SMALL BANKS AND FINTECH LENDING

COMMENTS

Joseph P. Hughes
Rutgers University

Financial System of the Future

Federal Reserve Bank of Atlanta
Georgia State University
Atlanta 2019
“Small Bank Lending Amidst the Ascent of Fintech and Shadow Banking: A Sideshow?”
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  - Fintech lenders: 2% to 7%
  - Small banks: stable share at 17%
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  - Small banks (<$10 Billion): stable share at 17%
- **Small banks reallocate mortgage lending**
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• Small banks’ reallocation *shares*
  – *two times* as responsive as shadow bank lenders
  – *four times* as responsive as fintech lenders
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- Small banks’ reallocation *shares*
  - two times as responsive as shadow bank lenders
  - four times as responsive as fintech lenders

- Small banks’ reallocation *levels*
  - three times as responsive as shadow bank lenders
  - eight times as responsive as fintech lenders
“Small Bank Lending Amidst the Ascent of Fintech and Shadow Banking: A Sideshow?”

- Why are small banks so responsive?
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• Strongest growth in small bank share of mortgage lending in counties with . . .
  – Borrower preferences for small banks
  • Share of loans approved that are accepted
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• **Capital market incentives** for small bank lending
“What Is Fueling the Fintech Lending Revolution?”
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• Small banks have comparative advantages in relationship lending.
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• Small banks are “disappearing.”
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• **Large bank retreat** in small business lending
“What Is Fueling the Fintech Lending Revolution?”

• Small banks have comparative advantages in relationship lending.

• Small banks are “disappearing.”

• Large bank retreat in small business lending

• As well as declining numbers of small banks

• May lead to fintech opportunities.
“What Is Fueling the Fintech Lending Revolution?”

- Consumer loans made by Prosper and identified as small business loans
  - loans to self-employed borrowers
  - loans to consumers identified as funds for business purposes
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- **Small bank**: less than $2 billion in assets

- **Small bank share**: percent of county bank branches owned by a small bank (0.583)
“What Is Fueling the Fintech Lending Revolution?”

• A **decrease** of one standard deviation in a county’s **small bank share** is associated with an **increase in Prosper loan volume** of 6.9% to 8.4%.
“What Is Fueling the Fintech Lending Revolution?”

• A decrease of one standard deviation in a county’s small bank share is associated with an increase in Prosper loan volume of 6.9% to 8.4%.

• Fintech loan volume is negatively related to the number of small bank branches and positively related to the number of large bank branches.
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- A decrease of one standard deviation in a county’s small bank share is associated with an increase in Prosper loan volume of 6.9% to 8.4%.
- Fintech loan volume is negatively related to the number of small bank branches and positively related to the number of large bank branches.
- Same findings for small bank loan volume
“What Is Fueling the Fintech Lending Revolution?”

- Fintech lending (Prosper) has grown faster where...
  - Small bank share is lower.
  - Small bank share has declined.
  - Internet access is better.
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• Fintechs enter local markets where there is insufficient small bank presence for small business credit needs.
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- Are there capital market incentives at work?
Capital Market Incentives

• Why are small banks disappearing?
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• What is the incentive to lend to small businesses at small banks?
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- Why are small banks disappearing?
- What is the incentive to lend to small businesses at small banks?
- At large banks?
Capital Market Incentives

- Why are small banks disappearing?
- What is the incentive to lend to small businesses at small banks?
- At large banks?
- Is fintech lending competitive?
Why are small banks disappearing?

- Hughes, Jagtiani, Mester, and Moon, *Journal of Banking and Finance*, 2019
- Top-tier bank holding companies
- At year-end 2003, 2013, 2016
Why are small banks disappearing?

- Accounting performance: ROA and Best-Practice ROA increase with bank asset size.
Why are small banks disappearing?

• Accounting performance: ROA and Best-Practice ROA increase with bank asset size.

