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Research Summary

Do Banks Lend Where They Borrow? A Study on Local Small Business Lending in the U.S.

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Introduction

In recent years, the majority of counties have lost bank branches. The impacts of closures have been particularly acute for dozens of rural counties that began with few branches and then lost half or more. Those rural counties tended to be poorer and less educated, and larger shares of their populations were Black.[1]

If small businesses rely on local branches for loans, they may lose access to adequate capital when those branches close. However, the emergence of the internet and sophisticated credit scoring techniques may have improved the ability of banks to evaluate potential borrowers at a distance. Increased access to loans from distant banks may ameliorate the effects on small businesses of local branch closures.

A new report from the Office of Advocacy examines changes over time in lending at a distance. The report shows that lending to businesses in counties where a bank has no branches is highly sensitive to economic conditions. During the 2007 recession, distant lending contracted far more sharply than local lending, leaving the share of loans made at a distance lower than it had been at the beginning of the century.

The United States has recently entered another recession because of the COVID-19 pandemic. In a recession, access to credit is vital for both the survival of small businesses and the recovery of the economy as a whole. The findings of this study suggest that the presence of local bank branches may improve resiliency to economic downturns.

Overall Findings

Distant loans are identified using Community Reinvestment Act (CRA) data on small business loans and Summary of Deposits (SOD) data on the location of bank branches with deposits. When a bank reported a loan to a business in a county where the bank had no branches with deposits, the loan was classified as distant.

A key challenge confronted in the analysis is the lack of distinction in the CRA data between traditional loans and credit available through credit cards. Credit cards differ from traditional loans in the amount of

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1 Board of Governors of the Federal Reserve System. (2019). Perspectives from Main Street: Bank branch access in rural communities. Accessed at https://www.federalreserve.gov/publications/files/bank-branch-access-in-rural-communities.pdf in October 2020.

This document is a summary of the report identified above, developed under contract for the Small Business Administration, Office of Advocacy. As stated in the report, the final conclusions of the full report do not necessarily reflect the views of the Office of Advocacy. This summary may contain additional information, analysis, and policy recommendations from the Office of Advocacy.

funding available, the cost of that funding, and the typical distance between borrower and lender. An examination of changes over time in distant lending therefore benefits from separating credit available through credit cards from traditional loans. The authors addressed the lack of distinction between credit cards and traditional loans by using data on the issuance of consumer credit cards to identify banks that specialize in credit cards and distinguishing lending by those banks.

A second challenge confronted in the analysis is the implementation of regulatory changes during the period examined. After the financial crisis of 2007 and 2008, the largest banks were subjected to stress tests to determine the adequacy of their capital reserves. If distant loans are made with less information, those loans may be riskier. The adequacy of the capital reserves at a bank depends on the riskiness of its portfolio, so the implementation of stress tests may have affected decisions about distant lending. The authors addressed this issue by identifying the banks subjected to stress tests and distinguishing lending by those banks.

Figure 1 shows changes over time in distant lending after excluding credit card banks and banks subjected to stress tests. Figure 1 shows a dramatic decrease in distant lending with the 2007 recession. The trend line for number of loans shows that the distant share fell from over 60 percent at the beginning of the period to under 20 percent and failed to return to its previous level by 2017, the most recent year for which data were available. The trend line for amount loaned shows that the distant share declined from over 20 percent to less than 15 percent before climbing to 26.4 percent in 2017.

After using statistical techniques to account for a wide range of bank characteristics, the authors found that the distant share of loans increased between 2001 and 2017. However, the statistical analyses also confirm that the distant share fell dramatically during the 2007 recession, reaching levels below that of 2001.

