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RESEARCH SUMMARY

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Finance Companies and Small Business Borrowers: Evidence from the 1993 and 1998 Surveys of Small Business Finances

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Finance companies play an important role in providing short- and medium-term financial capital to small business borrowers. They are the most important institutional providers of capital to small businesses after banks. This study examines whether finance companies' importance in providing financial capital to small business borrowers changed during the 1990s. This is interesting because the 1990s were a decade of rapid growth in financial markets, including expansion in interstate banking and lending by both finance companies and commercial banks. This study uses the most recent data on small business finances to evaluate the importance of finance companies to small business borrowers in 1993 and 1998; to assess what types of borrowers were attracted to finance companies; and to determine if these finance company borrowers paid higher loan prices.

Overall Findings

The analysis of the 1998 Survey of Small Business Finances (SSBF) confirmed the importance of finance companies as the second most important institutional supplier of credit to small business borrowers—they remained important providers of credit for vehicle loans, equipment loans, and lease financing. While on the surface, small business borrowers were more likely to utilize finance companies for traditional loans in 1998 than 1993, this result held only for capital leases and mortgage loans, which were not major sources of financing to small firms. (Fewer than 3 percent of small business borrowers held a lease or mortgage loan from a finance company in 1998.) Small businesses' use of the major products marketed by finance companies—vehicle and equipment loans—remained important but unchanged during 1993 and 1998. In addition, this study suggests that small businesses' relationships with finance companies remained virtually unchanged from 1993 to 1998; finance companies continued to attract good quality clients with low credit risk, similar to those who utilized commercial banks.

Highlights

- Finance companies are the second most important institutional lenders to small businesses, especially for vehicle and equipment loans and capital leases. The probability of using a finance company in 1998 was 13.3 percent; finance companies' share of the total aggregate value of traditional loans was 12.3 percent in 1998.
- Finance companies are especially important lenders for vehicle loans, where they supplied roughly 40 percent of all vehicle loans in 1998. In addition, finance companies provided over 20 percent of all equipment loans and over 18 percent of all capital

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leases during this period of time.

- The probability of using a finance company has remained relatively constant from 1993 to 1998 for all types of loans except leases and mortgages. Borrowers were more likely to utilize both finance company leases and mortgages in 1998 than 1993.
- The share of total aggregate value of traditional loans held by finance companies has remained relatively constant from 1993 to 1998 for all types of loans, except leases and mortgages. Borrowers held higher inflation-adjusted balances for both finance company leases and mortgages in 1998 than 1993.
- Low-risk borrowers were more likely to be attracted to finance companies than high-risk ones.
- Finance companies may charge higher interest rates on lines of credit and asset-backed loans than commercial banks. However, this result should be used with caution because it is based on a very small sample of line of credit and vehicle loans held by finance companies.

Methodology

This study utilizes the 1993 and 1998 versions of the Survey of Small Business Finances (SSBF). The SSBF is the national survey conducted by the Federal Reserve Board of Governors for information on small businesses' use of different financing sources. The 1993 survey has 4,638 observations representing nearly 5 million small businesses; the 1998 survey has 3,561 observations representing 5.2 million small businesses.

This study utilizes descriptive statistics and other linear and non-linear statistics to test its proposed hypotheses. Descriptive tables summarizing the probability of using all financial (credit union, savings and loan, commercial bank, finance company, brokerage, leasing company, and other non-depository institutions) and non-financial (family, other business, government, and other individuals) lenders for each type of traditional loan (lines of credit, capital leases, mortgages, vehicle, equipment, and other loans) and the shares of aggregate value of traditional loans held by financial and non-financial lenders are reported.

This descriptive analysis is supported by non-linear and linear regression analyses examining changes in lending patterns from 1993 to 1998, assessing the types of borrowers attracted to finance companies, and evaluating the prices charged by finance companies for lines of credit and asset-backed loans. Logit models are employed to examine changes in the probability of using a finance company over time; and to assess the types of borrowers attracted to finance companies in 1998 only. Tobit models are used to examine changes in the shares of the value of traditional loans held by finance companies over time. An ordinary least squares (linear regression) model was employed to evaluate prices charged by finance companies.

The final report was peer reviewed consistent with the Office of Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of economic research at *advocacy@sba.gov* or (202) 205-6533.

Ordering Information

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