SMALL BUSINESSES AND LARGE BANKS

Presented to

Office of Chief Counsel for Advocacy
U.S. Small Business Administration

Contract No. SBA - 7647-OA-92

Presented by

P. Michael Laub

and

State and Federal Associates, Inc.

The findings and recommendations stated in this report are those of the authors and do not necessarily represent the opinions and policies of the U.S. Small Business Administration.
ACKNOWLEDGEMENTS

The authors are especially grateful to the more than fifty bankers and bank regulators who met with us to discuss the issues we were charged with addressing. They were generous with their time, cooperative in furnishing information and ideas, and exhibited a high degree of enthusiasm for the subject matter. Mr. Charles Ou, Economist in the Office of Economic Research of the Office of Advocacy of the U.S. Small Business Administration was particularly helpful throughout the project as the Contracting Officer’s Technical Representative. He was a pleasure to work with, and made significant contributions to our efforts. Gregory J. Dean, Jr. Assistant Chief Counsel, Office of Advocacy, U.S. Small Business Administration was also very helpful regarding regulatory and legal matters. Any errors of omission or commission, and the conclusions and recommendations are solely those of the authors.
VI. Government Support of Small Business Finance .............................................................. 57

VII. Managerial and Policy Questions ..................................................................................... 65

A. Managerial Questions ........................................................................................................... 65
   1. Marketing Strategies ........................................................................................................... 65
   2. Organizational Structures ................................................................................................. 67
      a. How Are Customers Served Well? ................................................................................ 68
      b. How Are Costs Controlled and Volume Achieved? .................................................... 69
      c. Who Approves Credit and What Information is Used in the Process? ......................... 70
      d. What is the Role of the Branch System? ....................................................................... 71
      e. Where Does Small Business Fit in the Organization .................................................... 72
   3. Competition ....................................................................................................................... 73
      a. Non-bank Institutions .................................................................................................... 73
      b. Small Banks .................................................................................................................. 76
      c. Other Large Banks ......................................................................................................... 81

B. Policy Issues ......................................................................................................................... 82
   1. Supervisory Treatment of Small Business Banking Activities ........................................ 82
   2. Regulatory Burdens ......................................................................................................... 84
   3. Regulatory Restrictions on Banking ................................................................................. 87
      a. Branching ...................................................................................................................... 87
      b. Powers ........................................................................................................................... 88
      c. Capital Standards ......................................................................................................... 88
      d. Appraisal Standards ...................................................................................................... 89
   4. CRA ................................................................................................................................... 90

VIII. Summary of Recommendations and Conclusions .......................................................... 91

A. Banks................................................................................................................................... 91
B. Policy Makers....................................................................................................................... 92
C. Small Business Administrations ......................................................................................... 94
D. Small Businesses.................................................................................................................. 95

Bibliography
EXECUTIVE SUMMARY

To meet their financial services needs, small businesses depend mostly on commercial banks. Regardless of where the small business is located, banks are nearby to accept deposits, make loans, and offer other essential services. This arrangement has been true for so long that many observers assume there is a basic affinity between small businesses and small banks or certain branches of larger banks.

This assumption is under stress, however. The banking industry has been undergoing rapid, fundamental, and irreversible changes. Currents of uncertainty and confusion run through these changes. Many small banks and branches of larger banks are disappearing, as the banking industry consolidates. At the same time, different names are appearing on the banks and branches that remain, and non-bank competitors are becoming more important.

Because of the breadth and pace of these changes, the U.S. Small Business Administration (SBA) wanted to improve its understanding of how large banks are approaching the small business market. It engaged Dr. P. Michael Laub and S&FA to conduct this study, which is a critical part of that effort.

Key Findings

Our research indicates that large banks believe there are attractive profit opportunities in the small business market. As we will discuss more fully, for large banks:

- Small business is a key market;
- Reducing costs and improving customer service are critical to serving this market profitably;
- Establishing a solid relationship with small business customers is the objective; and
- Policymakers who are in tune with this large segment of financial services providers can help small business.
Small Business is a Key Market

Small business is a key market for large banks. Data from the 1989 National Survey of Small Business Finance indicates that neither large nor small banks dominate lending to small businesses. Other studies, such as a recent one by the Dallas Federal Reserve Bank, indicate that both large and small banks are active players in the small business market. The large banks participating in this study provide specific examples. In order to become more competitive, all of the 13 participating banks are in the process of reorganizing the way they address the small business market. These reorganizations are being driven by the need to reduce costs, focus effort, or add resources to this market segment.

