Old Program, New Banks: Online Banks in Small Business Lending

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Summary

Fintech lenders (**online banks**) expand credit.

- **Primary reason**: business model specialization and securitization.
  - Focus on a narrow scope of products for riskier borrowers that are not ripe for cross-selling.
  - More lending in markets with low income and low bank competition.
- **Key ingredient:** specifics of SBA program - **loan guarantees!**
  - Steer borrowers into high-guarantee loans
  - Charge higher interest rates
  - Offsets higher default rates
- **Consequences** of credit expansion:
  - Cross-subsidization from other lenders, borrowers, and government.
    - Higher default and guarantee rates
    - Guarantee fees paid by lenders are capped and not risk-related

Motivation

Changes to bank regulation and innovation in financial technology have caused a dramatic shift in the lending landscape away from brick-and-mortar banks to non-traditional lenders [1]. Much of the research has focused on differences in regulatory burden and the role of nonbank lenders on consumer lending, but **advances in financial technology** and **differences in business models** have produced a **new class of bank** whose operations are primarily online and lend to small businesses.

Data

- Loan data: SBA 7(a) program from 2010 to 2019.
- Bank data: FDIC Summary of Deposits, Statistics on Depository Institutions (SDI), and Call Reports.
- Economic location data: US Census, the Bureau of Economic Analysis (BEA), County Business Patterns (CBP), and a major credit bureau.
- Business ownership data: USAspending.gov.
- SBA Pools data: Bloomberg historical pricing.

SBA Institutional Details

Objective: serve creditworthy small business borrowers who cannot obtain credit at reasonable terms in private markets.

- Loans Terms
  - Maximum loan amount is $5 million
  - Interest rate is determined by lender but cannot exceed SBA maximums
- Guarantee Percentages
  - 50%-90% depending on subprogram and loan size
  - Most popular subprograms:
    - SBA Express 50% guarantee
    - Standard/Small 7(a) 75% or85%
- Guarantee Fees
  - Depending on size (**not risk**) - can pass on to borrower
  - Fee changes require Congressional Approval
- Goal: Zero-Subsidy Rate
  - Use guarantee fees and collateral to fund operations and payments on defaults
  - Estimated recovery rate: 37.5% (2020)

Loan Features and Outcomes

Online banks target specific loan characteristics resulting in differing loan outcomes.

⇒ Charge 0.5% higher interest rate.

⇒ Originate loans with 5% higher guarantees.

⇒ Loans are 6% more likely to be in default.

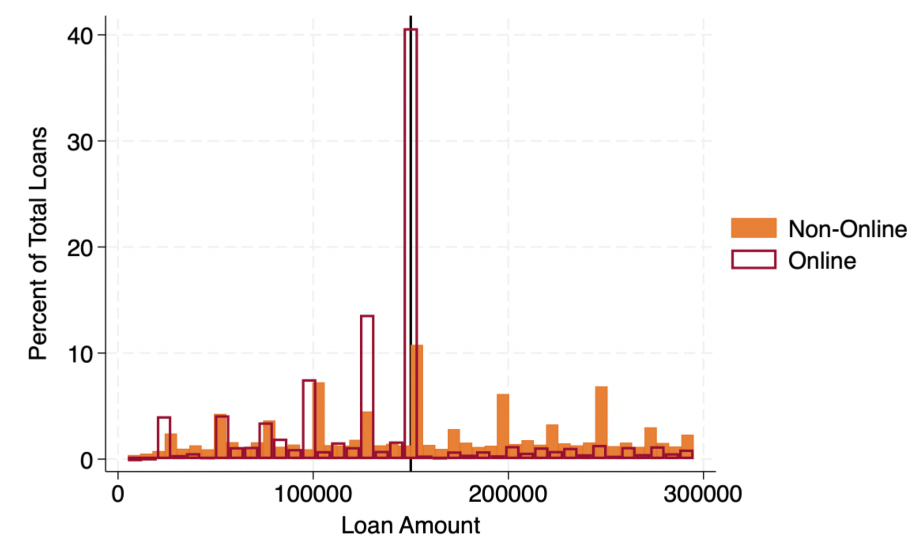

Figure 1:Percent of Loans by Loan Amount for Standard/Small 7(a) Loans

Consequence: Cross-Subsidization

High guarantees and high defaults of online bank loans generate a **transfer** coming from the guarantee fees paid by other lenders and the borrowers and the government.
Average expected guarantee subsidy: **2.03%** for online banks and **-0.08%** for other lenders.

Online Banks

FDIC-insured depository institution with

- < 10 physical branches and
- < 10% of loans made in headquarter state

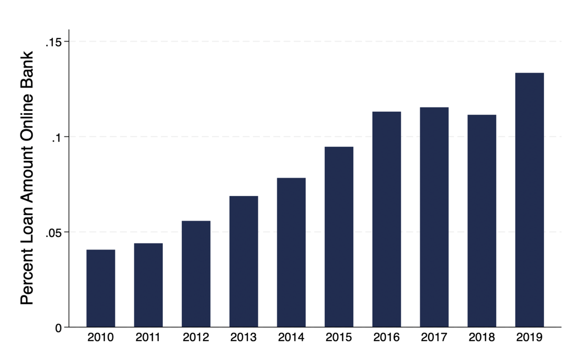

Figure 2:Online Bank Share by Loan Amount Over Time

Online banks are more **specialized** in assets, income, loan products, and SBA lending.

⇒ Business model: originate-to-distribute.

Credit Access

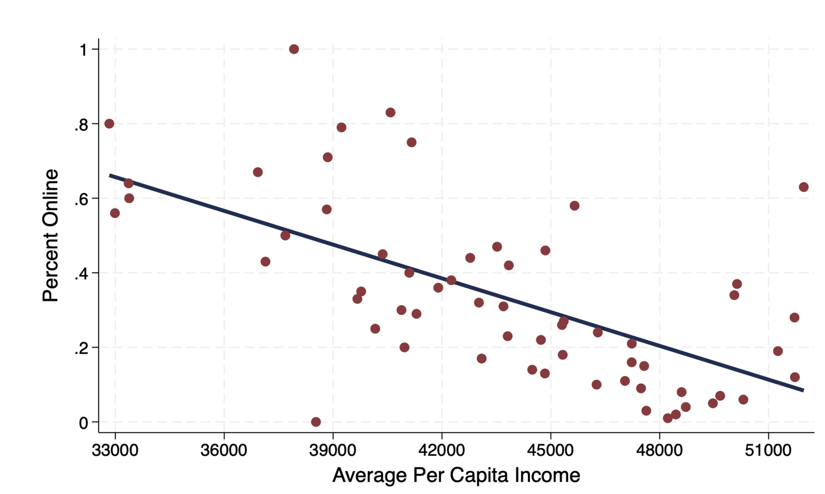

Figure 3:Percent Online by Average County Per Capita Income

Online banks **lend 30-40% more** in the worst economic counties, lending more in areas with lower income, higher unemployment, and lower bank competition.

Conclusion

Online banks have a more specialized business model, which leads them to target higher SBA guarantees and have higher default rates. With these high guarantees and defaults, online bank loans cost the SBA more, generating a cross-subsidy. Online banks expand credit access, lending more in economically disadvantaged and underserved areas.

Policy Implications

Generally, non-depository institutions cannot participate in the SBA lending programs.

- Effective **May 11, 2023**, SBA removed moratorium and has allowed new non-bank entrants.

References

[1] G. Buchack, G. Matvos, T. Piskorski, and A. Seru. Fintech, regulatory arbitrage, and the rise of shadow banks. *Journal of Financial Economics*, 130(3):453–483, 2018.

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