SECTION 3. Markets and Competition

This section investigates the market for small business lending, looking at how banks view their geographic reach in small business lending and what kinds of technologies and techniques banks use to bridge the physical distance between themselves and potential small business customers. The section also investigates what institutions, by geography and by size, banks consider to be their competition.

These questions matter because if banks have narrow lending areas, provide businesses with few options to apply for loans without visiting a branch, and do not consider themselves to be in competition with nonlocal financial institutions, many small business borrowers may have trouble switching to another lender if nearby banks or nearby bank branches close. Similarly, if small banks serve a substantially different set of customers from large banks and if banks view themselves as solely competing with other banks of similar size, small-bank customers may have trouble accessing credit at large banks if small banks' number and lending continue to decrease. On the other hand, if banks view nonbank financial institutions such as credit unions and financial technology lenders as important competitors, these organizations may be capable of filling in the gaps created by the changing structure of the banking industry.

3.1 What Is Your Bank's Geographic Market for Loans to Small Businesses?

The survey explores the geographic extent of banks' small business lending markets and seeks to learn whether large banks tend to have wider markets relative to their branch footprint than small banks. Previous studies have shown that small businesses located farther away from banks are less likely to obtain bank loans and that the relationship between distance and the likelihood of obtaining bank loans is stronger for smaller banks as well as for younger businesses or those that cannot clearly demonstrate creditworthiness.[22] The link between bank credit and proximity, however, may have been loosened by recent changes in the use of technology and the increasing availability of data, perhaps combined with the trend toward fewer small banks. Any such loosening would give banks a broader geographic market for their small business loans.

Specifically, the survey asked banks to describe the general geographic area where they focus their resources and outreach for commercial and industrial loans to small businesses.[23] The results show that small business lending remains focused substantially on areas close to bank locations, particularly for small banks.

[22] See Allen N. Berger et al., "Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks," *Journal of Financial Economics* 76, no. 2 (2005): 237–69, https://dx.doi:10.1016/j.jfineco.2004.06.003; Kenneth P. Brevoort and Timothy H. Hannan. "Commercial Lending and Distance: Evidence from Community Reinvestment Act Data," *Journal of Money, Credit and Banking* 38, no. 8 (2006): 1991–2012, http://www.jstor.org/stable/4123041; Udell, "What's in a Relationship?"; Kenneth P. Brevoort, John D. Wolken, and John A. Holmes, "Distance Still Matters: The Information Revolution in Small Business Lending and the Persistent Role of Location, 1993–2003," Federal Reserve Board, Finance and Economics Discussion Series, Working Paper No. 2010-08 (March 1, 2010), http://dx.doi.org/10.2139/ssrn.1559989; and Sumit Agarwal and Robert Hauswald. "Distance and Private Information in Lending," *Review of Financial Studies* 23, no.7 (2010): 2757–88, https://doi.org/10.1093/rfs/hhq001.

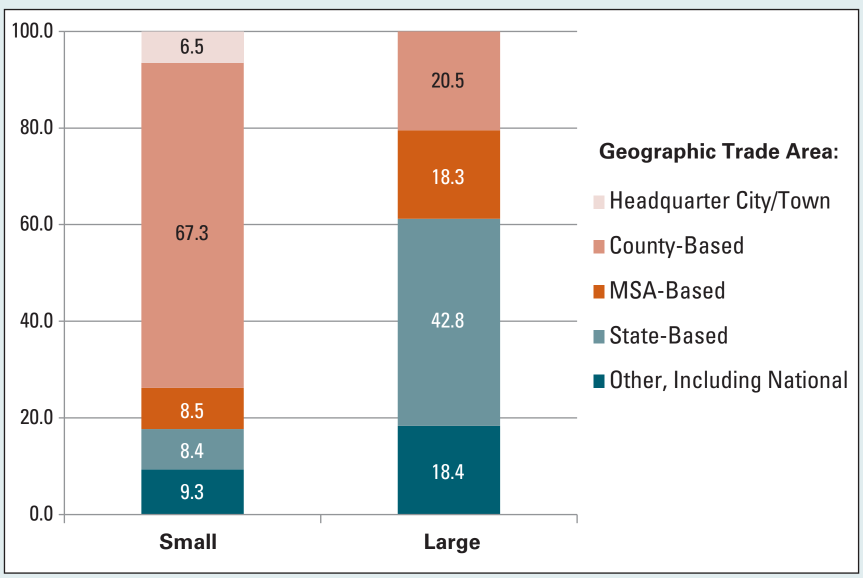
[23] The survey provided banks with nine geographical options and a write-in option. All the options were aggregated into five broader categories in order to meet the disclosure review thresholds for protecting respondents' identities. These aggregations do not change the qualitative results.

