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Big Banks Cut Back on Loans to Small Business

Small businesses get fewer loans from banks, turning to alternative lenders that charge significantly higher rates

Jorge Rodriguez, owner of a Peruvian restaurant in Los Angeles, turned to other lenders when his bank rejected him for a loan. *PHOTO: EMILY BERL FOR THE WALL STREET JOURNAL*

By RUTH SIMON

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The biggest banks in the U.S. are making far fewer loans to small businesses than they did a decade ago, ceding market share to alternative lenders that charge significantly higher rates.

Together, 10 of the largest banks issuing small loans to business lent $44.7 billion in 2014, down 38% from a peak of $72.5 billion in 2006, according to an analysis of the banks' federal regulatory filings.

Through August, banks this year originated 43% of business loans of up to $1 million, down from 58% for all of 2009, according to PayNet Inc., a tracker of small business credit.

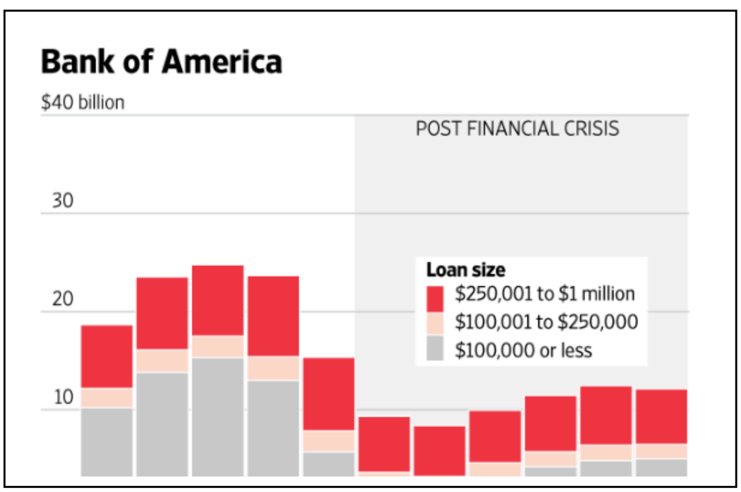
The change has opened the door to higher-cost alternatives: Nonbank lenders increased their market share to 26% from 10%, with corporations that lend to their business customers or suppliers making up the balance.

“At least 60% of our borrowers would fall into classic bank lending criteria,” said Rob Frohwein, chief executive of online lender Kabbage Inc., which charges rates that average about 39%, versus the typical 5% to 6% or so that banks charge small firms with good credit.

At some big banks, the credit card has become the default loan source for small businesses. Rates on cards issued to small businesses average 12.85%, according to Creditcards.com.

Small business spending on credit and charge cards will total an estimated $445 billion this year, up from about $230 billion in 2006, according to First Annapolis Consulting Inc., a payments consulting firm.

At J.P. Morgan, the Ink small-business credit card accounts for more than 90% of loans to businesses with $1 million or less in revenue. One reason is that it costs the bank about the same to originate a $100,000 small business loan as it does for one of $1 million, the company said. Credit cards cost a lot less to issue.



Small business loans are often as nearly as complicated for banks to complete as large loans, with less return. “We all struggle to make money on the lending side,” said Jay DesMarteau, head of small business banking at TD Bank. “It’s a lot of work to try and find these little companies, underwrite them and manage the book, when the units are high and the dollars low.”

“You have to figure out a way to make a $100,000 loan make economic sense,” said a J.P. Morgan spokeswoman, adding that a new, centralized loan operation is supposed to cut the cost and time of originating smaller loans.

The dollar amount of small loans to businesses held by banks increased by an average of 7.3% a year from 1998 to 2008, said DePaul University finance professor Rebel A. Cole, providing fuel for economic growth. Firms with fewer than 500 employees account for more than half of private sector jobs in the U.S. according to the Bureau of Labor Statistics.

Banks of all sizes held $598 billion in small loans to businesses as of Sept. 30, according to the Federal Deposit Insurance Corp., down nearly 16% from a peak of $711 billion in 2008. By contrast, loans to larger companies increased 37% during that time.

The largest banks “have essentially abandoned the small business market,” said Mr. Cole, who analyzed bank regulatory filings for The Wall Street Journal. The analysis looked at loans of up to $1 million, adjusting for bank mergers and acquisitions.

Weak demand, tighter lending standards and high costs have put a lid on small business borrowing in the past seven years, even as other types of financing—home mortgages, auto loans and corporate finance—have rebounded from the financial crisis.

Many big companies are locking in low-cost, long-term financing or borrowing to fund mergers, said John Elmore, vice chairman of consumer and small business banking at U.S. Bancorp. Small-business owners, by contrast, “are just more cautious or don’t have the degree of confidence to go full in,” he said, despite good financial performance.

A prolonged decline in new business formation has reduced the borrowing pool. Plus, banks have been slower to ease lending standards for small firms than for big ones after the recession.

Many banks, in fact, are less interested in small business lending because it isn’t as profitable as loans that more easily fit into standardized approval and repayment processes—such as credit cards and mortgages—and can be packaged into securities for sale to investors, according to Federal Reserve Bank of Cleveland senior policy analyst Ann Marie Wiersch.

Jorge Rodriguez, owner of a Peruvian restaurant in Los Angeles, said Wells Fargo & Co.—his bank for several years—turned him down three years ago when he sought financing to remodel and expand his business.

“They wouldn’t even look at me as a viable client,” said Mr. Rodriguez, who secured a $311,000 Small Business Administration loan from BBCN Bancorp Inc., a local community bank, with a recent rate of 5.5%.

Wells Fargo rejected Mr. Rodriguez again in 2014, he said, this time for a $25,000 loan to buy liquor and other supplies. He turned to two online lenders, with rates above 80%. He has since refinanced those high-cost loans
and secured additional funding to expand from Opportunity Fund, a nonprofit lender, that had an annual rate of 12.3%, the lender said.

A Wells Fargo spokesman said the bank follows a consistent process for evaluating loan requests but doesn’t comment on specific borrowers. The bank issues more small business loans than any other U.S. lender, he said.

Ric Breines, president of 2½-year-old ACDC Solar, a Lebanon, N.J., company that provides sales, marketing and project development for solar panel installers, said bank financing would help him expand beyond four employees. “But without five years of experience, without financial statements to back it up,” he said, “I think it’s unrealistic.”

Banks want to see a proven track record, Mr. Breines said: “It’s not like the olden days where I could borrow $100,000 on a handshake…based on what the banker knew about me personally, my business and prior experience.”

Lending by banks is concentrated among firms that are at least 10 years old, according to a PayNet analysis. “It’s the early stage companies that are getting hit hardest by the credit gap,” PayNet President William Phelan said.

All 10 banks in the analysis conducted for the Journal said they remained committed to small business lending. Some said the government data doesn’t capture small-business loans above $1 million, the reporting threshold.

Two of the banks, Wells Fargo and Capital One Financial Corp. , said they partner with nonprofit lenders that provide credit to small firms that may not qualify for conventional l oans. Wells Fargo said it extended roughly $50.9 million in loans, investments and grants to nonprofits that support small business economic development in 2014.

Bank of America Corp. began offering lines of credit of $10,000 to $100,000 this summer using a less expensive underwriting process that includes a review of checking and merchant payment processing accounts, instead of checking years of tax returns and financial statements.

Before the new program, “if you wanted $10,000, $15,000 or $20,000 in credit, the option we would give you would be a credit card,” said Bank of America Small Business Executive Robb Hilson. “If someone wants to buy a forklift, it doesn’t make sense to put it on a credit card.”