They're Just Not That Into You: The One-Sided Love Between Banks and Business Owners

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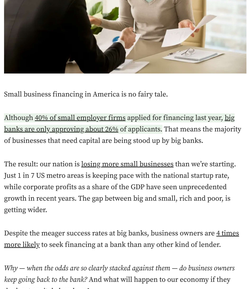

Small business financing in America is no fairy tale.

Although 40% of small employer firms applied for financing last year, big banks are only approving about 26% of applicants. That means the majority of businesses that need capital are being stood up by big banks.

The result: our nation is losing more small businesses than we're starting. Just 1 in 7 US metro areas is keeping pace with the national startup rate, while corporate profits as a share of the GDP have seen unprecedented growth in recent years. The gap between big and small, rich and poor, is getting wider.

Despite the meager success rates at big banks, business owners are 4 times more likely to seek financing at a bank than any other kind of lender.

Why — when the odds are so clearly stacked against them — do business owners keep going back to the bank? And what will happen to our economy if they don't get capital elsewhere?

Where's the Love for Small Business?

Let's talk about the root of the problem: big banks are not the best place for small business owners to find financing.

While many are quick to point a finger and cry "conspiracy!," there is no sexy backstory here. All the rismarole small business owners endure in their attempts to find financing is simply a combination of heavy regulation and minimal incentivization for big banks.

A quick recap: after the 2008 recession, many big banks reduced or eliminated small-dollar business loans as a means of restabilizing capital and passing the Federal Reserve's 2009 stress test. The regulatory red tape placed on big banks hasn't eased up since then, so it's no wonder that the nation's financial powerhouses aren't cozying up to small business owners, especially when they typically pose a greater risk of default than large-dollar borrowers.

Another point to consider: big banks aren't financially incentivized to support small business. Loans under $250,000 are considerably less profitable for banks than larger loans, so banks are simply more interested in courting the bigger prospects. This puts big banks in the habit of overlooking small business owners, who are most often seeking less than $100,000 in financing.

The rub is that small business owners really *need* financing. The average small business has just 27 days of cash in reserve, and 25% of small businesses have less than 13 days. That means most are less than a month-long slump away from their financial straits.

Small Business Owners Feel Snubbed

Don't let their record-high optimism fool you. Small business owners know there's a problem — and they're eager for a solution. A recent Lendio survey found that 48% of small business owners believe the financing ecosystem is broken, and 35% feel financially underserved. One small business owner commented that "it's all but impossible for small businesses to get the funding they need."

The 2018 annual FIS Global report found that 14% of small business owners have switched banks, and another 18% are planning to. The top reason for switching is fees and, just behind that, being declined for a loan or line of credit. Small business owners who are approved for financing, however, report a marked increase in satisfaction with their banks than non-borrowers.

All this snubbing is taking a toll on our collective entrepreneurial spirit. EIG reports "the US economy has become less innovative and entrepreneurial. From 1977 to 2014, the number of new firms per $1 billion in GDP fell from 95 to 25, and the number of patents outside of health and IT per $1 billion halved relative to the 1980s." The World Intellectual Property Organization also took note of the patent reduction, citing 8 successive years of decline in the number of potentially pending patent applications in the US in its 2017 report.

Economic experts are predicting that America will see another recession before the end of 2020, which could cause big banks to further distance themselves from small business. Our nation's business owners are already financially underserved, frustrated, and less innovative — how will they react when access to financing becomes even more abysmal? And what kind of toll will even more small businesses closing have on a receding economy?

Alternative Lending Starts Courting Small Business

Small business owners aren't the only ones who have picked up on big banks' lackluster enthusiasm. In recent years, enterprising fintech organizations have noticed the void left by banks and rushed to fill it.

The result has been a surge in the popularity of crowdfunding websites, microloan programs, and lending marketplaces for small business owners, as well as financing solutions that are focused on creating more opportunities for females and minorities specifically.

Most of these alternative lenders focus on improving upon the downsides of big bank financing. For example, the nonprofit microlending website Kiva lets small business owners finance up to $10,000 at 0% interest. And those with more modest needs can finance just a few hundred dollars. Affordable, flexible microloans like these support an entire segment of business owners who wouldn't be able to find a fitting financing option at a big bank.

The boom of the online marketplace has also been notable: lending marketplaces grew an estimated 700% between 2010–2014 and have continued at a steady clip since. Where the traditional application and approval process at big banks can take a month or two, lending marketplaces like Lendio leverage online applications and sophisticated algorithms to help small business owners find financing within days of applying.

It's Time to Play the Field

Despite the widening availability of alternative lenders, most small business owners still aren't leveraging them. Whereas almost 34% of business owners surveyed by Lendio report using bank financing, less than 4% have used an online lender.

In the wake of financial destruction left by the payday loan industry, a little apprehension about new lending models is to be expected. While there have been some unscrupulous firms out there, the major players in alternative lending are credible — and they're implementing the regulatory muster to prove it.

In addition to ensuring that their practices adhere to federal and state financial regulations, the nation's largest lending marketplaces are members of the Innovative Lending Platform Association (ILPA), a trade organization dedicated to advancing best practices and standards across alternative lending.

ILPA recently launched a model small business pricing disclosure called The SMART Box, which enables small business owners to compare financing options using consistent pricing metrics. This apples-to-apples approach improves transparency and eliminates the guesswork for small business owners exploring multiple financing options.

The Treasury department is also on board with implementing regulatory routes, recently releasing a 222-page report suggesting a national charter for online lenders and payment companies. The charter aims to provide regulatory guidance while still enabling alternative lenders to process applications, finalize approval, and fund small business owners faster than big banks have been able to.

With so many credible alternative lending resources available, it's time for small business owners to start playing the field — and start finding the financing they haven't been able to get at big banks.

Will Small Business Owners Get Their Happy Ending?

As small business loan options have become more widespread, the financing ecosystem has started to shift.

SBA loans continue to skyrocket, with more than $25 billion being approved in 2017. This year has already seen a 22% increase in the volume of approved SBA 7(a) loan dollars alone. And more than 250,000 small business owners have financed an estimated $2 billion through microlenders in the past 10 years.

Big banks are finally feeling the heat — and realizing they need to woo small business owners if they want to retain them. A July 2018 Federal Reserve survey of senior loan officers found that "almost all domestic banks that reportedly eased standards or terms on [Commercial and Industrial] loans over the past three months cited increased competition from other lenders as a reason for easing."

Many big banks are also partnering with lending marketplaces, which has proven to benefit all stakeholders involved: banks, marketplaces, and business owners. The partnership model helps marketplaces provide business owners with a wide variety of fast financing options while enabling banks to retain small business owners as customers.

Crucially, this model connects business owners who've been previously rejected to legitimate financing options — which means more American small businesses ultimately keep their doors open.

And it's not just small business owners who are getting a boost — our economy is also reaping the benefits. A recent study found that every dollar loaned to small businesses produces an average of $3.79 in gross output in that same community. And it doesn't take a large-dollar loan to make an impact — of the $10 billion in small business loans that were reviewed for the study, the average loan amount was just $55,498.

While critics have questioned the merits of alternative lending, the proof is raising our nation's economic bottom line right now. It turns out, a little competition and innovation in lending is good for everyone: it's keeping small businesses *in business*, boosting our economy, and nudging big banks toward more reasonable financing processes. We're a long way from fixing the financing ecosystem, but we're off to a good start.

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