These reorganizations stem from a shift in perspective. Formerly, large banks compared small businesses with large corporate customers and concluded that small business customers were relatively less profitable and more risky to serve. The new perspective focuses on the similarities between small business banking and consumer banking. Like consumers, small businesses are now being perceived as customers who need a wide range of services, all of which provide an opportunity for ongoing revenue and profit. Demand deposits are the most important of these products. Loans to small businesses are familiar financial services, not complicated examples of financial intermediation. A portfolio of small business loans yields steady profit and relatively little risk.

Strategy: Reduce Costs and Increase Customer Service

Historically, the role of lending officers was to identify prospects and develop them into a portfolio of borrowing small business customers. In order to do this, these lending officers had to understand the customers' businesses, as well as maintain expertise in credit analysis. These lending officers, in concert with loan committees, would determine whether to make a loan. Then, they would monitor the borrower's use of the loan proceeds and its progress toward repayment. Meanwhile, they would handle the other incidental needs of the business customer as well. Only the most routine services would be handled in the branch without the
lending officer’s knowledge. As a consequence, these lending officers could handle only a relatively small number of customers, and the logical way to earn the most money was to make the loans in their portfolio larger. This tendency kept the focus on businesses at the high end of the small business category or on middle-market or large corporations.

The first part of the new strategy being adopted by banks is to reduce the cost of doing business. Banks are able to price loans high enough to cover risk, but competitive pressure will not allow aggressive pricing of loans or other services. Profit margins thus depend heavily on reducing costs. The most important way in which leading large banks are attempting to reduce costs is to unbundle the traditional functions of the bankers who serve small business customers.

**Centralize Credit Analysis and Administration:** To implement this strategy, many of the participating banks are attempting to centralize their credit analysis and administrative expertise in the hands of relatively few people. Sophisticated technologies enable bankers to quickly obtain all of the information from small business customers that is collected in the branches or by relationship managers, as well as through discussions directly with customers. People in credit analyses and administration are not expected to market or sell the bank’s services. They are expected to make consistently sound decisions on loans to small business customers and to do it in a timely manner.

**Improve Customer Service:** The next part of the unbundling effort is to concentrate pro-active customer service responsibility in the hands of other bankers. It means creating a decentralized group of relationship managers who will have direct, regular contact with customers. These people might be former branch managers or former loan officers. They will be responsible for identifying prospects, developing them into customers, and ensuring that they continue to be satisfied. These bankers will be knowledgeable about the small business customer’s needs and how the bank’s products and services meet those needs.
**New Process Model:** This is the new model for large bank banking in the small business market. Specialists in credit analysis and administration concentrate on these two activities. Relationship managers are sales-oriented and concentrate on understanding and meeting their customers' needs. Both sides must work together to serve customers. This is true in the loan situation, but it is also true with those who specialize in cash management, trust services, and other specific product areas. The relationship manager will have considerable authority to make decisions about an individual customer. All of the banks using this model have left room for the judgment of the banker who meets face-to-face with a customer. Whether the banker's concern is the perceived potential in a customer relationship, the current value of that relationship, or competition, the relationship manager has the opportunity to lower prices on loans or set other favorable terms for the customer in order to win the business.

Through this strategy, large banks are creating a new process model for the small business market. It is designed to enable large banks to leverage their investments in technology; to lower costs by standardizing the more repetitive aspects of small business lending; and to enhance customer service through focused relationship managers.

**Relationship Banking**

It is not new for banks to strive for relationships with their customers. What is new is the heart of that relationship. There are many reasons for this view:

- The most commonly used product is the business checking account.

- The number of small business customer who are actually borrowing at any one point is small. Among the companies we interviewed, it ranged from 4-to-45 percent.

- More sources of credit are more widely available today. Examples include equipment suppliers, credit cards, etc. Securitization of small business loans has the potential to bring new players to the market.
Small business customers want to secure the access they have to credit, and they do it through banking relationships grounded with business checking accounts first and other products later.

Banks are better positioned to charge fees for cash management, payroll processing, retirement plans, etc.

