

# **Do Small Businesses Still Prefer Community Banks?**

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# Bank Type and Small Businesses

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- **Banks are a critical source of funding for small firms**
  - 57% of funding at small firms comes from banks (Wolken on the 2003 SSBF)
- **Community banks (small, single-market, local) are generally thought to be very important to small businesses**
  - Small business loans are about 26% of bank assets for institutions with <\$1 billion in assets (Ely & Robinson, 2001)
- **But megabanks (large, multimarket, nonlocal) play a role as well**
  - Large banks provide about 60% of small business loans (Berger and Black, forthcoming)

# Bank-Business Relationships: Costs & Benefits

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- **Benefits of strong bank-business relationships:**
  - **To Banks**
    - ✦ Extract proprietary information (soft information)
    - ✦ Set future contract terms and credit limits, and cross sell products
  - **To Businesses**
    - ✦ *Stronger relationships are associated with*
    - ✦ Better credit availability and credit terms
    - ✦ Improved firm performance

# Bank-Business Relationships: Costs & Benefits

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- **Costs of strong bank-business relationships:**
  - **To small businesses**
    - ✦ Private information may give bank market power (“hold up” problem) and allow extraction of rents
    - ✦ It raises the danger of premature withdrawal of services if the bank becomes financially distressed
    - ✦ Firms may bear additional costs to engage in multiple relationships to mitigate rent extraction and protect themselves from withdrawal of services

# Relationships with Large Banks

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Conventional wisdom says that large banks:

- Rely more on hard information
- Have weaker ties to the local community
- Are more likely to sever small business relationships than small banks
- And so tend to have weaker relationships with informationally opaque firms

# Relationships with Small Banks

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Business relationships are tricky. While a handshake may not always seem enough, a hug is always too much.

While conventional wisdom says that small banks:

- Have close ties with local community
- Are expected to have advantages in soft-information based relationships
- And so tend to have strong relationships with informationally opaque firms

# Why Challenge the Conventional Paradigm?

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Technological progress and deregulation have made it easier for megabanks to serve small, opaque firms:

(1) Small business credit scoring technology was not widely used by large banks until the mid-1990s

(2) Geographical deregulation (IBBEA of 1994), allows megabanks to operate virtually nationwide



# Recent Evidence to Counter the Paradigm

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- **Large banks may be able to serve opaque firms well using hard-information technologies**
  - Berger and Udell (2006), Frame, Srinivasan, and Woosley (2001), Frame, Padhi, and Woosley (2004), Berger, Frame, and Miller (2005)
- **Credit scoring is responsible for increase in lending distance in recent years**
  - DeYoung, Frame, Glennon and Nigro (forthcoming)
- **No significant disadvantage for large banks in small business lending**
  - Berger, Rosen, and Udell (2007)
- **Large banks lend to smallest & largest small businesses, with small banks specializing in lending to medium-sized small firms**
  - Berger and Black (forthcoming)
- **Small banks use hard-information technologies, fixed asset lending and credit scoring in addition to relationship lending**
  - Berger and Black (forthcoming), Berger, Cowan, and Frame (forthcoming)



# We Challenge the Paradigm in New Ways

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- We look at the role of bank type in banking relationships
  - Small bank vs. large bank
  - Single-market bank vs. multimarket bank
  - Local bank vs. nonlocal bank
    - ✦ We think of small, single-market, local banks as “community banks” and large, multimarket, nonlocal banks as “megabanks”
- And conduct two sets of tests

# Two Sets of Tests

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- **Main bank relationship type**
- **Strength of the main banking relationship**
  - Relationship exclusivity
  - Relationship length (years)

# Firm Types

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- Small, young, firms where principal owner is also manager, majority owner or has personal financial problems rely more on soft information-based relationships
- Larger more mature firms with diffuse ownership, without personal financial problems, and needing a wider array of products and services rely more on hard information-based relationships

