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RESEARCH SUMMARY

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The Impact of Structural Change in the Banking Industry on Small Business Lending

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Purpose

With the implementation of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, the pace of structural change in the banking industry should accelerate as large U.S. banks expand their regional and national franchises. While there clearly are economic motivations for these structural changes in the banking industry, there is some concern about the implications to small business firms across the country. Will small business credit supplies shrink due to the growth of large, complex banking organizations that acquire small banks, which historically have been more active in small business lending? This study employs recently available data to examine the relationship between bank structure and small business lending.

Scope and Methodology

The study overviews historical data on the relationship between bank structure and small business lending and examines recent bank mergers and acquisitions for their potential effects on small business lending. Two data bases are used in the investigation: Call Reports (which show the lending activities of banks) for the period June 1993 - June 1996, and the bank structure file data base. Also employed is a national survey of bankers involved in mergers and acquisitions, which offers their experiences concerning the effects of structural change on small business lending practices.

Three hypotheses are tested: (1) small business lending is related to different variables that capture bank structure; (2) changes in small business lending activity before and after acquisition are related to different variables that reflect bank structure; and (3) small business lending volume and the credit evaluation process are related to mergers and acquisitions.

Highlights

Consistent with other published research on this subject, the empirical results are mixed. However, the weight of the evidence points to more negative than positive effects of banking industry consolidation on small business lending.

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Key findings of the study include the following:
Regarding the relationship between small business lending and different variables that capture bank structure:

- Holding a number of factors constant in a multivariate context, Banking Holding Companies' (BHCs) member banks tended to make more small business loans (SBLs) as a proportion of total assets compared to independent banks. However, holding asset size constant, members of large BHCs tended to have lower SBL ratios than members of small BHCs.
- Banks in states previously allowing national entry of multiple BHCs or allowing statewide multiple BHCs tended to have lower SBL ratios.
- For branch banks, the results were similar to those for BHCs in many ways. Branch banks tended to make more SBLs than banks with no branches. However, large branch bank organizations tended to have lower SBL ratios than small branch bank organizations. Also, states allowing statewide branching tended to have lower SBL ratios compared to states with limitations on statewide branching.

Regarding the before- and after-merger activities of a sample of bank targets and buyers involved in acquisitions in the second half of 1993 and 1994:

- The total asset size of the target banks had a significant positive relationship with changes in SBL ratios before and after bank acquisitions. Evidence on whether or not banks that were independents or members of one-bank holding companies before acquisition changed their SBL ratios after being purchased by a larger organization was mixed, such that, *at least in the short run*, no clear inferences on how structural change affects small business lending activity can be made.
- Analyses of aggregate data for buyers and targets in acquisitions and mergers revealed that, when targets of simpler organizational forms join more complex organizations (e.g., large BHCs and branch banks), there are greater increases in small business lending compared to targets of complex organizational forms.
- Intrastate mergers are more beneficial to small business lending than interstate mergers, which can be interpreted to mean that mergers across state lines are not motivated by increasing access to the small business loan market. Interstate mergers are more likely motivated by the desire to expand a banking organization's large business loan market.

The results of the survey of bankers involved in mergers and acquisitions indicated that market share was not an important motivation for most bank mergers and acquisitions. Gaining entry into a new market, achieving higher operating efficiency, and profitability were important factors.

- Many respondents reported an increase in small business loans (less than $250,000) and medium business loans ($250,000-$1 million) due to their mergers or acquisitions.
- Less than 10 percent of the respondents reported a decrease in their small business loans as a result of a structural change. Also, less than 10 percent of the respondents reported an increase in their large business loans.
- Four characteristics of loan applicants seem to play a very important role in the credit decision process of a relatively large majority of the respondents before and after merger or acquisition: cash flow, financial ratios, collateral, and, most importantly, character of the manager of the borrowing firm.
- A majority of the respondents experienced no change in the following factors associated with small business loans: profitability, risk of default, number or dollar value, finance charges, approval rate, time to process loans, and offering of related loans.

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