• **ROA Inefficiency**, the difference between the Best-Practice and observed ROA, **is lower at large community banks than at small community banks.**
Why are small banks disappearing?

- Accounting performance: ROA and Best-Practice ROA increase with bank asset size.
- ROA Shortfall, the difference between the Best-Practice ROA and observed ROA, is lower at large community banks than at small community banks.
- Large community banks and midsize banks show better potential performance per unit of risk than small community banks.
Why are small banks disappearing?

• Large community banks achieve a higher Tobin’s $q$ ratio than small community banks.
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• Large community banks are more efficient at achieving their potential market value of assets than small community banks.
Why are small banks disappearing?

- **Large community banks** achieve a higher **Tobin’s q** ratio than small community banks.
- **Large community banks** are more efficient at achieving their **potential market value of assets** than **small community banks**.
- Compared to community banks, **midsize banks and larger banks** are more efficient at achieving their **potential market value**
Why are small banks disappearing?

- Large community banks achieve a higher Tobin’s $q$ ratio than small community banks.
- Large community banks are more efficient at achieving their potential market value of assets than small community banks.
- Compared to community banks, midsize banks and larger banks are more efficient at achieving their potential market value.
- Thus, there appear to be incentives for small banks to grow larger.
Does the Capital Market Reward Small Business Lending?

- We find that small business loans are an important factor explaining large community banks’ better performance compared to small community banks.
Does the Capital Market Reward Small Business Lending?

• We find that small business loans are an important factor explaining large community banks’ better performance compared to small community banks.

• Unlike small community banks, large community banks have financial incentives to increase lending to small businesses.
Does the Capital Market Reward Small Business Lending?

- We find that small business loans are an important factor explaining large community banks’ better performance compared to small community banks.
- Unlike small community banks, large community banks have financial incentives to increase lending to small businesses.
- Thus, concern that small business lending would be adversely affected if small community banks find it beneficial to increase their scale is not supported by our results.
Does the Capital Market Reward Small Business Lending?

- Xuan (Sarah) Zou (2019)
- Top-tier bank holding companies
- 2001 – 2017
- Cross sectional and panel data
Tobin’s $q$ and SBL/Assets
Tobin’s $q$
and Substitution of SBL for LBL
Tobin’s $q$ and Substitution of SBL for Nonbusiness Loans
Is Fintech Lending Competitive?

• Hughes, Jagtiani, and Moon (2019)
• Compare unsecured consumer lending by commercial banks and LendingClub
• In 2016 the largest banks and LendingClub had the highest nonperforming loan rate.
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Is Fintech Lending Competitive?

• How much of nonperformance is due to **lending to riskier borrowers** who default more often?
• How much is due to **inefficiency at assessing and managing credit risk**?
Is Fintech Lending Competitive?

• Use **stochastic frontier estimation** to decompose the nonperforming unsecured consumer loan ratio into
  
  – The **best-practice minimum ratio** that a lender could achieve if it were fully efficient at credit-risk evaluation and loan management
  
  – **inherent credit risk**
  
  – The portion due to less skill at assessing credit risk and managing loans
  
  – **lending performance inefficiency**
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  – The portion due to less skill at assessing credit risk and managing loans
  
  – **lending performance inefficiency** (difference between observed and minimum nonperformance)
Is Fintech Lending Competitive?

- Top-tier US bank holding companies
- LendingClub
- Year-end 2013 and 2016
- Stochastic frontier analysis to estimate minimum best-practice conditional on
  - scale of lending (lending technology)
  - economic conditions in a lender’s local markets
  - average contractual interest rate on consumer loans
Is Fintech Lending Competitive?

- LendingClub’s NPL ratio resembles that of the large consumer lenders.

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- LendingClub’s NPL inefficiency is the lowest – similar to the largest consumer lenders

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• What is the incentive to lend to small businesses at community banks?

• At large banks?

• Is fintech lending competitive with large banks? Community banks?