# Data

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- **We match**
  - The 2003 Survey of Small Business Finance (SSBF)
- **With**
  - Call Report Data
    - ✦ Balance sheet and income statement data on banks (2003)
  - Summary of Deposits
    - ✦ Competitive conditions in local banking markets (2003)

# Main Bank Type

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- Test 1: Type of bank serving as the "main" bank
- Conventional paradigm:
  - Small, young, owner-managed firms with important principle owners have main banking relationships with small, single-market, and local banks
- ***Main bank = f(firm size, age, ownership, other firm and owner characteristics, local market characteristics)***

# Strength of Relationship

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- Test 2: Strength of main relationships
  - Probability of exclusive relationship and length of relationship
- Conventional paradigm:
  - Small, young, owner-managed firms with important principal owners have stronger (exclusive and longer) relationships with small, single-market, and local banks
- ***Exclusive banking = g(firm size, age, ownership, other firm and owner characteristics, local market characteristics, main bank fragility and type)***
- ***Relationship length = h(firm size, age, ownership, other firm and owner characteristics, local market characteristics, main bank fragility and type)***

# Controls

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- **Firm and owner characteristics**
  - Firm size
  - Age
  - Owner / manager
  - Share of family ownership
  - Risk
  - Organizational form
  - Industry
- **Main bank fragility measures**
  - Total risk-based capital ratio
  - Nonperforming loan to gross total assets (GTA) ratio
  - Liquid assets to GTA ratio

# Summary Statistics

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Dependent variables	Mean
<i>Main Bank Type</i>	
Large bank	75%
Multimarket bank	63%
Nonlocal bank	59%
<i>Strength of Relationship</i>	
Exclusivity	57%
Relationship length (years)	11 years



# Summary Statistics

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<b>Exogenous variables</b>	<b>Mean</b>	<b>Std. Dev.</b>
Indicator if medium firm (\$100K-\$1million in assets)	0.31	0.46
Indicator if large firm (> \$1 million in assets)	0.28	0.45
Firm age (years)	16.36	12.19
Indicator if owner is manager	0.89	0.31
Indicator if family owned	0.82	0.38
Firm risk rating (6 is safest; 1 is riskiest)	3.87	1.45
Indicator if collateral on MRL	0.23	0.42
Indicator if firm is delinquent on payments	0.17	0.37
Indicator if firm has declared bankruptcy	0.01	0.09
Leverage ratio of firm	0.33	0.39
Percent minority owned	0.14	0.34
Indicator if corporation	0.67	0.47

# Regressions

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- **Binomial logits**
  - Main bank type, exclusivity of relationship
- **Present odds ratios**
- **OLS**
  - Relationship length
- **Use**
  - Robust standard errors
  - Survey weights (oversample small firms)
  - Three alternate measures of financial fragility

# Main Bank Type

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Primary bank is ...	<u>Large</u> (N=2846)	<u>Multimarket</u> (N=2610)	<u>Nonlocal</u> (N=2846)
Indicator if medium firm	1.203	1.048	1.142
Indicator if large firm	1.156	0.898	1.155
Firm age (years)	1.014**	1.001	1.003
Indicator if owner is manager	1.057	1.338	0.731
Indicator if family owned	0.920	1.002	1.057
Firm risk rating (6 is safest; 1 is riskiest)	1.019	1.052	1.037
Indicator if collateral on MRL	0.733	0.912	0.630***
Indicator if delinquent	0.906	1.004	1.146
Indicator if owner declared bankruptcy	0.662	0.676	0.386*
Leverage ratio of firm	0.833	0.880	1.225
Percent minority owned	1.841***	1.593***	1.273*
Market concentration	4.438	0.818	0.061***
Share of market (large, multimarket, local)	1.060***	1.000**	0.280**
Indicator if corporation	1.174	1.080	0.798*
Indicator if partnership	1.176	2.011**	0.898
Branching restriction index	0.991	0.986	1.029
R-squared	12.98	1.78	2.82

# Main Bank Type Results

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- We find little evidence that smaller, younger, owner-managed firms, with important principal owners have strongest relationships with small, single-market and local banks
- Small businesses' choice of large banks and nonlocal banks is motivated by convenience (significant positive coefficient on large bank market share)