Small banks have predominantly local trade areas for small business lending. As shown in Figure 3.1, small banks focus on the city where they are headquartered (6.5 percent), on counties containing or near their branches (67.3 percent), or on metropolitan statistical areas (MSAs) containing or near their branches (8.5 percent).[24] Combined, 82.3 percent of small banks selected one of these local options. Fewer than 10 percent of small banks focus their small business lending efforts on either state-based areas (8.4 percent) or at a national level (9.3 percent). The predominantly local focus of small banks suggests that if all small banks exit a particular area, out-of-area small banks will not fill the local small business lending gap.

Large banks generally spread their resources across larger geographic areas than small banks, but a substantial minority is, like small banks, locally-focused. As Figure 3.1 shows, large banks that describe their market area as at the state level constitute the largest share (42.8 percent) of large banks, and up to an additional 18.4 percent focus at the national level.[25] However, Figure 3.1 also shows that a substantial share (38.8 percent) of large banks consider their market to be based in a more local area. Among large banks, 20.5 percent consider their target geographic markets to be at the county level, and an additional 18.3 focus their efforts at the MSA level. Therefore, although a majority of large banks do not define their geographic markets at the level of the MSA, county, or city, the share that does focus small business lending efforts on these more local geographies is surprisingly substantial. This contrasts somewhat with the implications of the established view that large banks do not require proximity to their small business customers.

The overall findings suggest that the wider geographic focus of large banks may be able to fill some of the gap in small business lending that opens up when a small local bank closes. However, despite recent changes in technology and banking structure, location remains an important factor in small business lending for many banks of both sizes.

Figure 3.1: Percentage of Banks That Use This Geographic Level as Their Trade Area for Small Business Lending



Source: SBLS Question 15.

Notes: The survey question asks banks for the geographic market, or "trade area," where they focus their resources and outreach to generate small business lending. At the statistical significance of 10 percent, small banks are more likely than large banks to use a county-based geographic trade area; large banks are more likely than small banks to use an MSA or state-based geographic trade area.

24 An MSA is a geographical area with a relatively high population density at its core and close economic ties within its boundaries. MSAs may be smaller geographically than a state but may cross state lines (e.g., the Baltimore-Washington metropolitan statistical area).

25 The number of responses of large banks that described their market area as having a national focus did not meet disclosure review thresholds for protecting respondents' identities; thus, for both large and small banks these responses were combined with the write-in responses describing the banks' market areas as other than the options provided.

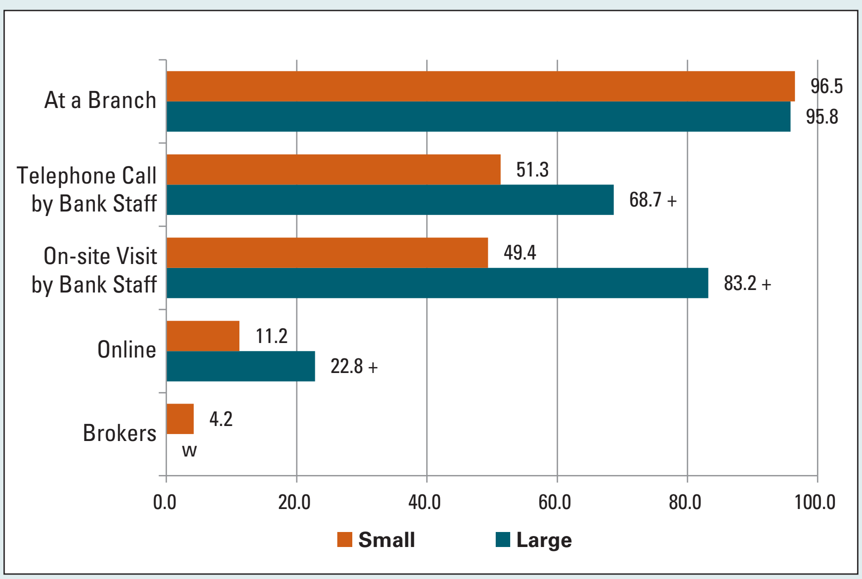
3.2 Where Can a Small Business Apply for a Loan from Your Bank?

