SECTION 7
Start-Up Lending

Start-ups—commonly defined as businesses less than two years old—play a vital role in the innovation that fuels the economy.[79] While start-ups are a small share of firms by employment, they make an outsized contribution to employment growth.[80] Access to credit is essential for start-ups because it provides them capital to grow their businesses. Start-up financing may be even more important in the wake of the COVID-19 pandemic, after which there was a surge in business formation.[81]

Banks may be reluctant to lend to start-ups because these firms often lack documentation, credit scores, and other hard information used to evaluate loan applications. Yet banks are an important source of credit for these firms. According to the Federal Reserve Banks' 2022 Small Business Credit Survey, 22 percent of employer start-ups that applied for loans applied at small banks and 39 percent applied at large banks. These shares compare favorably to the 37 percent of the most-established employer small businesses (those 21 or more years in business) that applied for loans at small banks and the 45 percent that applied at large banks.[82]

Start-up funding comes in many forms, from loans to equity financing. Research suggests that debt financing is a desirable form of financing for start-ups. "Pecking order" theory holds that the debt financing provided by banks is generally preferred for funding start-ups, as equity funding often requires founders to give up some control of their company.[83] There is also evidence that start-ups that receive business loans grow faster and are more likely to survive than start-ups financed with equity or personal loans.[84] But more recent research suggests that start-ups are more likely to apply for small loans from online vendors than from banks.[85] Thus, the linkages between banks and start-ups are worth studying.

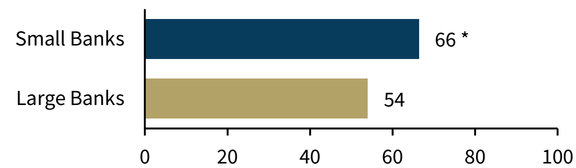
This section focuses on the factors that affect banks' willingness to lend to start-ups. It explores differences in how small and large banks evaluate loan applications from these firms and how banks manage the risk of lending to start-ups.

7.1 Start-Up Lending by Bank Size and Other Factors

The survey finds that 66 percent of banks make loans to small businesses they consider to be start-ups (based on banks' own definitions).[86]

Figure 7.1 shows a modest but statistically significant gap in start-up lending by small banks compared with large banks: 66 percent of small banks typically lend to start-ups compared with 54 percent of

FIGURE 7.1
Percentage of Banks That Typically Lend to Start-Ups, by Bank Size



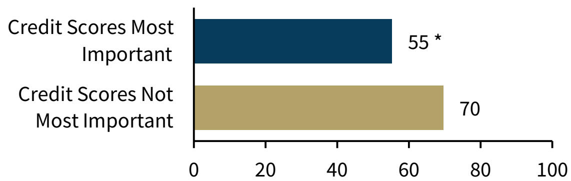
Source: SBLS 2022 Question I.A11.
* Denotes a statistically significant difference between small and large banks at the 10 percent level.

[79] In the 2022 SBLS, banks that define start-ups based on age defined the maximum age of a start-up as 1.9 years on average (Source: SBLS 2022 Question I.A10).
[80] Haltiwanger, Jarmin, and Miranda (2013).
[81] Decker and Haltiwanger (2022).
[82] Author calculations using employer firm data from the 2022 Federal Reserve Banks' Small Business Credit Survey. Other financing options in the survey included finance companies, online lenders, credit unions, and community development financial institutions.
[83] Myers and Majluf (1984).
[84] Cole and Sokolyk (2018).
[85] Wiersch, Lipman, Wilson, and Misera (2022).
[86] Calculated by taking the average response across all banks to Question I.A11.

large banks.[87] Survey results suggest that much of this gap can be attributed to the tendency of large banks to rely more on hard information, particularly information from credit bureaus, in evaluating loan applications (see Section 3). Start-ups, which by definition have a limited history of operation, may not have credit histories as strong as those of older firms.

FIGURE 7.2

Percentage of Banks That Typically Lend to Start-Ups, by Credit Score Importance

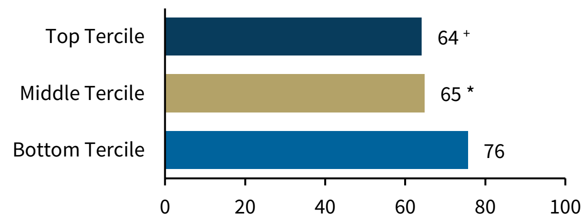


Source: SBLS 2022 Questions I.A11 and I.C8.
Note: Banks were classified as "Credit Scores Most Important" if they ranked credit scores as the top aspect of a loan application for a $25,000 loan.
* Denotes a statistically significant difference between "Credit Scores Most Important" and "Credit Scores Not Most Important" at the 10 percent level.

