business loans comprise 35 percent of small-banks' assets, they only made up 2 percent of that for larger banks in 2016 (*Chart 2*). This proportion has held over time. In 2007, small-business loans made up roughly 44 percent of small-banks' assets compared with only 3 percent for larger banks. This partly reflects that large borrowers' capacity to borrow from community banks is limited by institutional size and small banks' need to maintain a diversified portfolio.

This high concentration of small-business loans highlights a possible unintended consequence of the consolidation among community banks: making it more difficult for small business to access credit.

The number of community banks has steadily declined, with contraction

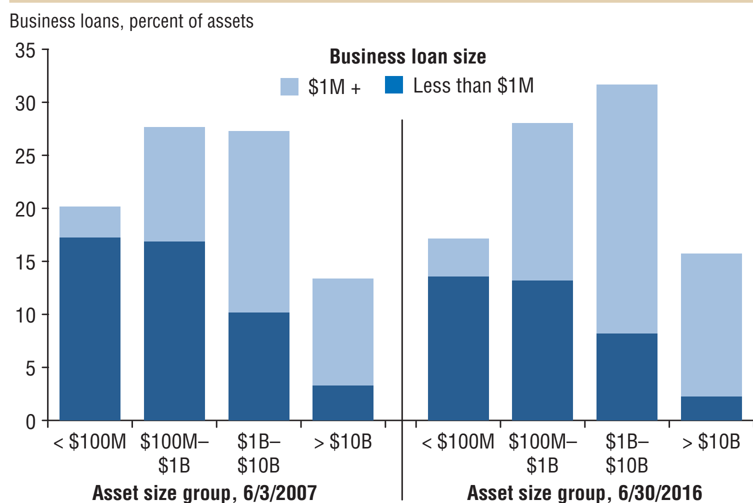
Chart 1 U.S. Banks Cutting Small-Business Loan Concentrations



NOTES: Data are adjusted for inflation. Data are year end except for 2016, which is through June 2016.

SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

Chart 2 U.S. Community Banks Focus on Small-Business Loans



SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

particularly pronounced among the smallest banks (*Chart 3*). The number of institutions with assets less than $100 million fell roughly 64 percent between 2000 and 2016, from 4,528 institutions to 1,636 as of June 2016.[5] As a group, the number of community banks has dropped by just more than 40 percent since June 2000.

Moreover, although bank failures have eased from peak levels in 2009 and 2010, as broader industry conditions improve, few new banks are being formed. On average, 138 new banks were chartered each year from 1990 to 2010; only one new bank has been chartered during each of the past five years (*Chart 4*).[6]

Bankers argue the industry is less inviting to newcomers. They cite reduced earnings prospects due to the low interest rate environment and greater expenses required to meet demands of increasing regulation attributable to the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act.[7]

Less Small-Business Credit

One way to determine the cause of the drop in small-business loans is to create hypothetical lending scenarios for 2016 based on prefinancial crisis data to assess whether changes in banks' small-business lending practices or financial institution consolidation best explain the decline in the banks' small-business concentrations.

Controlling for the effects of consolidation explains only a small part of the decline in banks' small-business portfolios; if banks had the same asset size distribution today as in 2007, their small-business portfolios would only be $19 billion higher.

However, if small-business loans are calculated based on 2007 small-business loan concentrations for banks of each size category, the data suggest a different story. If 2007 lending patterns stayed consistent, banks would report more small-business lending, even with the consolidation experienced over the past 10 years (*Chart 5*). The data indicate small-business loans make up a smaller part of portfolios among banks of all sizes.

The pullback in small-business lending is a product of several factors, with regulatory burden among the most prominent. More stringent requirements are also hurting larger banks' ability to provide credit to small businesses. Large banks have indicated they are less likely to make small loans because the cost of processing a $100,000 loan is comparable to that of a $1 million loan.[8] As a result, large banks have significantly reduced loans below a certain threshold, typically $250,000, or have stopped lending to businesses with revenue less than $2 million.[9]

The fixed costs associated with regulatory compliance, such as hiring another employee to help comply with additional requirements, make it disproportionately expensive for smaller banks to adapt to the tighter regulatory regime implemented since the financial crisis. And, regulatory burden hits the smallest community banks much harder than the larger community banks, as evidenced by comparing ratios of total compliance expenses to noninterest expenses. The average ratio of compliance expenses to noninterest expenses was roughly 8.9 percent for banks with assets of less than $100 million compared with 2.9 percent for larger community banks, those

with assets of $1 billion to $10 billion.[10] Higher regulatory compliance expenses shift resources from core operations.