The survey further explores the geographic extent of banks' small business lending market by looking through the lens of where small businesses are able to apply for loans. The finding above that small banks tend to define their lending areas more locally than large banks suggests that the two sizes of banks are using different methods to reach their small business customers. Understanding whether in fact methods differ, and if so, how, may become increasingly relevant as branches continue to close and bank assets become further concentrated in large banks. Given the increasing use of technology by banks, it might be expected that banks use the Internet to provide greater convenience to more-distant customers. Further, since large banks are thought to use more technology in their small business lending decisions than small banks do, it might be expected that large banks' greater reach is made possible by allowing online applications for small business loans.

Specifically, the survey asked banks where and how potential small business borrowers can submit applications for commercial and industrial loans.[26] The results suggest, surprisingly, that large banks for the most part extend their geographic reach farther than small banks through staff-time-intensive methods, with only a few large banks using online platforms.

Unsurprisingly, the survey finds that more than 95 percent of both small banks and large banks accept applications for small business loans through their branches, as shown in Figure 3.2. About one-half of small banks also accept applications through phone calls (51.3 percent) and on-site visits by bank staff (49.4 percent). However, large banks generally provide their small business customers with a broader range of ways to submit loan applications; they allow, on average, 3.5 different ways in which small businesses can apply for loans, compared with 2.7 different ways for small banks.[27] Interestingly, the broader reach of large banks is driven less by use of the Internet and more by use of telephones and cars:

Figure 3.2: Percentage of Banks That Allow Small Business Borrowers to Apply for Loans Using This Method



Source: SBLS Question 23.

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 large banks are more likely than small banks to allow small business borrowers to apply for loans using this method. Banks may select multiple answers; results will not sum to 100.0 percent.

[26] The survey gave banks eight options and the ability to write in three additional answers not already listed. The responses were aggregated for clarity of presentation and to comply with the requirements related to protecting respondents' identities.

[27] The survey provided banks with eight possible ways and a write-in option. The difference between what large banks report and what small banks report is statistically significant.

large banks are 11.7 percentage points more likely to accept loans online than small banks, but 17.4 percentage points more likely to accept applications during phone calls, and 33.8 percentage points more likely to accept applications during on-site visits by bank staff. Overall, only 22.8 percent of large banks accept small business applications online, compared with the 83.2 percent that are willing to via on-site visits. On-site visits have clear geographic limitations, so the willingness to make such visits to accept a loan application gives some insight into the continued importance of distance in small business access to credit.

The fact that the great majority of large banks provide staff-time-intensive ways for prospective borrowers to submit loan applications and have not adopted online submission of applications could reflect several properties of bank lending to small businesses. First, it may be hard for banks to adapt small business lending to an online environment, for direct human interaction appears inherent in the process. Even large banks, whose small business lending methods are shown in Sections 2 and 5 to rely more heavily on evaluating standard data against preset limits, have thus far not generally found it worthwhile to pursue online small business loan applications. Second, if there is a way to make online small business lending profitable, there appears to be an opportunity for innovation by financial technology (FinTech) firms. To date, there have been few partnerships between small banks and FinTechs, but recent surveys have shown banks to be open to the possibility.[28]

3.3 Who Are Your Bank's Competitors?

To investigate whether small and large banks serve distinct sets of small business customers, the survey looked at the competition these banks face. The evidence from the survey so far indicates that there is substantial geographic segmentation in the small business lending market. (To recapitulate: many banks largely lend to businesses near their branches, which in turn suggests that small business borrowers are limited to borrowing from nearby banks. Further, as bank branches decline in number, the local focus could leave small businesses with few or no feasible sources of bank credit. This concern may be partly mitigated by the fact that large banks tend to lend in broader areas than small banks.) In addition, there may also be segmentation by bank size: some small businesses may be better served by small banks than by large banks because small banks provide a more appropriate set of services or use a broader array of information to determine creditworthiness.[29] Indeed, studies have found that small banks are more likely to lend to relatively smaller and younger firms and large banks are more likely to lend to larger and more mature small firms.[30] If this is the case, some small businesses may not be able to compensate for the loss of a local small bank by using the services of a more distant large bank.