Banks that use more hard information in underwriting, that emphasize information from credit bureaus in the loan process, or that require personal credit scores are all less likely to lend to start-ups by 10 to 15 percentage points (Figures 7.2, 7.3, and 7.4).[88] For example, 55 percent of banks that primarily make small loans based on credit scores and other information from credit bureaus lend to start-ups, while 70 percent of banks that primarily make small loans based on other factors lend to start-ups (Figure 7.2).

FIGURE 7.3

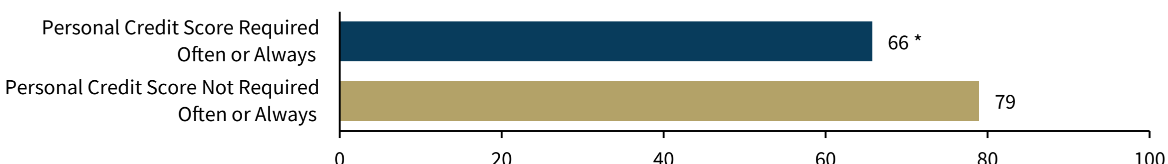
Percentage of Banks That Typically Lend to Start-Ups, by Use of Hard Information



Source: SBLS 2022 Questions I.A11 and I.C4.
Note: Banks were classified as "Top Tercile" if they were in the top third for hard information score for loans of $25,000, "Middle Tercile" if they were in the middle third, and "Bottom Tercile" if they were in the bottom third.
+ Denotes a statistically significant difference between "Top Tercile" and "Bottom Tercile" at the 10 percent level.
* Denotes a statistically significant difference between "Middle Tercile" and "Bottom Tercile" at the 10 percent level.

FIGURE 7.4

Percentage of Banks That Typically Lend to Start-Ups, by Requiring a Personal Credit Score



Source: SBLS 2022 Questions I.A11 and I.C7.
Note: Banks were classified as "Required Often or Always" if they indicated that they "often" or "almost always or always" required that small business borrowers have a personal credit score for a loan of $25,000.
* Denotes a statistically significant difference between "Personal Credit Score Required Often or Always" and "... Not Required Often or Always" at the 10 percent level.

87 This does not necessarily contradict the results from the Federal Reserve Banks' 2022 Small Business Credit Survey that start-ups were more likely to borrow from large banks than from small banks, since the 54 percent of large banks that lend to start-ups may collectively originate more loans to start-ups than the 66 percent of small banks due to differences in scale.

88 These results focus on bank underwriting practices for small loans.

7.2 Managing Risk in Start-Up Lending: SBA Lending and Meetings With Applicants

Results from the survey show that banks seem to manage the risk of lending to start-ups by leveraging soft information, such as that gleaned from meeting with potential borrowers, and by using government-guaranteed loans, such as those offered through the SBA 7(a) program (see Section 2).

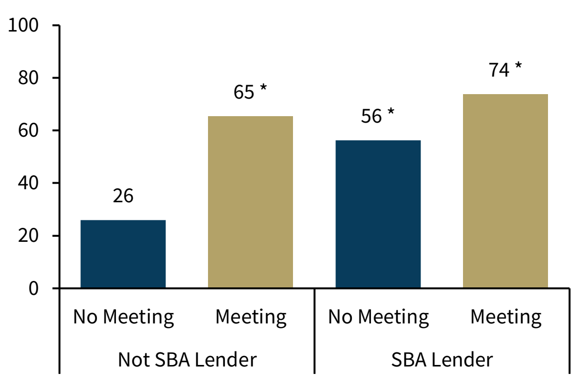
Twenty-six percent of banks that do not have direct meetings between decision-makers and applicants and that do not participate in any non-PPP SBA program typically lend to start-ups, while banks that meet one or both of those criteria have a 56 to 74 percent likelihood of lending to start-ups (Figure 7.5).

The specific strategy used to mitigate start-up lending risk varies by bank size. Small banks appear to use meetings with applicants to manage the risk. As discussed in Section 3, small banks are much more likely than large banks to meet with applicants (89 percent of small banks and 39 percent of large banks meet with applicants). A majority of small banks that hold such meetings typically lend to start-ups (69 percent), compared with a minority that do not hold meetings (45 percent) (Figure 7.6).

