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Banking Consolidation and Small Business Lending: A Review of Recent Research

A Working Paper by Dr. Charles Ou
Office of Economic Research

March 2005

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Introduction

Banking consolidation has continued to accelerate over the past several years, assisted by technological innovations in information management and statistical modeling, and by the large merger and acquisition (M&A) deals of the late 1990s. Total domestic assets held by the largest 50 bank holding companies (BHC) rose from around 52 percent in June 1997 to nearly 70 percent in June 2002, and the number of small banks with assets under $500 million declined from 8,647 in June 1997 to 7,208 in June 2002. The perennial question about the impact of banking consolidation on the availability of financing to small business remains a major concern to small business researchers and policymakers. This paper provides a review of recent major studies conducted over the past several years.[1]

The impact of banking consolidation on small business credit markets can be best analyzed in the analytical framework proposed by Berger, et al. (1997 and 1998). The impact can be examined from the perspective of (1) the direct impact on small business lending by the acquiring and acquired banks, and (2) the overall impact on financing received by small businesses in the small business loan market. The state of competition in the post-merger credit markets also has much to do with the potential impact on small business lending; reduced competition in the post merger era is expected to have greater adverse effects on credit availability. Moreover, competition in local small business loan markets is affirmed by the continued presence of a viable and progressive community banking system that competes with larger banks. In post-merger markets, the success or

[1] The Office of Economic Research of the Office of Advocacy organized the conference "The Changing Banking Structure and Its Impact on small Business Lending in 2000. See conference summary, Office of Advocacy, www.sba.gov/advo/news.htm/#confereences.

failure of these banks should provide evidence of the impact.

Several recent studies have attempted to find answers to questions about the impact of banking consolidation on small business lending. Namely, with banking concentration, will the small business lending market remain competitive? Are large banks and BHCs retreating from the small business loan markets after M&A? What is the future of small community banks?

Recent studies show:

- Small business credit markets remain competitive for most small firms and profitable for small business lenders;
- M&A activities by large banks/BHCs did reduce their small business lending;
- Large banks are aggressively entering certain segments of small business credit markets;
- Availability of credit to most small firms has not been adversely affected by large bank M&A;
- There continues to exist a viable and competitive community banking system in the United States.

Summary of Findings

1. <u>Small business credit markets remain competitive for most small firms and profitable for small business lenders.</u>

Overall, most small business credit markets in the United States remained competitive after 10 years of accelerated banking consolidation. The overall markets for small business credit and financial services remained profitable and continued to grow. The acquisition of local and regional banks by large BHCs affects segments of the credit market differently. Large banks' entry into new markets allows them to exploit different segments of the small business credit market — penetrating some segments while retreating from others. Findings from research by Kolari (2003) confirms the profitability of small business lenders. Studies by McNulty and others (2002 and 2004) confirm small community banks' abilities in managing risk for profitable operation over the past several years of banking consolidation. Using data on credit experiences collected from surveys of National Federation of Independent Business (NFIB) members, Professor Jonathan Scott found that while those small businesses that experienced M&A in their primary banking institutions reported "dissatisfaction with their new banking partners in services received and in additional fees, most of them reported no decline in the competition in the banking market that served them." (Scott, 2003). The beneficial results of M&A among community banks were reported by Avery and Samolyk (2003). The study concluded that "small business lending tended to increase in local markets after two local community banks merged, especially if a third community bank also operates in those markets," implying that as long as there are competitors in a given market, M&A by two small banks improves efficiency in banking operation and, thus, enhances market competition. These studies highlight the importance of market competition in assuring the beneficial impact of industry consolidation on small business borrowers.

2. <u>M&A activities by giant banks/BHCs reduced their small business lending</u>.

Banking consolidation, especially merger and acquisitions activities by giant banks/BHCs, has had adverse impacts on small business lending. These giants have retreated from the overall small business credit market after the M&A rush of the late 1990s. Studies by Craig and Hardee of the University of Houston (2004) found that increased banking concentration in local markets led to declines in credit limits and in the amount of actual credit granted to small firms. A study by PM Keypoint (2005) found that small business lending by the 50 largest BHCs declined after M&A activities in 1997-2002. The PM Keypoint study also found that the nature of the banking consolidation, whether it is a merger or an acquisition, has different impacts on a bank's lending to small firms — namely, adverse impacts were found to be most severe when the acquiring bank(s) merges with the acquired bank(s) and centralizes business-lending operations.

