SMALL BUSINESS

RESEARCH SUMMARY

No. 234

February 2004


# The Impact of Bank Consolidation on Small Business Credit Availability


by Dr. Steven G. Craig and Dr. Pauline Hardee., Houston, TX 08035
under contract no SBA-HQ-02-M-0459, 2004. 39 pages


The banking industry has been undergoing an extensive period of consolidation, accelerated since the federal interstate banking legislation of 1994. As small firms are the source of most job growth, and since the bulk of small business credit is primarily from banks, the effects of institutional change on small business credit is a major economic issue.

The importance of small banks to small businesses is shown, for example, by the fact that in 1999 small business loans were 25.5 percent of bank assets for institutions with less than $1 billion in assets. On the other hand, for banks with assets of more than $5 billion, small business loans were only 7.85 percent of total assets. This research investigates the consequences to small business credit from banking consolidation by examining two separate components of the credit process—credit limits and credit levels, using primarily the Survey of Small Business Finances of 1998 (Survey).

## Overall Findings

The research found that credit access had been significantly reduced for small businesses, but that actual credit balances had fallen by less than the fall in credit limits. These results suggest that while small businesses are less likely to borrow from the banking sector in markets with a greater degree of banking consolidation, when they do so they take advantage of improvements in pricing to borrow greater amounts. Small businesses have increasingly turned to non-bank sources of financing to satisfy their credit needs. Interestingly, this non-bank option seems to be more important for small businesses with negative rather than positive equity.

These findings are essentially mirrored in the market for lines of credit and other loans, with some important exceptions. Regarding total credit limits, non-bank institutions were not able to compensate for small firms' reduced access to large banks' lines of credit. In other loans, however, it was found that non-bank institutions do compensate for reductions in bank credit, although the finding is stronger for credit levels than credit limits.

## Highlights

Small businesses receive less credit on average in regions with a large share of deposits held by the largest banks, irrespective of how debt is measured. Details follow:

• When access to credit is measured by credit limits, reductions in lending in response to large banks' greater market share is larger than when credit access is measured by actual credit balances.

• The market for lines of credit, especially the line limits, seems to be most affected by banking consolidation. Regarding total credit limits, non-bank institutions were not able to compensate for small firms' reduced access to credit resulting from a greater


This *Small Business Research Summary* (ISSN 1076-8904) summarizes one of a series of research papers prepared under contracts issued by the U.S. Small Business Administration's Office of Advocacy. The opinions and recommendations of the authors of this study do not necessarily reflect official policies of the SBA or other agencies of the U.S. government. For more information, write to the Office of Advocacy at 409 Third Street S.W., Washington, DC 20416, or visit the office's Internet site at *www.sba.gov/advo*.

share of large banks in lines of credit. Additionally, non-bank institutions are not able to make up for shortfalls in credit limit levels.

- Credit reductions appear more severe in total when access to credit is examined through the firm's decision to borrow as well as the bank's decision to grant credit, than when the amount of debt as a share of assets is used as a measure.
- Credit reductions are found to occur for firms with both positive and negative equity.
- Non-bank financial institutions are making up a considerable part of the credit reduction in terms of the level of credit conditional on borrowing, but not completely in the case of access to credit.
- The activity of non-bank financial institutions appears to be especially important for firms with negative rather than with positive equity.

## Scope and Methodology

The research methodology is to use the Census regions divided into urban and rural areas to define a banking market, and then to use the individual firm data on small firms from the Survey to ascertain the extent to which credit access has changed. The analysis extrapolates from differences in the regions to changes over time, since each region contains a different banking market as measured by the extent to which large banks are important, and the extent to which large banks participate in the small business lending market.

The data for the analysis is the 1998 Survey of Small Business Finances, combined with credit market information from the various federal regulatory agencies. The variables employed in the regression analysis describe two aspects of the banking market: the share of deposits held by banks of a certain size, and the extent to which banks are associated with holding companies. Variables from the Survey describing the firms are extensive, and include credit history, industry, and other firm attributes.

The focus of the research method is to estimate two separate regressions for a variety of credit definitions. The first regression is access to credit, measured simply by whether or not a small business is using credit from a particular source. This regression is estimated using a linear probability model. The second step is to estimate the level of credit, as a share of assets, for firms utilizing a particular credit source. This step is estimated using weighted least squares, to adjust the Survey data to fit the national characteristics of small businesses. The pair of models is estimated separately for firms with positive and negative equity. Finally, the regression analysis is separated to estimate the firms that utilize banks and the firms that use non-bank financial institutions for their credit needs.

## Conclusion

The banking industry has been undergoing an extensive period of consolidation, and this process has accelerated since the federal interstate banking legislation of 1994. With small banks providing a substantial share of banking credit to small firms, the potential impact on the availability of credit to small businesses if all small banks are absorbed by large institutions becomes a real concern to small business policymakers.

The research found that credit access had been significantly reduced for small businesses, but that actual credit balances had fallen by much less. Small businesses have increasingly turned to non-bank sources of financing to make up the shortfall, especially for credit other than credit lines, which were supplied primarily by large banks.

## Ordering Information

The full text of this report and summaries of other studies performed under contract to the U.S. Small Business Administration's Office of Advocacy are available at ***www.sba.gov/advo/research***. Printed copies are available for purchase from:

National Technical Information Service
5285 Port Royal Road
Springfield, VA 22161
(800) 553-6847
(703) 487-4639 (TDD)
*www.ntis.gov*
Order number: PB2004-102510

To receive email notices of new Advocacy research, press releases, regulatory communications, and publications, including the latest issue of *The Small Business Advocate* newsletter, visit ***http://web.sba.gov/list*** and subscribe to the appropriate Listserv.