There is only a slight difference in likelihood of start-up lending between large banks that do and do not meet with applicants. Instead, large banks seem to rely on government guarantees, particularly through SBA programs, to manage the risk of lending to start-ups. As discussed in Section 2, large banks are much more likely than small banks to be SBA lenders (84 percent of large banks versus 36 percent of small banks). Figure 7.7 shows that being an SBA lender is associated with a greater likelihood of lending to start-ups among large banks: 59 percent of

FIGURE 7.5

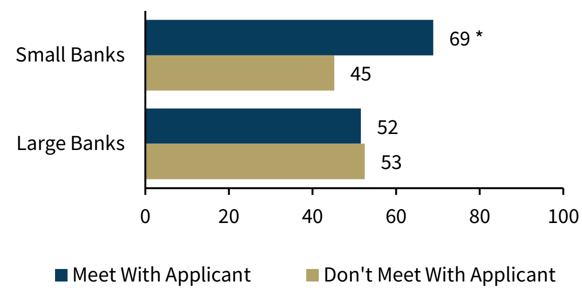
Percentage of Banks That Typically Lend to Start-Ups, by Whether a Decision-Maker Meets With Applicants and Whether Bank Makes SBA Loans



Source: SBLS 2022 Questions I.A11, I.B11, I.B16, I.B21, I.B26, and III.B1.
Note: Banks were classified as “Meeting” banks if they ever indicated that loan approvers typically met with small business borrowers at any level and “No Meeting” banks otherwise. Banks were classified as “SBA Lenders” if they originated SBA loans (other than PPP loans) in 2021 and “Not SBA Lenders” otherwise.
* Denotes a statistically significant difference between “No Meeting and Not SBA Lender” banks and the other categories at the 10 percent level.

FIGURE 7.6

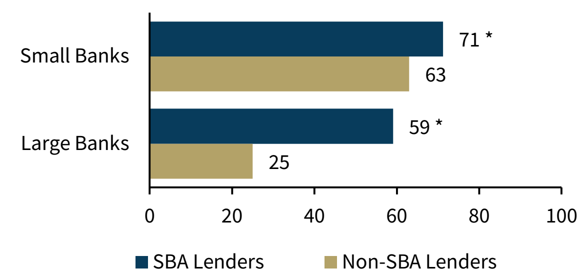
Percentage of Banks That Typically Lend to Start-Ups, by Whether a Decision-Maker Meets With Applicants and Bank Size



SBLS 2022 Questions I.A11, I.B11, I.B16, I.B21, and I.B26.
Note: Banks were classified as “Meet With Applicant” banks if they ever indicated that loan approvers typically met with small business borrowers at any level and “Don't Meet With Applicant” banks otherwise.
* Denotes a statistically significant difference between "Meet With Applicant" and "Don't Meet With Applicant" at the 10 percent level.

FIGURE 7.7

Percentage of Banks That Typically Lend to Start-Ups, by Whether Bank Makes SBA Loans and Bank Size

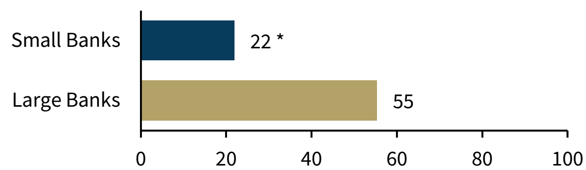


Source: SBLS 2022 Questions I.A11 and III.B1.
Note: Banks were classified as “SBA Lenders” if they originated SBA loans (other than PPP loans) in 2021 and “Non-SBA Lenders” otherwise.
* Denotes a statistically significant difference between “SBA Lenders” and “Non-SBA Lenders” at the 10 percent level.

SBA lender large banks lend to start-ups, compared with 25 percent of non-SBA lender large banks. The corresponding difference among small banks is much smaller, with 71 percent of SBA lender small banks and 63 percent of non-SBA lender small banks lending to start-ups.

Survey responses also suggest that large banks rely on government-guaranteed programs to support their start-up lending. The survey asked banks that both typically make loans to start-ups and that make government-guaranteed small business loans to approximate the portion of their loans made through a government-guaranteed program.[89] Among banks that make loans to start-ups, 55 percent of large banks and 22 percent of small banks make half or more of their loans to start-ups using a government guarantee (Figure 7.8).

FIGURE 7.8
Percentage of Start-Up Lending Banks Where Most Start-Up Loans Are Made With a Government Guarantee, by Bank Size



Source: SBLS 2022 Questions I.A11 and I.A12.
Note: Only banks which typically made loans to start-ups are included. Banks were classified as making most start-up loans with a government guarantee if they made government-guaranteed loans and indicated that "Around half," "Most," or "All or almost all" loans they made to start-ups were government-guaranteed.
* Denotes a statistically significant difference between small and large banks that lend to start-ups at the 10 percent level.

