The FDIC Podcast – Community Banks and the Paycheck Protection Program

BRIAN SULLIVAN: Welcome back to the FDIC Podcast, where we talk about the banking system in this country and how it touches our financial lives. I'm Brian Sullivan with the Federal Deposit Insurance Corporation and in this episode, we're going to talk about the intersection of our banks and our small businesses.

When the global pandemic hit earlier this year, the economic ripple effects swept across the small business landscape. In response, the Paycheck Protection Program…or the PPP…was created, making $659 BILLION available to small businesses to keep them operating, to keep their workers on the payroll. Administered by the Small Business Administration, this Paycheck Protection Program rested on the ability of our nation's banks to offer loans to qualifying businesses, and to forgive those loans if certain conditions were met.

This massive effort also relied heavily on our nation's *community* banks…those smaller banks with deep roots into the small business sector. At a recent community bank research conference, FDIC Chairman Jelena McWilliams addressed the challenges facing small businesses during this period of economic uncertainty…

FDIC CHAIRMAN JELENA MCWILLIAMS: "One of the key constraints facing small businesses is financing. Because these firms are generally too small to access capital markets, their success often hinges on their access to bank credit and this is something we're focused on. Despite the entrance of other financial institutions into the small business lending space, banks remain the most common form of external financing for small businesses.

"Supporting small businesses is one of the key roles that community banks play in our financial system. The overwhelming majority of community banks focus their commercial and industrial lending on small businesses. Community banks often identify themselves, and often are identified by their competitors, as having key advantages in the speed with which they can deliver funding, and they often exhibit more flexibility than large banks in not having minimum loan amounts or not using standardized loan products.

"These attributes, as well as strong ties to their communities and borrowers, likely explain why community banks have played an outsized role in the Paycheck Protection Program."

BRIAN SULLIVAN: The FDIC *just* released a new analysis about how community banks are doing in lending money to small businesses through the Paycheck Protection Program.

And joining us to talk about this is Diane Ellis who directs the research division at the Federal Deposit Insurance Corporation…and Angela Hinton, a senior FDIC financial analyst and one of the chief authors of this analysis. Diane, Angela, thank you for being with us….

DIANE ELLIS: Happy to be here Brian.

ANGELA HINTON: Thanks for having us.

BRIAN SULLIVAN: Diane, let me begin with you. Just how important is this relationship between smaller community banks and small businesses?

DIANE ELLIS: Well, Brian, it's pretty important. And there's been a lot written about it, how important community banks are to small businesses as a source of financing and why that might be the case. The general consensus in the literature is that community banks are particularly important at relationship lending. That is, they have some mix of informational advantages and a flatter organizational structure that makes them good at relationship lending. And that provides a lot of value to small businesses who might have difficulty coming up with hard information about their credit worthiness. And by hard information, I think, I mean, things like credit scores or audited financial statements. And then the implication of this in the literature suggests that consolidation among community banks could have a real knock-on effects for small business growth.

Now that's sort of a standard view in the bank consolidation literature, but new research by a couple of FDIC economists looks at the problem from an opposite perspective. They asked the question, what if consolidation occurring in community banks is due at least in part to the decline of small businesses? For example, it's noteworthy that the GDP of small businesses as a share of the US economy declined by nearly five percentage points from 1998 to 2014, while total deposits of community banks fell by 15 percent over the same time period. So, this research finds that community banks are consolidated the most in those counties that are most susceptible to business consolidation.

BRIAN SULLIVAN: So that really points to there being a really, a symbiotic relationship between smaller community banks and small businesses.

DIANE ELLIS: Yeah. And I think that's a great word. That's the word that comes to my mind is as well, symbiotic. Really the health of one depends upon the health of the other and vice versa.

BRIAN SULLIVAN: Now Chairman McWilliams referred to community banks playing an 'outsized role' in the Paycheck Protection Program and what is meant by that…outsized role?

DIANE ELLIS: Yeah. She made that statement based upon what banks reported in their quarterly call report. A call report contains information about a bank's financial health and offers us a window on what's on the bank's balance sheet. So, we looked at the second quarter call report data and analyzed the share of all loans and all commercial and industrial loans…and you can think of those as business loans…held by community banks and non-community banks. So it's essentially, we looked at the activity of small banks versus big banks, and we found that while community banks hold 15 percent of all loans and 13 percent of all business loans, they held 31 percent of all of the PPP loan balances as of the second quarter. So that's the evidence that smaller community banks are playing a big, even outsized role in the PPP lending space.

BRIAN SULLIVAN: Punching above their weight as it were.

DIANE ELLIS: You got it.

BRIAN SULLIVAN: Okay. Angela, you and your colleagues poured over the data that the banks report. What are the big takeaways you found in the numbers?

ANGELA HINTON: So, the big takeaways Brian, are that generally, not just community banks but the entire banking industry, played a huge role in providing PPP loans to small businesses, which isn't a huge surprise. But in fact, 82 percent of FDIC insured institutions participated in the program offering loans to their small businesses, local small businesses. To give you a few numbers here, we found that FDIC insured institutions held 482 billion or 92 percent of total PPP loans approved by the SBA at that time. They also held the majority of the number of loans approved by the SBA at the time. Now, as Diane mentioned, community banks in particular really punched above their weight in this space, they held 148 billion of that 482 billion, or 31 percent of those loans. Well, in the normal course of their activity, they only hold 15 percent of all bank loans.

BRIAN SULLIVAN: And they were doing it where? And in certain parts of the country or in a broader area?