Discussion

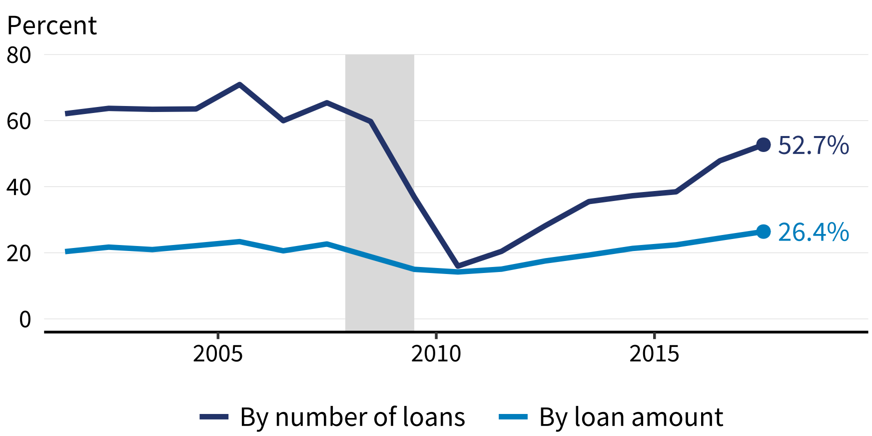
Small businesses account for almost half of all economic activity[2] and create the majority of new jobs.[3] The availability of credit to small businesses affects their growth and is a matter of concern for policymakers.

Data on lending to small businesses are vital for assessing the availability of credit. The current data are limited, and the study identifies several

2 Kobe, K., and Schwinn, R. (2018). Small business GDP 1998—2014. US Small Business Administration Office of Advocacy. Accessed at https://cdn.advocacy.sba.gov/wp-content/uploads/2018/12/21060437/Small-Business-GDP-1998-2014.pdf in October 2020.

3 US Small Business Administration Office of Advocacy. (2019). Frequently asked questions. Accessed at https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/24153946/Frequently-Asked-Questions-Small-Business-2019-1.pdf in October 2020.

Figure 1: Share of lending at a distance



Credit card and stress tested banks excluded. Shading indicates recession.
Sources: CRA, SOD; FFIEC and FDIC

Data, Methods, and Limitations

CRA loan data are published online by the Federal Financial Institution Examination Council (FFIEC). One important limitation of the data is that they represent business loans that are small, $1 million or less, rather than loans to small businesses. While business loans that are small are a reasonable and commonly used proxy measure for loans to small businesses, some large businesses borrow smaller amounts and some small businesses borrow larger amounts. A second important limitation of the data is that banks with assets below a threshold of about $1 billion were exempt from the requirement to report small business loan originations, although some banks below the threshold reported them anyway. Banks above the threshold account for about 75 percent of total bank assets.

SOD data are published online by the Federal Deposit Insurance Corporation (FDIC). An important limitation of the data is that banks have discretion about to which branches deposits are assigned. In some cases, loans were classified as distant when they were made in a county where a bank had a branch but reported no deposits for that branch. However, such cases were rare, and the authors reported that classifying such loans as local did not significantly change the results of the analysis.

Although the study was motivated in part by the potential for changes in technology to increase distant lending, the study does not evaluate the effect of changes in technology on distant lending. After using multiple regression to account for a large number of variables, the authors found that distant lending increased over the last two decades. Such a change is consistent with a positive effect of technological innovation on distant lending, but the study does not show that the increase was caused by technological innovation.

Consistent with the Office of Advocacy's data quality guidelines, this report was peer reviewed. More information on the process can be obtained by contacting advocacy@sba.gov or 202-205-6533.

opportunities for improvements. Among them is separate reporting of business loans and credit extended to businesses through credit cards. Loans and credit cards are not equivalent, and the failure to distinguish between them impedes efforts to assess trends in lending. Consumer loans and credit cards are currently reported separately, and business loans and credit cards should also be reported separately.

An increase in distant lending likely benefits communities with few or no bank branches. However, the study shows the risk of relying on distant loans. When the economy contracted, distant lending plummeted. Such a drop could leave communities dependent on distant loans without access to credit when it is most crucial, both for the survival of local businesses and for the recovery the broader economy. Policies that preserve access to local bank branches may improve resiliency to economic downturns like the recession caused by the COVID-19 pandemic.