There are also measurements of regulatory burden outside of dollars and cents. The size and complexity of the call report—banks' quarterly accounting of their operations and finances—provide a telling proxy for the increase in official requirements. Call report filings were four pages in 1950, grew to around 30 pages in the 1980s and are 84 pages currently. The number of items within them also increased, from 53 at the end of 1970 to 2,379 in fourth quarter 2015.[11]

Regulators have taken some measures to ease the regulatory burden on smaller institutions, such as reducing the call report page count to 61 pages for banks with assets of less than $1 billion.

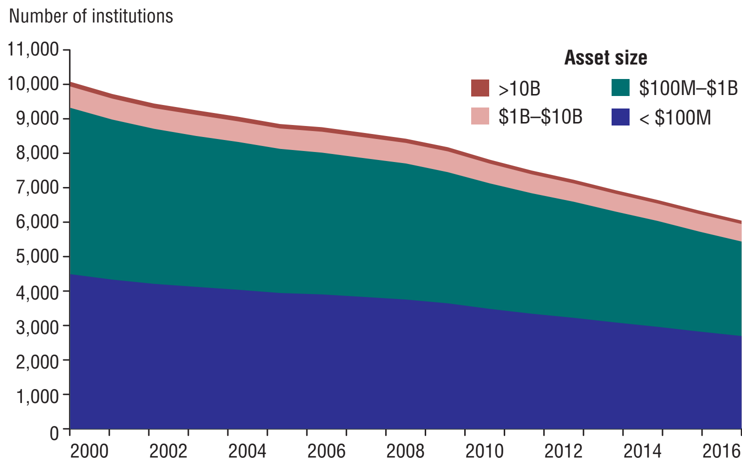
Another notable regulatory barrier for smaller banks is the standardization of underwriting under the Dodd–Frank Act, particularly involving the Consumer Financial Protection Bureau created under the act. Standardized models used by regulators to identify safe products for consumers may not be as applicable to the community banking model, which has historically been more dependent on personal relationships.[12]

Credit availability for small business appears to be improving but remains relatively tight given current economic conditions. Paradoxically, two surveys of small-business owners—the monthly National Federation of Independent Businesses (NFIB) and the quarterly Wells Fargo/Gallup survey—found weaker demand for credit despite a more optimistic outlook among small-business owners. The December 2016 NFIB survey reported increasing small-business optimism even as those businesses encountered difficulties fulfilling their borrowing needs.[13] However, the 2016 quarterly Wells Fargo/Gallup Small Business survey suggests access to credit is improving, with 36 percent saying it was somewhat or very easy for their companies to obtain credit over the past 12 months—the highest level since fourth quarter 2008.[14]

Lingering Structural Barriers

Community banks play an important role in lending to small business.

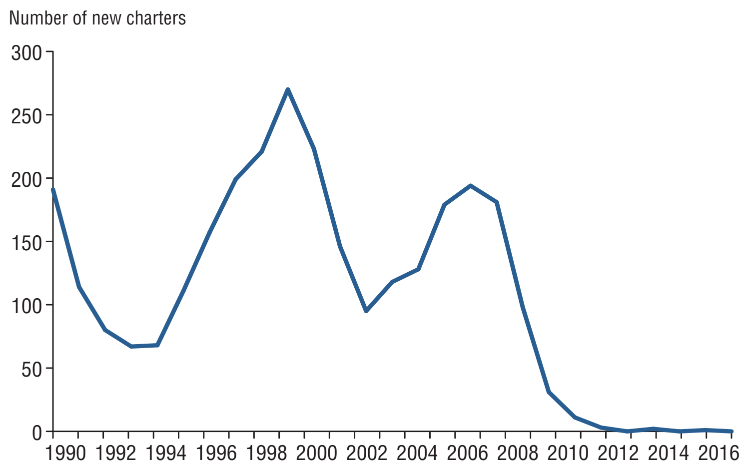
Chart 3 Consolidation Concentrated in Smallest Institutions



NOTES: Data are adjusted for inflation. Data are year end except for 2016, which is through June 2016.

SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

Chart 4 Rate of New Bank Formation Declines



NOTE: Data are year end except for 2016, which is through 2016.

SOURCE: Federal Deposit Insurance Corporation.