Specifically, the survey asked banks to select which types of financial institutions (banks and nonbanks) they consider to be frequent competitors for small business lending, and to rank their top three most important competitors. If the small business lending market is as geographically segmented as the findings so far indicate it is, banks should not typically view banks that lack a physical presence

[28] See Hilary Burns, "This Fintech Partnership Could Serve as Template for Small Banks," *American Banker,* April 16, 2018, https://www.americanbanker.com/news/this-fintech-partnership-could-serve-as-template-for-small-banks; and American Bankers Association. "How Banks Partner with FinTech for Digital Lending." *ABA Bank Marketing.* March 26, 2018, https://ababankmarketing.com/insights/how-banks-partner-with-fintech-for-digital-lending/.

[29] Stein, "Information Production"; David A. Carter, James E. McNulty, and James A. Verbrugge, "Do Small Banks Have an Advantage in Lending? An Examination of Risk-Adjusted Yields on Business Loans at Large and Small Banks," *Journal of Financial Services Research* 25, no. 2–3 (2004): 233–52, https://doi.org/10.1023/B:FINA.0000020663.21079.d2; and Berger et al., "Does Function Follow Organizational Form?"

[30] George W. Haynes, Charles Ou, and Robert Berney, "Small Business Borrowing from Large and Small Banks," in *Business Access to Capital and Credit,* edited by Jackson L. Blanton, Alicia Williams, and Sherrie L. W. Rhine, 287–327, Federal Reserve System Research Conference, 1999, http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=D208864BBCA8E4D281034D453A1F3D7F?doi=10.1.1.474.279&rep=rep1&type=pdf; and Berger et al., "Function Follow Form?"

in their markets as competitors. And to the extent that there is segmentation by bank size—with smaller firms more likely to borrow from small banks, as studies have found to be the case—small banks would be expected to compete solely with other small banks and large banks with other large banks.[31] But if, instead, most small businesses can be served by banks of any size, there should be more competition between banks of differing sizes. And if banks frequently view various nonbank institutions as important competitors, small businesses may be able to borrow from these organizations in the event they lose access to their current preferred lender.