ANGELA HINTON: They did it everywhere. They did it in metro areas with very large populations and smaller areas and then very rural areas as well. So, your big cities, your medium-sized cities and in rural areas. They provided PPP loans in all 50 states and nearly every state saw that over three-fourths of their community banks participated in the PPP. They participated everywhere and they participated heavily everywhere. Community banks of all sizes participated in the PPP program. You know, community banks is not a one-size-fits-all bucket. We have community banks that are as large as $10 billion and we have community banks that are $300 million. As we might've expected, the larger community banks generally made larger PPP loans and made more PPP loans but on the other side of that story, is that the smallest community banks tended to make the smallest PPP loans. So, they're indicating that those smaller community banks are likely supporting the smallest of small businesses, the ‘mom and pop’ shops.

BRIAN SULLIVAN: Angela, there are so many ways to look at small businesses and so many ways to define what a small business is. When you look at PPP lending to small businesses, what are you really measuring here?

ANGELA HINTON: So, regarding FDIC call report data in particular, lending to small businesses as measured by the size of the loan, as opposed to the size of the business, because the size of the loan is readily accessible data for a bank, whereas size or determining whether the business they're lending to as a small business is not really within the bank’s purview. So, the FDIC, again for ease of reporting, set a loan limit in 1993 when this line item was added to the call reports. And so it says that currently any commercial and industrial loan or business loan less than $1 million represents a small business loan.

Now, it turns out that small business lending more broadly, like taking a step back from banking and the FDIC, is very difficult to measure. For one thing, it's not even really clear what we mean by a small business. The Small Business Administration defines a small business as a business with 500 employees or less. Other organizations focus on the revenue of a small business or a business and say that, you know, if they have revenue of less than a million, they're a small business. There's no right or wrong answer, but it's important to realize you do get a different answer depending on who's asked.

BRIAN SULLIVAN: Diane is measuring the loan size, loans of less than $1 million. Is that an accurate proxy for small business?

DIANE ELLIS: Well, unfortunately it's getting to be a less and less accurate proxy as time goes on. As Angela mentioned, this was set in 1993, so you can imagine with inflation, it's becoming less viable. And it's a real challenge because this is such an important issue to have such a challenge measuring it is difficult. So, we had some economists look at how accurate this measure or this proxy might be based upon some survey data that we have and as you might suspect, they find large loans, larger loans to small businesses and smaller loans to large businesses. And when they take a more inclusive view, they've concluded that actually small business lending could be up to 23 percent higher than what is indicated by that proxy so, that's quite a bit and has some pretty big implications for how we evaluate small business lending. So, for example, after the Great Recession, based upon the proxy data, it looked like banks were pretty slow to start up their small dollar business lending, but bigger loans bounced back quickly. But even if that small portion of big loans are actually going to small businesses, it might paint a much more optimistic picture of the recovery.

BRIAN SULLIVAN: Is it possible then, that the data you're looking at could actually understate just how important community banks are to small businesses?

DIANE ELLIS: Oh, yeah. That's exactly what I'm trying to say.

BRIAN SULLIVAN: Well, I'd like to get back to a point that was discussed earlier when we started talking about just how important these smaller community banks are to the mom and pops out there. Diane, what are the things that really set community banks apart and *how* they lend to small businesses? You touched on it earlier.

DIANE ELLIS: Yeah. And you know, really one of the things that really stands out about community banks is speed. In that small business lending survey that I mentioned, more than 80 percent of community banks put down decision or funding speed is one of their advantages. Only 45 percent of larger banks said speed was one of their advantages. So that's a pretty striking difference. And it's again, consistent with the theories economists have about this relationship lending that I mentioned earlier. It's fewer layers of approval and a smoother flow of the so-called soft information between that layers makes them much faster at decision-making.

BRIAN SULLIVAN: I want to give both of you a final word here, but if you step back from all of these numbers and all of the analysis, it seems to point to and correct me if I'm wrong, and I want to hear your take on this, that if not for these community banks out there…smaller community banks that are based sometimes in a single state or even in a single small town…that if not for these banks, then the challenges being experienced by the small business community during this very challenging time would be even more severe. I'd like to get your take on that.

DIANE ELLIS: Yeah. That's important, Brian. The way I see it is if you're a well-established small business that has this hard information, you have a credit score, you have audited financial statements, you know, when you walk into the doors of a large bank, that bank may be able to serve your credit needs but you have to be able to sort of fit into their template, you know. You have to sort of be able to fit into their box which relies upon that hard information.

If you're a small startup and just don't have that kind of information, you're going to have, there are going to be a lot more challenges in meeting the underwriting requirements of a larger bank. A smaller community bank, which relies upon this soft information, they may know you. They may have known you for years because you have lived and worked in the same community. They may know about your prior work history, or they may have the time to go through your business plan and so forth. They're willing to rely upon that softer information and tailor their products to meet your unique needs. That's where community banks excel. And there are a lot of these kinds of small businesses out there and so community banks are essential to meeting the credit needs of those kinds of organizations.

BRIAN SULLIVAN: Angela, your high-level take on all this.

ANGELA HINTON: I completely agree with everything that Diane said, and I'll just say that this PPP program only proved what she said to be even more true, or it confirmed what she's saying. So even prior to this pandemic and the PPP loan program, community banks did hold an outsized share of small business loans. We've always known that they've been really great in the small business space, but I think through the PPP program, they've actually only increased their share of small business loans, confirming that they really are the dominant players here, relatively speaking. And that the smallest businesses went to the smallest community banks to try to get funding and make it through.

BRIAN SULLIVAN: Angela Hinton and Diane Ellis of the Federal Deposit Insurance Corporation. Thank you so much for joining us.

DIANE ELLIS: Thanks Brian.

ANGELA HINTON: Thank you, Brian.