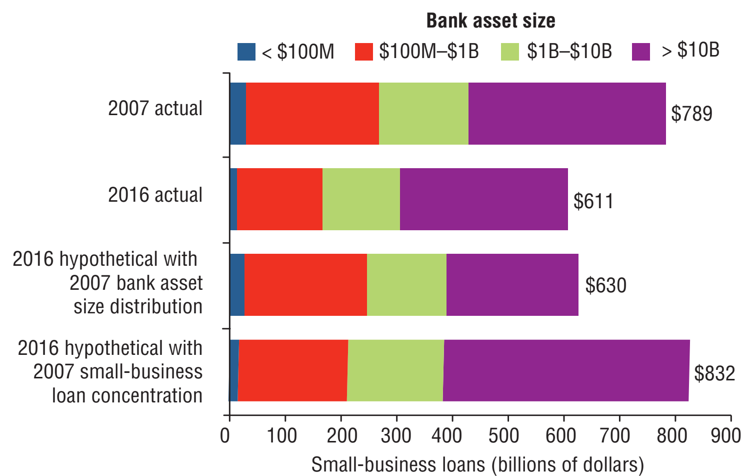
Conventional wisdom suggests a decline in the number of smaller banks has reduced small businesses' access to credit. Yet, the decline in small-business lending extends beyond financial industry consolidation.

Loan portfolios across banks of all asset sizes are shifting away from small-business loans, suggesting consolidation is not the greatest cause for a drop in banks' small-business lending. The drivers behind banks reducing their small-business lending include stricter regulatory requirements, tighter lending standards, shrinking demand for credit and structural changes in the banking industry.

While a great deal of attention has been paid to the effects that regulatory burden has had on banks and their ability to lend, challenges to small-business lending were present before the financial crisis and have only intensified since the end of 2007.

It is too soon to tell if weaker small-business lending represents a new, longer-run credit gap or if small businesses will be able to adjust by obtaining credit outside traditional channels. Whatever the driving forces may be, it is imperative

Chart 5 What Explains Soft Lending to Small Businesses?



SOURCES: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council; author's calculations.

that small-business owners obtain adequate access to credit markets because of the importance of small businesses to the economy.

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Notes

[1] "Who Creates Jobs? Small vs. Large vs. Young," by John C. Haltiwanger, Ron S. Jarmin and Javier Miranda, National Bureau of Economic Research, NBER Working Paper no.16300, August 2010, www.nber.org/papers/w16300.pdf.

[2] "2015 Small Business Credit Survey Report on Nonemployer Firms," Federal Reserve Bank of Cleveland, December 2016, www.clevelandfed.org/community-development/small-business/about-the-joint-small-business-credit-survey/2015-joint-small-business-credit-survey.aspx.

[3] "An Analysis of Small Business Patents by Industry and Firm Size," by Anthony Breitzman and Diana Hicks, November 2008. A report developed under a contract with the Small Business Administration, Office of Advocacy, http://rdw.rowan.edu/cgi/viewcontent.cgi?article=1011&context=csm_facpub.

[4] Data from SBE Council Database, Small Business Facts & Data, http://sbecouncil.org/about-us/facts-and-data/.

[5] Institutions include both commercial banks and savings and loan associations.

[6] Data from FDIC Statistics at a Glance, Commercial Banks and Savings Institutions data for New Reporters from 1990–2016 year to date.

[7] "Community Banking in the 21st Century," Federal Reserve Bank of St. Louis, Sept. 28–29, 2016, www.communitybanking.org/documents/2016-Conference-Papers/CB21Cpublication_2016.pdf.

[8] "Fall of 2013 Small Business Credit Survey," by Federal Reserve Bank of New York, September 2013, www.newyorkfed.org/smallbusiness/Fall2013/index.html.

[9] "Why Small-Business Lending Has Not Recovered," by Karen Mills, *Forbes*, Aug. 4, 2014, www.forbes.com/sites/hbsworkingknowledge/2014/08/04/why-small-business-lending-has-not-recovered/#612b3a92c0b4.

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[12] "Regulatory Burdens: The Impact of Dodd–Frank on Community Banking," testimony by Hester Peirce, director of Financial Markets Working Group, July 18, 2013, http://mercatus.org/publication/regulatory-burdens-impact-dodd-frank-community-banking.

[13] Data from *December 2016 Report: Small Business Optimism Index*, National Federation of Independent Business, November 2016, www.nfib.com/surveys/small-business-economic-trends/.

[14] Data from *Wells Fargo Survey: Small Business Optimism Up Slightly in Third Quarter*, Wells Fargo/Gallup Small Business Index, August 2016, https://wellsfargoworks.com/small-business-optimism-up-slightly-in-third-quarter.

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