The Future of Small Business Lending:
CREDIT ACCESS DURING THE RECOVERY
AND HOW TECHNOLOGY IS CHANGING THE GAME

LendIt USA

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WHY WORRY ABOUT ACCESS TO CREDIT FOR SMALL BUSINESSES?

- Small businesses account for half of U.S. jobs:

28 Million Small Businesses

- Non-Employer (~23M)
- Employer* (5.7M)
  - High-Growth (~200K)
  - Suppliers (~1M)
  - Main Street (~4M)

Source: U.S. Census Bureau; *remaining 500,000 business are Non-Supplier Businesses in the Traded Sector
WORKED FOR PRESIDENT OBAMA AS HEAD OF THE SMALL BUSINESS ADMINISTRATION (2009-2013)
SMALL FIRMS HIT HARDER IN CRISIS, ACCOUNTING FOR 60% OF JOB LOSSES

Source: Bureau of Labor Statistics, Business Dynamics Statistics (latest as of 3Q13). Chart shows the change in the number of charges by firm size, specifically "small businesses (firms with fewer than 500 employees) and large businesses (firms with more than 500 employees)."
THE WHITE HOUSE ECONOMIC TEAM DURING THE HEIGHT OF THE GREAT RECESSION
TURNAROUND IN SBA LENDING

- Swift action to spur SBA lending, resulted in record years in ’11, ’12 and ’13

Source: Small Business Administration. 7(a) and 504 loan volume since Fiscal Year 2008. As of May 2014.
CREDIT FROZE DURING CRISIS, SLOW TO RECOVER FOR SMALL BUSINESSES

Source: Federal Reserve, “Senior Loan Officer Survey” as of April 2014.
CYCLICAL AND STRUCTURAL PROBLEMS PLAGUE THE SMALL LOAN MARKET

Small Business loan assets fell by 18% in the recession and have not trended back up

Community Banks supply close to 40%* of loans to small businesses, but are being consolidated

Source: Federal Deposit Insurance Corporation, Call Report Data. As of January 2014
* Per reports from the FDIC Acting Chairman Martin Gruenberg and a December 2012 survey of small business finances conducted by the Federal Reserve Bank of Atlanta
FIRMS WANT SMALL LOANS, WHICH AREN’T PROFITABLE FOR BANKS

ABOUT 70% OF SMALL BUSINESSES WANT LOANS BELOW $250K

HOW TECHNOLOGY IS CHANGING THE GAME

TOTAL DEBT CAPITAL OUTSTANDING AS OF 4Q13
FOR SMALL BUSINESSES ($ BILLIONS)

Source: Bank loans data taken from FDIC Call Reports; SBA data sourced from SBA publicly available information; Credit card data sourced from creditcards.com; remainder sourced from interviews with industry experts, and authors’ analysis.
ONLINE LENDERS GAINING TRACTION WITH SMALL BUSINESSES

- 2014 Joint Small Business Credit Survey by Federal Reserve banks of New York, Atlanta, Cleveland and Philadelphia
- 18% of small businesses say they applied for credit from online lenders

<table>
<thead>
<tr>
<th>Credit Sources</th>
<th>Application Rate</th>
<th>Approval Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large national bank</td>
<td>35%</td>
<td>31%</td>
</tr>
<tr>
<td>Large regional bank</td>
<td>41%</td>
<td>45%</td>
</tr>
<tr>
<td>Small regional or community bank</td>
<td>34%</td>
<td>59%</td>
</tr>
<tr>
<td>Online lender</td>
<td>18%</td>
<td>38%</td>
</tr>
</tbody>
</table>

THREE INITIAL ONLINE MODELS DEVELOPED – BUT LINES ARE NOW BLURRING

**Online Balance Sheet Lenders**
Use balance sheet capital from institutional investors and decisions loans via proprietary risk scoring algorithms that rely largely on cash flow data, credit scores, social data, industry, geographic and other firmographic information.

**Lenders Agnostic Marketplaces**
Connect small business borrowers to a series of lenders that are part of their online marketplaces; most work with conventional lenders like big and small banks, SBA lenders as well as alternatives like OnDeck and Kabbage.

**Peer to Peer (P2P) Platforms**
Peer to peer, initially consumer-focused. Now, greater emphasis on small businesses. New funding sources from institutional investors.

Source: Authors’ analysis
ONLINE MARKETPLACE IS EVOLVING RAPIDLY

All aspects of the business models are changing:

<table>
<thead>
<tr>
<th>Sources of Customers</th>
<th>Product</th>
<th>Sources of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Partnerships</td>
<td>▪ Account Receivable/Invoice Lending</td>
<td>▪ Individuals</td>
</tr>
<tr>
<td>▪ Consortiums</td>
<td>▪ Term Loans</td>
<td>▪ Institutional Lenders</td>
</tr>
<tr>
<td>▪ Traditional Banks</td>
<td>▪ Short-term Cash Advances</td>
<td>▪ Hedge Funds</td>
</tr>
<tr>
<td>▪ Loan Brokers</td>
<td></td>
<td>▪ Traditional Banks</td>
</tr>
<tr>
<td>▪ Direct Online Customer Acquisition</td>
<td></td>
<td>▪ Syndication Markets</td>
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</table>

Small business customer does not always know what product will best meet their needs.
## WHO HAS COMPETITIVE ADVANTAGE?

<table>
<thead>
<tr>
<th></th>
<th>Traditional Banks &amp; Other Lenders</th>
<th>Online Lenders</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital</strong></td>
<td>• Low cost capital from deposits&lt;br&gt;• Federally insured</td>
<td>• Higher cost capital from institutional and other sources looking for yields&lt;br&gt;• At risk in a downturn</td>
</tr>
<tr>
<td><strong>Customer Service</strong></td>
<td>• Small business spends an average of 26 hours on loan paperwork&lt;br&gt;• Response comes within weeks or months</td>
<td>• Streamlined online application&lt;br&gt;• Response within minutes or days</td>
</tr>
<tr>
<td><strong>Credit Assessment</strong></td>
<td>• Costly personal underwriting or reliance on FICO scores</td>
<td>• New credit algorithms (unproven)</td>
</tr>
<tr>
<td><strong>Source of Customers</strong></td>
<td>• Large pool of existing customers (on which extensive data is available)</td>
<td>• Customer acquisition costs can be 15 percentage points (without sourcing alliances)</td>
</tr>
<tr>
<td><strong>Regulation</strong></td>
<td>• Heavily regulated</td>
<td>• Largely unregulated except at state level and by SEC</td>
</tr>
</tbody>
</table>
WHAT IS THE APPROPRIATE LEVEL OF REGULATION FOR THE ONLINE SMALL BUSINESS LENDING MARKET?

Two views:

### NEED FOR REGULATION
- No current designated federal regulator
  - Should there be one?
  - CFPB? Other?
- Lack of transparency on costs to small business owners
- Concern that this might be the next ‘subprime market’
  - Emergence of loan brokers
  - High costs

### IMPROVE EXISTING REGULATION/ENCOURAGE MARKET MECHANISMS
- Clarify existing state and SEC regulatory oversight
- Let nascent market develop
- Current industry move to improve transparency
  - Consistent disclosure of cost metrics
  - Borrower ‘Bill of Rights’
- Internal industry oversight increasing on loan brokers
The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game

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