A well-satisfied customer, obtaining this core service from the bank has the potential to stay with the bank for many years. Relationship managers focus on customer service and expand the bank's relationship from this core to other products. Expanding the relationship depends on adding value to it. This is accomplished by understanding customer needs and meeting those needs with additional products or services. In many cases, this value lies in communicating that credit is available and in providing greater convenience in the provisions of services and more information about those services.

Relationship banking is a critical goal for large banks. If they do not find effective ways to deliver added value to their small business customers through relationships, their products and services will become commodities, customers will skip from one financial institution to another, and profit margins will collapse. If banks do succeed in adding value through relationships, they should be able to secure their competitive position.

**Policymakers’ Opportunities**

To the degree that they are successful in this effort, the banking industry will be stronger and small businesses will continue to have this choice in the range of financial services available to them. Both of these outcomes are positive. Although starting from different perspectives, these outcomes have been encouraged by past regulatory and economic policies.
There are a number of ways in which policymakers can help large banks assist small businesses succeed in the future:

- The complex structure of the regulatory burden placed on banks should be studied to find ways in which this burden can be relieved and to lessen the consequential detrimental effects on small businesses;

- Regulators should focus on the risk of the bank’s small business loan portfolio, not individual loans to small businesses;

- Restrictions on branching across state lines should be eliminated in order to lower bank costs and encourage geographic diversity;

- Appraisal standards that were tightened under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) should be loosened;

- The "best practices" of the SBA regional and district offices concerning outreach in the community, should be identified and replicated throughout the country;

- SBA's interface with large, multi-area banks should be made more uniform; and

- Cooperative, community outreach opportunities between large banks and the SBA should be identified and pursued.
I. INTRODUCTION

Small businesses and banks depend on one another for much of their success. Small businesses rely on banks to provide efficient depository and check processing services. When they need money, small businesses look to banks as a source of loans. Banks are also one of the financial services providers that can help small businesses establish retirement plans, manage payroll, and meet other daily needs.

Banks, on the other hand, need small business customers because they offer significant profit potential and because small businesses tend to be steady, high-volume users of their branch system. Furthermore, banks are oriented, by their history and by current regulatory policy, toward the communities in which they have offices. Small businesses represent a critically important stabilizing influence in a community.

These mutual needs create an important relationship between small businesses and banks. However, this relationship has been buffeted by market and regulatory forces in the past. We expect this buffeting to continue in the future. On the plus side, small business has been credited with creating most of the new jobs in the economy over the last decade, while it is supplanting the family farm as a symbol of the American ideal. Small business has taken on an aura which is attracting the attention of academicians, policymakers at all levels of government, and, perhaps most importantly, companies that want to compete for their business. But small business is also affected by globalization of the economy, by recession, and by technology in ways that are often threatening. Small business must adapt more quickly than larger companies because it does not have the resources to wait out many trends.

The banking industry has also been changing rapidly. During the 1980s, the industry changed fundamentally when state governments began to permit interstate banking. Today, virtually every major metropolitan area is served by banks controlled by bank holding companies from outside the area. These banking organizations have another perspective, which in the best
cases, complement their community perspective. This new perspective is driven by a senior management with responsibility for multiple banks in many different small business markets.

In addition, banks' competitive boundaries are changing. As large banking organizations are forming they are bringing more sophisticated competition to many markets. This, in turn, is causing smaller banks to sharpen the focus of their strategies. Non-bank competitors are also developing ways to penetrate the small business market for financial services. In a sense, large banks are on the middle ground. Small independent banks emphasize their single community ties and focus on a niche where they can be strong competitors. Non-bank competitors, who have more tenuous community ties, concentrate on niches where the profit opportunities are high and community orientation is much less important to customers.

Despite their different situations, it is important to realize that large banks, small banks, and non-banks all are facing many of the same problems. Competition is increasing. The costs are high and must be reduced to remain competitive. The small business market is growing at a time when many of the other markets are shrinking. They all have the small business market in view, and want to cultivate it.

In the face of this change, it is important for advocates and other interested parties to understand how large banks relate to small businesses. The SBA commissioned Dr. P. Michael Laub and S&FA to conduct this research project to ensure that it would gain this understanding.