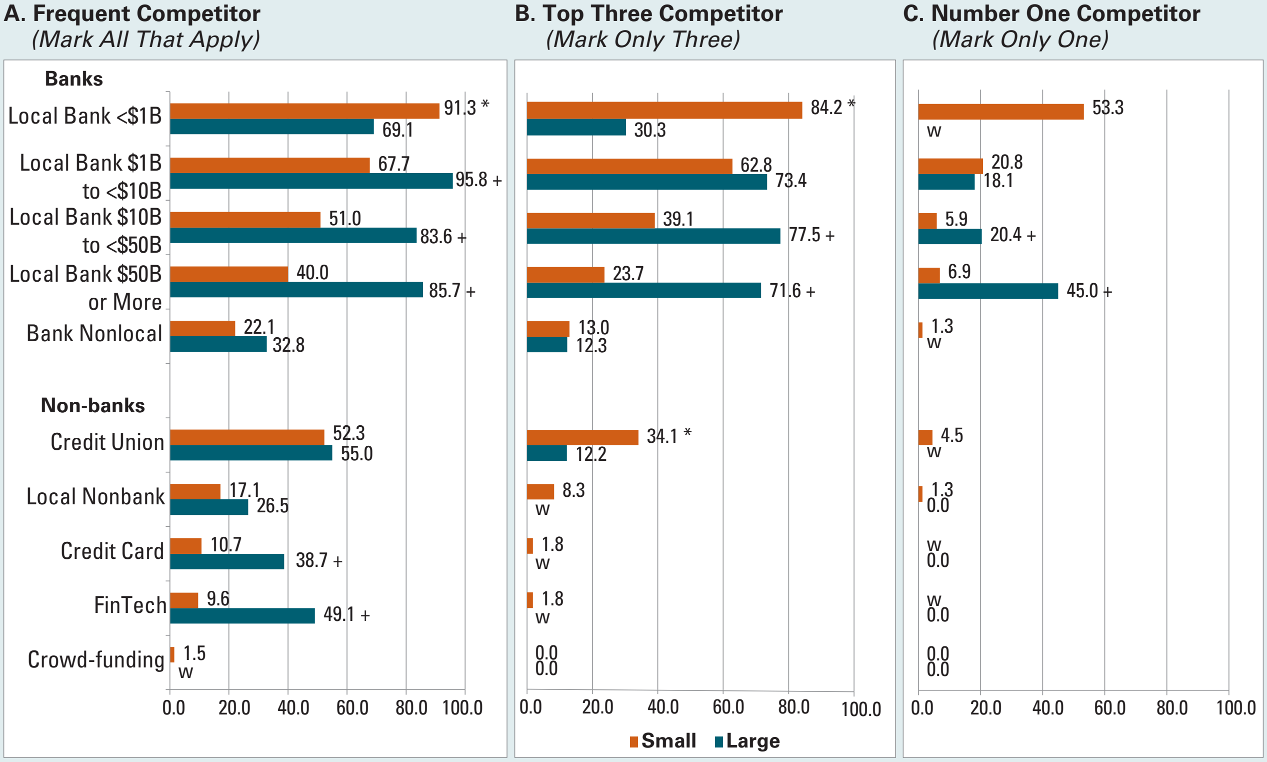
The survey finds that the most common and important competitors are other banks with a local branch presence, providing further evidence for geographic segmentation. Figure 3.3 shows the proportion of small and large banks that view each type of institution as a frequent competitor, a top three competitor, and its number one competitor (Panels A, B, and C, respectively). The overwhelming majority of both small and large banks (86.9 percent and 83.5 percent) view a local bank of some size as their number one competitor (Figure 3.3, Panel C). In contrast, nonlocal banks are seen as frequent competitors by only 22.1 percent of small banks and 32.8 percent of large banks (Figure 3.3, Panel A), with even fewer reporting them as top three competitors (Figure 3.3, Panel B), and almost no banks reporting nonlocal banks as their number one competitor (Figure 3.3, Panel C). The importance of nearby competitors reaffirms that physical presence is extremely important for small business lending, even for large banks. These findings are consistent with the finding (discussed below in Section 4) that large banks view their branch networks as sources of competitive advantage.

Banks typically view other banks of similar size to be their most important competitor—evidence consistent with segmentation by bank size in the small business lending market. Figure 3.3, Panel C, shows that nearly three-quarters of small banks believe their number one competitor to be another small local bank, either banks with less than $1 billion in assets (53.3 percent) or banks with $1 billion to $10 billion in assets (20.8 percent). Similarly, roughly two-thirds of large banks view another large bank to be their number one competitor, with this share encompassing competitor banks with $10 to $50 billion in assets (20.4 percent of large banks) and banks with greater than $50 billion in assets (45.0 percent).

When competition is considered more broadly, however, with the focus on frequent competitors for small business lending (Figure 3.3, Panel A) and on top three competitors (Figure 3.3, Panel B), there is much less market segmentation by size and much more overlap between small and large banks, with large banks particularly inclined to view small banks as competitive threats. A substantial majority of large banks (69.1 percent) view even banks with less than $1 billion in assets as frequent competitors for small business lending, and slightly less than one-third (30.3 percent) view them as top three competitors. It is also not uncommon for small banks to see large banks—and even the largest banks—as competitors, with 40.0 percent viewing banks with more than $50 billion in assets as frequent competitors and 23.7 percent viewing them as a top three competitor. This partial segmentation between small and large banks suggests that there is a reasonably wide base of small business customers that are capable of borrowing from either small or large banks. The overlap is most noticeable in how banks with $1 billion to $10 billion in assets are viewed. Figure 3.3, Panel A, shows that almost every large bank—more than 95 percent—views these "larger" small banks ($1 billion to $10 billion in assets) as frequent competitors, and Figure 3.3, Panel B, shows that three-quarters of large banks (73.4 percent) view them as top three competitors. Majorities of small banks also view this group of small banks as frequent and top three competitors. Further, statistically equal shares of small and large

[31] In support of this notion, the Community Banking in the 21st Century 2017 survey finds that community banks primarily compete with other community banks for small business loans (defining community banks as those with $10 billion in assets or less). 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.

