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Small Business Research Summary

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Small Business in Focus: Finance

U.S. Small Business Administration, Office of Advocacy, 2009. 136 pages.

Small Business in Focus: Finance is the first publication in a new research series by the Office of Advocacy. This initial publication contains four research papers:

- *Lending to Small Businesses by Financial Institutions in the United States.* Victoria Williams and Charles Ou, Office of Advocacy.
- *An Examination of Financial Patterns Using the Survey of Small Business Finances.* George W. Haynes, Montana State University at Bozeman; James R. Brown, Iowa State University. Under contract no. SBAHQ-07-M-0381.
- *How Strong is the Link between Internal Finance and Small Firm Growth? Evidence from Survey of Small Business Finances.* George W. Haynes, Montana State University at Bozeman; James R. Brown, Iowa State University. Under contract no. SBAHQ-07-M-0381.
- *Who Needs Credit and Who Gets Credit? Evidence from the Survey of Small Business Finances.* Rebel Cole, Krähenbühl Global Consulting. Under contract no. SBAHQ-06-Q-0013.

Purpose and Scope

This compendium of four studies sponsored by the Office of Advocacy offers insight into the ways small businesses use financing, based on data from various sources, particularly the Federal Reserve Board's Survey of Small Business Finances (SSBF). The last SSBF surveyed more than 4,000 firms in a nationally representative sample of businesses operating in the United States in December 2003. The survey amassed new information on the characteristics of each business and its top three owners, the firm's income statement and balance sheet, and details of the sources and uses of financing, as well as each firm's recent borrowing experience and use of trade credit. Previous surveys conducted in 1987, 1993, and 1998 are available for many comparison purposes. The researchers use descriptive statistics, regression models, and other statistical techniques to test their hypotheses.

Highlights

Lending to Small Businesses by Financial Institutions in the United States

A paper by Charles Ou and Victoria Williams of the Office of Advocacy notes that the funding markets for small firms in the United States consist of multitudes of markets of varying sizes scattered in widely dispersed geographic areas with various numbers of borrowers and fund suppliers in each market. The authors use data from the Survey of Small Business Finances, statistics from the Reports of Condition and Income (or Call Reports), and data provided in compliance with the Community Reinvestment Act to profile the small business loan markets. The report offers an overview of small business borrowers in the financial markets; discusses the credit and capital markets that serve them; and looks at small firm borrowing patterns—what they borrowed and from which suppliers—based on the 2003 SSBF. The paper takes a look at the growth of small business lending by depository institutions since mid-1990 and examines the emergence of a national market for small business credit cards.

Among the report's conclusions are the following:

- Commercial banks and other depository institutions such as savings banks and thrifts remain the most important suppliers of credit to small firms. In

June 2007, 7,485 depository institutions with 97,300 branches operated in the United States.

- Lending to small businesses increased steadily in both value and number from 1995 to 2007. The number of the smallest loans increased very rapidly.
- Nevertheless, the small business share of banks' loan and asset portfolios has declined steadily, especially in the smallest loan category.
- The very large increase in the number of the smallest loans under $100,000—by 300 percent from 1995 through 2007—can be attributed to the promotion of business credit cards by large lenders.
- A small number of large lenders participate in the business credit card market; they make few or no other small business loans.
- The financial services industry has experienced significant structural changes over the past two decades. The relative importance of financial institutions of varying sizes has changed, with the largest institutions with assets in excess of $10 billion accounting for 76 percent of total assets and 65 percent of total business loans in June 2007.
- The share of the smallest loans that is held by the smallest lenders with assets under $500 million fell from roughly 25 percent in 1996 to 7.1 percent in 2007.

An Examination of Financial Patterns Using the Survey of Small Business Finances

This contract study by George Haynes and James Brown compares SSBF samples from 1993, 1998, and 2003, looking at both the characteristics of the business owners sampled and what has changed in their financing patterns. The descriptive section examines the proportions of small businesses using each type of loan and lender, the number of loans, and the aggregate value by each type of loan and lender. The study also explores in detail the relative importance of banks, thrifts, and finance companies in the markets for small business lending, including small business use of mortgages.The analytical section focuses on commercial banks and finance companies and offers a number of observations, among them:

- The share of small businesses using any credit increased from 79.1 percent in 1993 to 89.0 percent in 2003.
- The share of firms using traditional loans increased substantially over the 1993-2003 period for mortgages but remained nearly the same for all other traditional loans.
- The share of small businesses using commercial banks declined over the period, while the share using finance companies increased. Nevertheless, commercial banks continued to be the most important source of loans, with more than 46 percent of small business borrowers acquiring 50 percent or more of the value of their loans from commercial banks in 2003.
- The share of firms using nontraditional loans, particularly credit card loans, also increased considerably.
- The use of nondepository institutions increased by 28 percent and the use of nontraditional credit increased by nearly 33 percent.

How Strong is the Link between Internal Finance and Small Firm Growth?

This contract report by George Haynes and James Brown finds that internal funds are critically important to small firm growth, in contrast to the outside capital used by publicly traded firms. While outside capital is often needed, internal capital is critically important for small business growth. The findings include the following:

- Small growth firms are more likely than non-growth firms to have lines of credit, motor vehicle loans, capital leases, equipment loans, and loans from commercial banks and finance companies.
- The relationship between internal funds and employment growth is especially important for very small and women-owned firms.

These results highlight the importance of programs that effectively reduce the costs of borrowing and increase net profits in fostering the growth of small businesses, especially very small and women-owned businesses.

Who Needs Credit and Who Gets Credit?

Contract research by Rebel Cole also uses data from the SSBF to classify small businesses into four groups based on their credit needs—nonborrowers, discouraged borrowers, denied borrowers, and approved borrowers—and to model the credit allocation process into a sequence of three steps. The author provides an analysis of credit availability that accounts for the inherent self-selection involved in the credit application process: who needs credit, who applies for credit conditional upon needing credit, and who receives credit conditional upon applying for credit. He makes several important observations:

- Nonborrowers—those who do not need credit—look much like approved borrowers—those who apply for and receive credit, consistent with the "pecking order" theory of capital structure. This theory suggests that firms opt for funding from sources with the lowest degree of asymmetric information. That is, they rely on a hierarchy of financing sources beginning with internal funds, followed by debt, and then equity.

- Discouraged borrowers—those who need credit but fail to apply for fear of being turned down—resemble denied borrowers—those who apply for credit but are turned down—in many respects. They differ significantly, however, along a number of dimensions. This finding calls into question previous studies that have pooled together these two groups in analyzing credit allocation.
- Denied borrowers differ from approved borrowers across numerous dimensions.
- After controlling for a variety of variables, the researchers found that firms whose owners were African American were denied credit at a far higher rate than firms whose owners were white, and this percentage has increased over time, rather than decreased, as shown in each successive SSBF.

The study also provides new SSBF evidence using methodological improvements, including identification of applications to renew existing lines of credit, which allows, for the first time, differentiation between new lines of credit and renewals.

Note

These reports were 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***.

The url of this report is ***www.sba.gov/advo/research/rs348tot.pdf***.

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