FinTech and Small Businesses

A Webinar Sponsored by
the ***Private Capital Research Institute*** and
the ***Private Capital Project at Harvard Business School***
(with support from the Division of Research at Harvard Business School)

June 16, 2021

On Wednesday, June 16th, a panel of researchers, investors, and entrepreneurs met to discuss the role of FinTech in supporting small business growth. The panelists were Sabrina Howell (New York University's Stern School of Business), Eyal Lifshitz (CEO and Founder, Bluevine), Karen Mills (Harvard Business School and Administrator of the U.S. Small Business Administration, 2009-2013), and Frank Rotman (Founding Partner, QED Investors). The discussion was moderated by Shai Bernstein (HBS).

The importance of small business

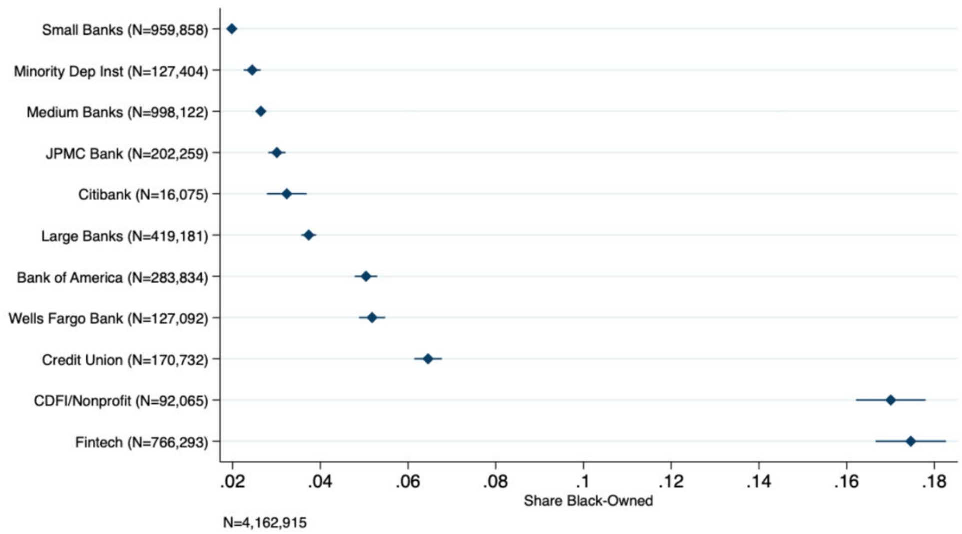
In an era of accelerating market concentration, small businesses remain vital to the U.S. economy. According to the U.S. Small Business Administration (2019), the 30 million small businesses in the U.S. account for 60 million jobs, approximately half of all jobs. The universe of small businesses is widely heterogeneous in terms of legal structure and goods and services offered. Approximately 80 percent of those businesses do not hire full-time employees, and instead rely on self-employment and independent contractors. Of the remainder, small businesses range from corporate suppliers to customer-facing "Main Street" shops to high-growth firms. While small businesses as a category are crucial to the U.S. economy, they face a range of needs and challenges, especially when it comes to raising capital.

What are key barriers to raising capital?

Small businesses often face a number of obstacles while securing debt financing that larger businesses do not. Prospective investors and banks find it challenging to assess the business's financial prospects due to lack of financial data, significant heterogeneity between businesses, and their sensitivity to economic downturns. While traditionally, small community banks played a large role in lending to small businesses, the 2008 Recession caused many of these banks to fail or merge, further complicating the pipeline of capital to small businesses.

On top of the broader challenges to raising capital, minority- and women-owned small businesses face even greater barriers to securing loans. Howell et al. (2021) use data from the Paycheck Protection Program (PPP) to attempt to disentangle credit risk from race in the ability to raise capital and to quantify the barriers faced by racial minorities. The PPP was implemented by private sector lenders but guaranteed by the federal government, thereby eliminating credit risk from the lending decision. The PPP data allowed the researchers to quantify how lending decisions vary by race, holding other factors constant. The data shows that traditional banks of all sizes lend a small share of PPP loans to black-owned firms (less than 5 percent) while approximately 17 percent of loans distributed by nonprofit lenders and FinTech firms went to black-owned businesses.

Black-Owned Business PPP Lending by Institution Type



How can FinTech help level the playing field?

For the reasons discussed above, small businesses, and in particular minority and women-owned businesses, face challenges when seeking a loan from a bank. The FinTech industry has successfully alleviated some of these frictions with innovative and data-driven approaches. First, FinTech companies have used alternative methods of lending that open up capital that may otherwise not be available for businesses without established credit histories. In addition, FinTechs have been able to utilize alternative data sources, such as information from a core checking account or a QuickBooks account, to assess the credit-worthiness of a borrower. Such innovations allowed business owners to access capital based on data other than credit scores.

In addition to the FinTech industry's innovations in the lending space, Fintech has also been able to provide basic financial services to small businesses and self-employed people that larger employers are able to administer in-house. For example, larger employers will provide financial services and benefits to their employees, such as withholding wages for taxes, reserving cash for paid vacations, and offering retirement plans. Instead of investing time and resources to administer these services themselves, small businesses can rely on FinTechs for support in these regards. Finally, FinTechs can also help small business owners with the logistics of running their businesses, from incorporating as a legal entity to assisting with invoicing.

The future of FinTech and banking

Traditional banks offer a wide array of products (e.g. checking, lending, and wealth management) to a variety of clients (e.g., both consumer and corporate clients). Before the Internet was ubiquitous, the business model of providing a bundle of products to a range of clients was successful because of the high costs of information for an individual client. However, FinTechs have taken advantage of the explosion of technology and information and have introduced specialized services that allow customers to find the best-in-class financial product without the help of a bank. In fact, individual banking products are often inferior to those offered by specialized FinTech firms and banks do little to reduce frictions or price when a client uses the same bank for a suite of financial products.

To bank or not to bank

One decision facing many FinTech firms is whether or not to obtain a banking license. A banking license could allow Fintechs to take deposits and significantly lower their cost of capital, resulting in reduced interest rates for their small business customers. However, a banking license would also subject a FinTech firm to increased regulation and oversight. Many FinTechs, such as Square, have decided that the benefits of a banking license outweigh the costs, and have applied for such a license. This trend might be worrisome for traditional banks, as their former FinTech partners may become banking competitors. More than likely, banks will need to innovate their business models and technologies to compete with the more specialized FinTech firms.

References

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