Figure 3.3: Percentage of Banks That Consider This Institution a Competitor for Small Business Lending



Source: SBLS Question 16.

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 this institution a competitor for small business lending; “+” that large banks are more likely than small banks. “Nonlocal Bank, Any Size” is an aggregation of separate options for nonlocal banks of different sizes. “FinTech” is an aggregation of separate options for nonbank online lenders and marketplace lenders. See Question 16 of the SBLS for the complete list of response options provided. In Panels A and B, banks may select multiple answers; results will not sum to 100.0 percent.

banks (20.8 percent and 18.1 percent) consider banks with $1 billion to $10 billion in assets as their number one competitor.

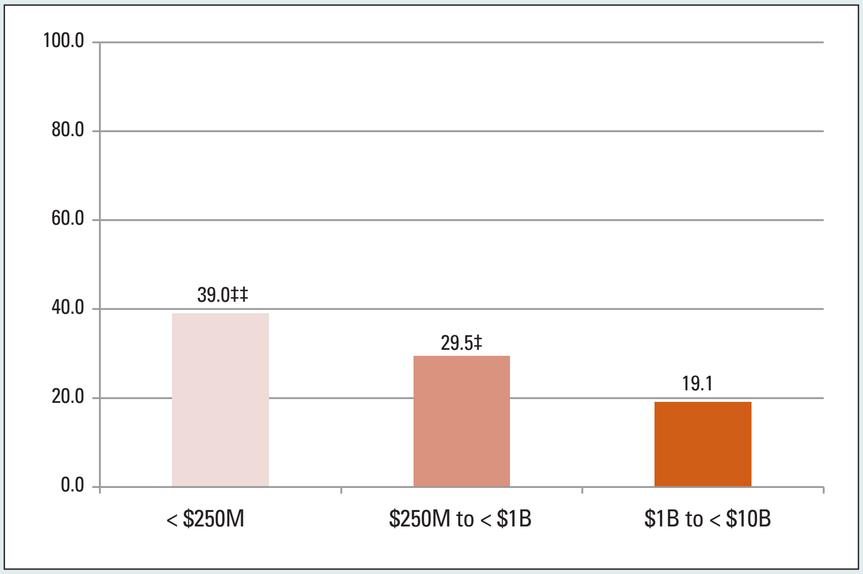
Turning to the nonbank results, banks’ chief competitor among nonbanks is credit unions. Recent changes in the regulations governing credit unions have expanded the small business lending capacity of these institutions.[32] However, credit unions are typically quite small, with the median credit union having only $30 million in assets in 2017.[33] They are also focused more on their membership, which is often drawn from local populations. Thus, they would be expected to serve small businesses that are much like the small businesses served by small banks, thereby posing greater competition to those banks than to large banks.

The survey largely confirms these expectations. Figure 3.3, Panel A, shows that a slight majority of

[32] For example, the National Credit Union Administration adopted a new approach to and definition of member business lending; the new approach and definition are seen as increasing the commercial lending capacity of federally insured credit unions. See 81 Fed. Reg. 13530–13559 (March 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-03-14/pdf/FR-2016-03-14.pdf; and Robby Knapp, “Member Business Loans: What Credit Unions Should Focus on Right Now,” *Credit Union Journal,* June 20, 2017, https://www.cujournal.com/opinion/member-business-loans-what-credit-unions-should-focus-on-right-now.

[33] National Credit Union Administration, *Credit Union Data Summary 2017 Q1,* https://www.ncua.gov/analysis/Pages/call-report-data/reports/paca-facts/paca-facts-2017-Q1.pdf.

Figure 3.4: Percentage of Banks That Consider Credit Unions to Be a Top Three Competitor for Small Business Lending
(Small Banks Only)



Source: SBLS Question 16.