Our efforts were designed to look at seven major questions concerning large bank's business approaches to small businesses. These questions and our summary answers to them are stated below:

- How are small business needs perceived by banks? In other words, do the financial services small businesses need form a sufficiently large market with adequate profit potential? As we will discuss throughout this report, the answer is clearly "yes";
- How are large banks organized to meet those needs? Banks are restructuring their organizations so that they can serve this market more efficiently. New approaches are being developed, approaches that use technology to help centralize decision-making and view employees who spend time with the small business customer as the manager and developer of a multi-faceted financial services relationship;

- How do banks market their services to small business? These relationship managers are interested in cross-selling products to customers so that they build the relationship. They are also even more focused than their predecessors on cultivating accountants, lawyers, and other sources of referrals. In addition, banks have developed computer linkages to small business customers, giving small business managers not only more opportunity to manage their bank finances, but also tying that customer more closely to the bank;

- How do banks deliver those services? The branch system is still critical to the small business customer because the branch handles the constant stream of the routine cash and check processing requirements of the small business. Credit products are being "sold" by relationship managers or branch managers, but the decision-making is moving to centralized, volume-oriented centers of activity;

- What do banks expect to gain from meeting those needs? Profits. Banks are being driven toward the small business market for two reasons, both stemming from profits. The first is that costs must be reduced in order to achieve the full profit potential. Reorganization and changes in delivery systems result from trying to reduce the costs of serving this market. The second is that good margins remain in the small business market, margins that are as attractive as those of middle-market and corporate lending in past years. Banks want to hold on to this market;

- How do different types of banking institutions answer these questions? Banks that are in the most competitive markets tend to be further along in reorganizing for efficiency. To reorganize, these banks are using technology, and centralizing credit analysis and underwriting. Likewise, these banks also tend to think more about their sales force, people whose primary responsibility is to sell products to small business customers. These banks have a high level of commitment to the small business market and its profit potential;
- How is the rapid evolution of the financial services industry affecting approaches to the small business market? The industry's evolution is both a reaction to competition and is being driven by it. Competition is coming from outside the banking segment but it is also intense among banks. Competition has brought tremendous change in deposit services, with mutual funds capturing a huge share of the market, and it has brought equally significant changes in other areas. Much of this competition is the result of technological change. The cost of obtaining and processing financial information has declined. Small banks can purchase services and resell them to customers who formerly could only obtain them from large banks. Non-banks can offer products very similar to those offered by banks. Compared to the evolution in middle market and corporate lending, for example, the small business market is just beginning to see the influence of this competition. It is early and, thus far, much of it has proceeded without great notice. The resulting changes in organization, delivery, and marketing that we will discuss in this report, are critically important. The banks must succeed with them, or their share of the small business market will decline as surely as it has in other markets; and

- What are the policy implications of the answers to these questions? Viewed narrowly, the answers to these questions simply describe many of the ways in which large banks and small businesses relate to each other. More important, however, is what these answers suggest to bank management, small business advocates, and small business owners. It is clear that these answers suggest changes in the way large banks' small business efforts will be managed and how small business advocates must interact with large banks.

The brief answers to these questions provided here are fully developed in our report. These issues permeate our discussion of small business banking in the future, the evidence for a model of small business banking, and what this model means for bank management and policymakers interested in small business.

We have provided a clear picture of how large banks see the small business market and are organizing themselves for competitive advantage in that market. For small business advocates, the answers to these questions -- this report -- will be a way to measure how well they themselves are organized or positioned to work with banks in support of small business. Indeed, in
our recommendations, we indicate ways in which the SBA should adjust to increase its compatibility with the large banking organizations that have such a large share of this market.

II. BACKGROUND

Lending money has been a relatively straightforward business. Banks, for example, have provided depositors with safe, liquid instruments in which to invest, and have lent depositors' funds to borrowers under an agreement that the bank would profit through the interest repaid. In the process, banks assumed the credit risk inherent in lending. Over the past half dozen years, substantial changes have occurred in the business environment, and the business of lending -- particularly to small businesses -- has been altered in fundamental ways. Changes in technology, regulations and the nature of small businesses have had an impact on the way in which profits are made and credit risks are determined.

Banks, particularly large banks, are both agents and victims of the changing business environment. Over the past five or six years, many large banks have changed the way they view the small business market and have developed business strategies, and practices to capitalize on newly perceived opportunities.

In this section of our report, we summarize these emerging strategies and practices regarding small businesses. We also discuss the implications for government policies. Policymakers consider small businesses to be very important to the long-term health of the entire economy because of their role as a source of jobs and innovation. Government policies and programs for stimulating the growth of this sector should incorporate an understanding of how this important component of the banking industry views small businesses.
A. Legislative and Regulatory Changes

The 1989 enactment of FIRREA was the major legislative event affecting banking practice in the past five years. The requirements of FIRREA, and regulator's interpretation of the requirements, has brought about many changes in bank activity.

