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RESEARCH SUMMARY

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Assessing the Profitability and Riskiness of Small Business Lenders in the Banking Industry

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Purpose

Small banks have traditionally been one of the major suppliers of credit to small firms in the United States. In recent years, there has been concern that deregulation and consolidation in the industry, by reducing the number of small banks lending to small businesses, will reduce bank lending to small businesses overall.

This research looks more closely at the reasons for the availability of bank credit to small business by asking how profitable small business lending is. The research suggests two possible hypotheses:

• If the "specialization hypothesis" is verified, banks will be *more* profitable as they specialize in small business lending.

• If, on the other hand, the "diversification hypothesis" prevails, banks will be *less* profitable as they specialize in small business lending.

Overall Findings

Small business lending can help banks, especially large banks, diversify and reduce the risk of failure. The specific findings depend on which of two definitions of profit are used:

• The rate of return on assets (ROA) relates a bank's profits to its resources—in other words, it measures the "bottom line"—how profitably a bank has used each dollar of assets under its control. The study finds generally that small business lending neither reduces nor increases a bank's profitability measured as return on assets—that is, neither of the two hypotheses is accepted.

• The rate of return on equity (ROE) relates a bank's profits to its shareholder equity—and is relevant to shareholders who are concerned about the profitability of their investment. Using this measure the study finds that banks can benefit from specializing in small business lending, especially by reducing the risk of failure.

If larger, more diversified banks are the future of the industry, small business lending can play a positive role by contributing to diversification and reducing the risk of bank failure.

Highlights

The determination of whether small business lenders are more profitable than other banks hinges on the definition of profits used.

Using Return on Assets as the Measure of Profit

• For four of the five bank size groups, small business lending had no effect on the bank's profitability.

• An exception is that small business lending did lower the profits of very small banks with assets under $100 million over the period studied.

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• Also, there was weak evidence that small business lending lowered the profitability of larger banks in recent years. This decline is probably related to the economic slowdown.

Using Return on Equity as the Measure of Profit

• Small banks specializing in small business lending are well diversified and have relatively low risk compared with banks specializing in other kinds of lending as well as those with a balanced portfolio.

• Large banks (with assets over $500 million) that specialized in small business loans had the lowest risk and high levels of diversification compared with banks specializing in other loan areas.

• The study concludes that while small business lending tends to lower bank profitability to some degree, bank risk is commensurately reduced, not only for small banks but also for large banks.

• The results therefore support the specialization hypothesis—small business lenders had higher return on equity compared to other banks.

Scope and Methodology

To assess the profitability and riskiness of small business lending, the researchers conducted various tests on data from banks' annual Call Reports of Condition and Income for 1994-2001. Small business loans are defined as loans of less than $250,000

To compare the performance of small and large banks, five asset size categories of banks are defined: those with assets of less than $100 million, $100 million to $300 million, $300 million to $500 million, $500 million to $3 billion, and more than $3 billion. Analyses were divided into two parts:

(1) univariate and multivariate tests that focused on how small business lending affects banks' rate of return on assets (ROA) and

(2) "efficient frontier" analyses that focused on how small business lending affects banks' rate of return on equity (ROE) and associated capital risk.

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 on the Internet at ***www.sba.gov/advo/research***. Printed copies are available for purchase from:

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