# Exclusivity of Relationship

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## Firm has an exclusive relationship with primary bank

Indicator if medium firm	0.497***	0.496***	0.497***
Indicator if large firm	0.381***	0.380***	0.379***
Firm age (years)	0.998	0.999	0.999
Indicator if owner is manager	0.859	0.858	0.866
Indicator if family owned	0.758	0.774	0.760
Firm risk rating (6 is safest; 1 is riskiest)	0.974	0.972	0.973
Indicator if collateral on MRL	0.751*	0.746*	0.748*
Indicator if delinquent	0.822	0.837	0.831
Indicator if owner declared bankruptcy	1.279	1.319	1.310
Leverage ratio of firm	0.364***	0.368***	0.364***
Percent minority owned	0.776	0.774	0.773
Market concentration	1.042	1.152	1.107
Large bank share of market	1.004	1.003	1.004
Indicator if corporation	1.259*	1.251*	1.254*
Indicator if partnership	1.608	1.618	1.612
Financial fragility (E/A, NPL, RBCR)	0.007**	0.029	0.411
Indicator if primary bank is large	1.112	1.227	1.186
Indicator if primary bank is multimarket	1.108	1.100	1.083
Indicator if primary bank is nonlocal	0.982	0.975	0.974
Branching restriction index	1.160***	1.158***	1.158***

N = 2610, R-squared ~ 7%

# Length of Relationship

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	<b>Length of relationship</b>		
Indicator if medium firm	0.042	0.042	0.042
Indicator if large firm	0.075	0.075	0.075
Firm age (years)	0.033***	0.033***	0.033***
Indicator if owner is manager	0.108	0.106	0.108
Indicator if family owned	0.087*	0.090*	0.087*
Firm risk rating (6 is safest; 1 is riskiest)	0.048***	0.049***	0.048***
Indicator if collateral on MRL	-0.135**	-0.139**	-0.135**
Indicator if delinquent	0.035	0.037	0.035
Indicator if owner declared bankruptcy	0.234	0.243	0.235
Leverage ratio of firm	-0.045	-0.042	-0.045
Percent minority owned	-0.027	-0.026	-0.027
Market concentration	0.177	0.207	0.178
Large bank share of market	-0.004***	-0.004***	-0.004***
Indicator if corporation	-0.064	-0.066	-0.064
Indicator if partnership	-0.085	-0.083	-0.085
Financial fragility (E/A, NPL, RBCR)	-0.151	-3.185	-0.062
Indicator if primary bank is large	0.159***	0.159***	0.160***
Indicator if primary bank is multimarket	0.122***	0.128***	0.121***
Indicator if primary bank is nonlocal	-0.078*	-0.075*	-0.078*
Branching restriction index	0.005	0.005	0.005
N = 2610 , R-squared ~ 25%			

# Strength of Relationship Results

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- **Medium and large firms less likely than small firms to have exclusive relationships with their main banks**
  - Consistent with conventional paradigm or that larger firms require larger array of financial services?
- **Riskier banks (lower E/A ratios) more likely to have exclusive relationships**
  - Counter to the prediction that firms choose multiple banks to avoid the risk of a fragile main bank
- **Small firms no more likely than medium or large firms to have a longer relationship with their banks**
- **Firms whose primary bank is large or multimarket have longer relationships with their banks**
  - (Coefficients no different than zero for exclusivity)

# Conclusions

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- Traditionally argued that “community banks” (small banks that operate locally in a single market) tend to have strongest relationships with smallest, least informationally transparent small firms
- We find that opaque small firms are not more likely to have a community bank as their main bank
  - But mixed evidence on whether opaque small firms have stronger relationships with their main banks and the type of bank with which firms have stronger relationships
- Finally, we hypothesize that the conventional paradigm is more likely to hold in earlier years
  - Expect more conformance with the predictions of the paradigm using the 1993 SSBF. That’s next...