Cohabitating With Startups

lending business customers risk management

Summary: Getting a loan from a large bank can be a challenge for a small business startup. This is good news for community banks.

The Census Bureau finds that pretty much from 2010 onward, the proportion of 18-24Y olds cohabitating with someone exceeded those living with a spouse (9.4% vs. 7.3%). Meanwhile, today about 14.8% of those ages 25-34Ys say they too cohabitate with a partner vs. 40.3% who live with a spouse. As the data clearly shows, cohabitation is a thing.

Switching gears, we know that getting a loan from a large bank can be a challenge for a small business startup. Large banks have global standards for determining credit worthiness that can be difficult for these new business owners. This is good news for community banks and small business owners alike.

Look no further than the FDIC's Small Business Lending Survey. It found community banks are much more likely to use more diverse and "soft" data in determining credit worthiness of borrowers. This data can include information like training, education and personal credit history. As a result, small businesses that can't get through the door of a big bank are much more likely to get a meeting and a loan at a community bank.

The problem for small business startups is that they are, by definition, risky enterprises. About 50% of all small businesses fail within the first 4Ys, according to the SBA. That's why the largest banks try to mitigate the risk of this customer type with stricter and more standardized underwriting criteria and requirements. According to the survey, fewer than 10% of large banks use the same underwriting criteria for small businesses as they do for large businesses. At community banks, 40% use the same underwriting criteria.

The data finds about 80% of large banks require a loan guarantee (most often from SBA) to originate the loan vs. just 27% of community banks. Also, only 8% of large banks will accept a personal/third party loan guarantee vs. 20% of community banks. This may not be surprising, but it is important.

Another important difference: large banks are more likely to use standardized loan products that have a minimum loan size. About 70% of large banks have a minimum loan size for their top small business loan vs. just 15% for community banks. In addition, 64% of large banks use standardized loan products vs. just 8% of community banks.

That doesn't mean that community banks are more likely to lend to riskier businesses. Rather, community banks take a different approach to assessing risk, using their closeness to their community and a broader range of "soft" criteria to judge creditworthiness. Community banks are also more willing to customize loans to the needs of the borrower. As a result, community banks can lend to viable startups that might not get anywhere at a large bank.

While touting the importance of community banks in startup financing, the survey also strikes a note of caution. It points to the fact that a decline in the number of community banks could become an issue for smaller businesses and jobs growth too. Simply put - without enough community banks, small business formation and growth could decline and that isn't good for anyone (no matter who they are cohabitating with).

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