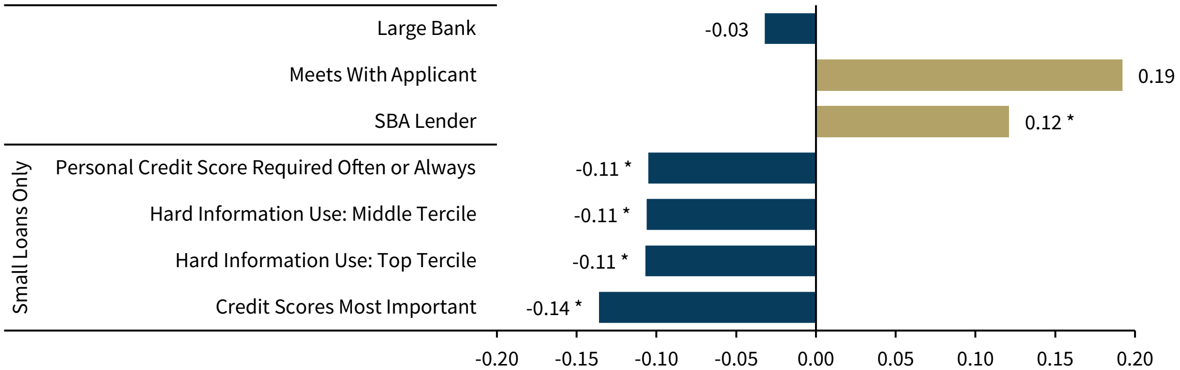
7.3 Evaluating Factors That Influence Bank Lending to Start-Ups

Many factors important to determining which banks lend to start-ups—bank size, whether the bank meets with applicants, whether the bank is an SBA lender, whether the bank requires personal credit scores, whether the bank generally uses hard information, and whether the bank emphasizes credit bureau information in underwriting—correlate with each other or with bank size, making it difficult to distinguish the importance of any one factor. For example, as discussed in Section 3, large banks are more likely than small banks to require personal credit scores and to rely on credit bureau information in their lending. A natural question, then, is whether the gap in start-up lending between large and small banks in Figure 7.1 remains after accounting for these factors.

Figure 7.9 shows how each factor independently correlates with bank lending to start-ups.[90] Each factor remains statistically significant and economically meaningful except for size which decreases substantially and becomes statistically insignificant. In other words, once meeting with applicants, use of personal credit scores, and emphasis on credit scores in underwriting are accounted for, large banks are as likely as small banks to lend to start-ups.

[89] Banks chose from the following options for their approximations: "all or almost all," "most," "around half," "some," or "none or almost none."
[90] See Appendix A.9 for an explanation of the multinomial regression specification.

FIGURE 7.9
Selected Characteristics of Banks That Typically Lend to Start-Ups, Results of Multivariate Analysis



Source: SBLS 2022 Questions I.A11, I.B11, I.B16, I.B21, I.B26, I.C4, I.C7, I.C8, and III.B1.
Note: Results are coefficients from a multivariate linear probability regression with "typically lends to start-ups" as the dependent variable and the listed characteristics as the independent variables.
* Denotes that the coefficient is statistically significantly different from zero at the 10 percent level.

Bank lending to start-ups can be compared across the 2022 and 2016 surveys with certain caveats. The comparison shows that start-up lending by banks may have declined somewhat between the two survey periods. In 2016, about 79 percent of banks made C&I loans to start-ups; in 2022, 66 percent of banks indicated that they typically lend to start-ups.[91] This decline may be due to changes in the wording of the survey question rather than bank behavior. The 2016 survey focused on commercial and industrial (C&I) lending rather than business lending generally and asked banks if they ever made loans to start-ups. The 2022 survey broadened the question to include business lending other than C&I lending and asked if banks typically make loans to start-ups (rather than ever lending to start-ups).[92]

7.4 Conclusion

This section investigates some of the factors underlying how banks provide crucial financing to start-up firms. Larger banks, because they are more likely to use hard information more intensively, are less likely to lend to start-ups. Banks seem to mitigate the risks of lending to start-ups in two ways: meeting with potential borrowers to gather soft information and using government-guaranteed loan programs such as the SBA 7(a) program. Small banks primarily use the first strategy, while large banks mostly use the second. Given the divide between small banks and large banks in start-up lending, continued industry consolidation could result in a change in the availability of bank credit to start-ups.

[91] FDIC (2018).
[92] There are also additional caveats about interpreting changes between the 2016 and 2022 surveys, as the two surveys were conducted in different interest rate environments and the 2022 survey was conducted during the aftermath of the COVID-19 pandemic and the implementation of the Paycheck Protection Program.