3. Large banks are aggressively entering certain segments of small business credit markets.

Large efficient banks constantly explore technological innovations and statistical modeling to find lower-cost means of delivering credit and financial services to small firms.[2] While the impact of these efforts has yet to be reflected in banking data, giant banks/BHCs have been actively promoting the credit-line/credit-card markets for small firms over the past several years. The number of outstanding small loans under $100,000 increased from 7.7 million in June 1999 to 15.7 million in June 2002. However, because of the relatively small outstanding balance of loans in this category, huge increases in these accounts over the past three to five years have not had much impact on the growth of overall outstanding loan balances.[3]

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[2] They have used information technology and statistical modeling to reduce the administrative costs of small business lending and to replace relationship lending which costs more to large banks. See Berger, A., and G. Udell, "Small Business Debt Finance in the 21st Century," paper presented at "Entrepreneurship in the 21st Century", March 26, 2004. Office of Advocacy, U.S. Small Business Administration. See also, the Conference report.

[3] See Office of Advocacy, U.S. Small Business Administration, "Small Business and Micro Business Lending in the U.S., 2002 Edition", December 2003. See also, the previous editions of the "Small Business Banking Studies."

4. Availability of credit to most small firms has not been adversely affected by large bank M&A.

Whether the availability of credit to small business has been adversely affected by banking consolidation is less definitive. The degree of competition in small business loan markets has much to do with the outcome, i.e., in a competitive small business loan market, the gap in funding created by the retreat of large banks is usually filled by other banks, new banks, and non-bank lenders. Craig and Hardee (2004) indicated there is increased borrowing from the non-bank financial institutions in markets where large bank lending was found to have declined. Goldberg, et al, (1998, 1999) and DeYoung (1999, 2003) found that new banks that specialize in business lending have entered the market.[4] So, as far as the availability of small business lending is concerned, what matters most is competition in small business loan markets. As long as banking consolidation does not reduce competition in small business markets, credit availability will not be significantly affected.

5. There exists a viable and competitive community banking system in the United States.

The continued presence of a healthy community banking system in the United States banking industry confirms the existence of a competitive U.S. small business lending market. Findings from the NFIB study (Scott, 2003) and the 2003 conference report from the Federal Reserve Bank of Chicago confirm the vitality of the community banking system (FRB Chicago, 2003). The report by NFIB also confirms the dynamic of community banks in providing financial services to small businesses. Several papers presented at the Federal Reserve Bank of Chicago

[4] Goldberg, L.G. and L. J. White, 1998, "De nova banks and lending to small businesses: an empirical analysis," Journal of Banking & Finance, 22, August, pp.851-867.

conference "Whither the Community Bank?" concluded that while a large number of community banks had disappeared during the past 20 years, a large number of efficient and profitable community banks remain. In fact, numerous "well run" or "best practices" community banks that have generated significantly higher returns than average large banks. These "best practices" banks have used "a business model that was clearly different from the one used by the average large bank," with greater reliance on core deposit funding, incurring lower levels of non-interest expenses, and generating less non-interest income.[5] As reported earlier, one of the studies confirms the profitability of small community banks (For a summary, see "Whither the Community Bank? A conference summary" in *Chicago Fed Letter*, May 2003, No. 189a).

Conclusion

The impact of M&A in the banking industry on the small business loan markets depends much on how large banks approach the new markets they enter. Large efficient banks constantly search for the lowest cost and highest value-added credit services for their small business customers. They are, therefore, moving away from relationship banking, which is costly for large banks, into more automatic and quantitative data-based business lending. Broader financial services with higher added-value are also provided by these giants.

Banking consolidation affects small business loan markets differently depending on the degree of competition in these markets. The adverse impacts on small business are greater where market competition is less or has been reduced by

[5] Other papers discussed the community bank business model, differentiating their products by maximizing their local connections for information generation and dissemination, and offering "customized" services demanded by small business owners (The so-called soft information discussed by J. Scott).

banking consolidation.

As long as small business lending is profitable, as it has been, there will be an adequate number of suppliers in the market to supply credit and financial services. Small business credit markets will remain vast, differentiated, and segmented. Community banks will remain an important participant in the small business markets as they continue to develop differentiated services (special relationships and localized expertise) that larger banks cannot provide. The entry of large banks into local markets contributes to the credit supply for small firms by bringing some segments of small business borrowing directly into the markets served by national lenders and by servicing others through participation in secondary markets.[6]

[6] One market that giant BHCs are exploring is credit line/credit card markets for small businesses/small business owners. The underwriting standards for these loans will be uniform with predictable risk.

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