Notes: At the statistical significance of 10 percent, "‡‡" denotes that banks with less than $250 million in assets are more likely than banks with $250 million to less than $1 billion in assets and more likely than banks with $1 billion to less than $10 billion in assets to consider a credit union to be a top three competitor; "‡" that banks with $250 million to less than $1 billion in assets are more likely than banks with $1 billion to less than $10 billion in assets.

both small and large banks (52.3 and 55.0 percent) report frequent competition with credit unions. However, Figure 3.3, Panel B, shows that more than one-third (34.1 percent) of small banks view credit unions as a top three competitor, compared with only 12.2 percent of large banks.[34] Similarly, Figure 3.4 shows that among small banks, those with less than $250 million in assets are about twice as likely as those with $1 billion to $10 billion in assets to see credit unions as a top three competitor (39.0 percent compared with 19.1 percent). This is consistent with the finding that banks tend to view other banks of similar size as their top competitors. Nonetheless, Figure 3.3, Panel C, shows that only 4.5 percent of small banks view a credit union as their number one competitor, implying that other banks remain the predominant source of competition for small banks. These results suggest that credit unions would be able to fill only a small share of any potential loss in access to small business credit resulting from the loss of local small banks.

Among other nonbank lenders are FinTech firms and credit card issuers. The availability of "big data" has recently prompted FinTechs to enter the small business lending market. Since these institutions generally use technology much as large banks do, they might be expected to be more competitive with large banks.

And in fact the survey shows that FinTechs are considered as competitors only for large banks, but only as frequent competitors, not as top competitors. Figure 3.3, Panel A, shows that only about one in ten small banks view FinTechs and credit card issuers as frequent competitors, while Figure 3.3, Panel B, shows that fewer than 2 percent consider each (FinTechs and credit card issuers) a top three competitor.[35] In comparison, sizeable numbers of large banks list FinTech and credit card issuers among their frequent competitors (49.1 percent and 38.7 percent)—likely because these institutions lend in an even more transactional manner than large banks, relying almost exclusively on hard data and

[34] The number of large banks that view credit unions as a number one competitor falls below the reporting threshold for protecting respondents' identities.

[35] The number of small banks that view credit card companies or FinTech firms as a number one competitor falls below the reporting threshold for protecting respondents' identities.

automated technologies. This view of FinTech and credit card issuers as frequent competitors of large banks dovetails with the results reported in Section 5.1 showing that two-thirds of large banks offer credit cards as one of their loan products for small business customers. Thus, these large banks are setting themselves up for direct competition with credit card issuers. However, almost no large banks view FinTechs or credit card issuers as a top three or number one competitor.[36] Thus, while FinTechs may eventually reshape the lending landscape, they are not currently viewed as a major competitor, and their ability to mitigate any loss to small businesses' access to credit if the number of local small banks were to decrease would be minimal.

3.4 Conclusions

This section finds that banks compete locally and largely use traditional "technologies" such as the brick-and-mortar branch, the car, and the telephone as conduits for loan applications from small businesses. Large banks are more willing to make use of off-site approaches than small banks, likely contributing to their larger lending areas. Many of these larger organizations, however, remain locally-oriented, and all banks view other local banks as their most important and most frequent competitors. The results support previous findings that physical distance is a key component of small business lending, so that from the perspective of small businesses, the country largely remains segmented into a series of local lending markets rather than constituting a single, integrated market. The recent decline in the number of bank branches across the country may therefore create significant problems for small businesses' access to credit if the decline means that small businesses are left with a greater distance to the nearest bank branch.

In terms of competition between banks, there is evidence that small and large banks have a partly overlapping small business clientele. The fact that, to some extent, small and large banks consider themselves to be in frequent competition with the other for small business borrowers suggests that many small businesses are capable of borrowing from either type of bank. At the same time, however, the fact that banks' main competitor tends to be a similarly sized bank suggests that small and large banks offer somewhat differentiated services that appeal to distinct groups of customers. Thus, the degree to which small businesses are able to substitute large banks for small ones will determine how much credit disruption small businesses may face as consolidation in the banking industry continues.

Many banks experience some competition in small business lending from emerging nonbank financial institutions, but few banks consider these to be among their most important competitors. Small banks are more concerned than large banks about credit unions, while large banks view both credit unions and FinTech firms as competition. This suggests that, in the absence of significant growth, nonbank institutions will have only a limited ability to fill any gaps in small businesses' access to credit that result from the trend toward fewer small banks and fewer bank branches.

[36] The number of large banks that view credit card companies or FinTech firms as a top three or number one competitor falls below the reporting threshold for protecting respondents' identities.