

The Value to Banks of Small Business Lending

By Joe Peek, University of Kentucky; Lexington, KY 40506-0034
Under contract SBAHQ-05-M-0435 [37] pages.

This study investigates the contribution of relationship lending to the value of banks by estimating the market premium placed on the small business loan portfolios of banks.

This approach contrasts with the previous literature that has focused almost exclusively on the value of lending relationships to the firms that obtain access to bank lending, finding that firms, both large and small, accrue substantial benefits. The underlying hypothesis of this study is that relationship lending is mutually beneficial, benefiting banks as well as the firms to which they lend.

Such a finding would have important implications for bank behavior. For example, to the extent that small business lending increases the market value of banking organizations, consolidation of the banking industry that takes the form of reducing the emphasis on small business lending of acquired banks with a particular expertise in small business lending may be value destroying for the acquirer, and thus not in the best interests of shareholders.

Overall Findings

The authors find that for commercial and industrial loans, small business lending does, in fact, add value to banking organizations overall. This evidence suggests that at least for small banks, the added revenue associated with relationship lending exceeds the added information costs associated with evaluating and monitoring small business commercial and industrial loans. Small business lending was found to be a profitable market niche for small publicly traded banking organizations in the United States.

Highlights

The authors provide direct evidence on the value to banks arising from relationship lending by estimating

the market premium placed on the small business loan portfolios of banks. Among the findings are that:

- Small business loans in the form of commercial and industrial loans with original amounts of \$1 million or less add 10.5 cents to the value of a banking organization for each dollar of such loans held in the bank's portfolio relative to larger commercial and industrial loans.
- This value-enhancing effect emanates from the sample of the smallest banking organizations, those with assets less than \$500 million.
- The value-enhancing effect arises primarily from holdings of the smallest category of commercial and industrial loans, those with original amounts of \$100,000 or less, with the differential effect for the smallest category of banks being over 28 cents per dollar of such small business loans.
- The authors find no evidence that small commercial real estate loans, which tend to be transactional rather than relationship loans, provide a differential effect on bank value beyond that produced by commercial real estate loans more generally. However, commercial real estate loans do produce value for the smallest category of banks.

Scope and Methods

The authors use data from four primary sources: the Federal Reserve's Quarterly Consolidated Financial Statements for Holding Companies, the Federal Reserve's Consolidated Reports of Condition and Income for individual banks (call reports), the Federal Reserve's National Information Center database (NIC), and the Center for Research in Security Prices. The sample consists of the set of publicly traded banking organizations. Annual data for small business loans are obtained from the Small Business Loan Survey section of the June bank call reports.

Because some of the key explanatory variables can be consistently collected only starting from 1994, the empirical analysis is based on annual observations from 1994 through 2005.

The Small Business Loan Survey provides information on loans with original amounts of \$1 million or less in two different loan categories: commercial and industrial loans to U.S. addresses in domestic offices (CI) and commercial real estate loans secured by nonfarm, nonresidential properties in domestic offices (referred to as commercial real estate loans, CRE). The survey also disaggregates these loans into three size categories based on original loan amounts: less than or equal to \$100,000, more than \$100,000 through \$250,000, and more than \$250,000 through \$1 million. Since data on small business loans are available only at the individual bank level and most publicly traded banking organizations are holding companies, the small business loan data were aggregated to the holding company level. For this purpose, all commercial and savings bank subsidiaries of the holding companies are identified using the Federal Reserve's NIC database.

The sample excludes foreign-owned banks, as well as banks located outside the continental United States. Since some of the holding companies are financial services holding companies for which commercial banking activities are not their primary line of business, such organizations are excluded from the sample. Finally, the sample excludes observations with extreme values (outliers), defined as observations with values for the dependent and independent variables that are more than four standard deviations away from the variable's mean value. After applying these filters, the sample is an unbalanced panel that includes a total of 4,333 observations on 817 banking organizations.

In order to test the key hypothesis that relationship lending in the form of small business lending by banking organizations is value enhancing, the authors relate small business lending activity to the market-to-book ratio of the banking organization. They relate bank market value to the book values of assets and liabilities, and to the flows of income produced by off-balance-sheet activities, since the reported notional values are uninformative about the value of such activities.

The authors' empirical specification allows a disaggregation of the total market premium or discount placed on banks into its components by estimating separate valuation coefficients for the individual portfolio categories. The key hypothesis

test is whether the estimated coefficients on bank holdings of small business loans are significantly greater than unity. If so, then small business lending adds to the market value of banking organizations. However, they focus on the differential effect of small business loans relative to that for total loans in that category in order to better control for the average effects of changes in the economic environment on all business loans, with a significant positive estimated coefficient on small business loans indicating that small business loans are value enhancing relative to larger loans.

This 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

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

National Technical Information Service
5285 Port Royal Road
Springfield, VA 22161
(800) 553-6847 or (703) 605-6000

www.ntis.gov

Order number: PB2007-108158

Paper A04 (\$29.50)

Microfiche A01 (\$14.00)

CD-ROM A00 (\$22.00)

Download A00 (\$17.95)

For email delivery of Advocacy's newsletter, press, regulatory news, and research, visit <http://web.sba.gov/list>. For Really Simple Syndication (RSS) feeds, visit www.sba.gov/advo/rsslibrary.html.