Throughout our interviews, three themes dominated the discussions of changes in laws and regulation. First, recent changes in regulation impose administrative costs on banks which have the effect of discouraging small business lending and of increasing the costs small businesses must incur in acquiring bank services. Second, non-banks can provide many of the financial services needs of small businesses but do not incur the costs of complying with the bank regulations, putting banks at a competitive disadvantage, particularly for the "best" small businesses. Third, there is a growing disparity between the way regulators and large banks judge the credit risk of small business loans. Regulators examine and evaluate individual loans. Large banks, on the other hand, evaluate credit risk on the basis of the performance of a portfolio consisting of hundreds or thousands of individual loans.

- Regulations impose costs on banks and small businesses

Large banks make the argument that many of the regulations of the past several years have been adopted without an appreciation for the unique nature of small business lending or the costs imposed on small business in complying with the regulations. Small businesses are particularly hurt by the requirements for property appraisals and environmental surveys because many loans are secured by real estate.

In addition, banks incur administrative costs to establish and maintain loan documentation files and processes to satisfy very detailed regulations. For example, banks must maintain records documenting that the appropriate financial statements were obtained from the borrower and that the financial documents were reviewed as part of the process of approving the credit. These requirements impose costs on the banks making
loans, but they also impose a "cost" on small businesses. These regulations can have the effect of discouraging loans that do not comply exactly with quantitative formula. For example, a banker may have second thoughts about approving a loan where the loan-to-value ratio is not within the accepted range, even when the borrower has an excellent profit record.

- Regulations put banks at a competitive disadvantage

One of the major changes in the market over the past half dozen years has been the entry of many non-bank competitors such as leasing companies, investment bankers, and specialized finance companies such as GE Capital, which are not as heavily regulated as banks. These competitors are comparatively free to build a business among small companies. Hence, regulations increasingly put banks at a competitive disadvantage relative to non-bank competitors.

Some large banks feel that the regulations, and the way in which they are applied, also put them at a competitive disadvantage with regard to small banks. For example, small banks may not enforce requirements for property appraisals with the same intensity as large banks.

The federal Community Reinvestment Act (CRA) has also had an impact on the way in which banks view and deal with small businesses. Although CRA is not new, the requirements have received increased attention from regulators, boards of directors, and senior bank officials in the past five or six years. Banks are required to take steps to determine and help meet the credit needs of the communities they serve. Banks argue that the CRA requirements put them at a competitive disadvantage with non-banks because they must bear the cost of developing and keeping documentation of their efforts to identify and meet community credit needs. In addition, banks must bear the costs of regular examinations in which their CRA programs are reviewed.
• Competition among banks has intensified

Until the early to mid 1980s, one policy thrust of the strategy of federal and state banking laws was to promote safety and soundness of the banks by limiting or controlling competition among them. State branching laws were often designed to protect the market within which each bank operated. State laws also prohibited or restricted local banks from out-of-state competition.

Since the mid 1980s, states have gradually eliminated state restrictions on branch locations and on interstate banking through the multi-bank holding company mechanism. While full, nationwide interstate banking is still prohibited by federal law, large bank holding companies compete against each other and against local banks in most urban markets throughout the country. One impact of this competition has been to intensify the search for "under served" segments of the economy such as small businesses and to force multi-bank holding companies to search for profitable ways of meeting the needs of these segments.

Many states have also gradually embraced an alternative regulatory concept of encouraging competition among banks as a mechanism to broaden services to bank customers including small businesses.

The increased competition within the banking industry has had a dual impact on large banks. On the one hand, large banks have been expanding into market areas from which they had been excluded thus bringing sophisticated financial services such as export financing and aggressive cash management services within the reach of many small businesses. On the other hand, large banks find themselves in the position of having to defend their existing markets against competition from other large banks. As a consequence, many large banks find it is necessary to offer broader services targeted to the needs of small businesses or risk loosing those businesses as clients to aggressive competition.
B. The Changing Marketplace

Even if FIRREA and the associated regulatory changes had not been enacted, banking practice in 1993 would have been vastly different than it was in 1985. The marketplace within which banks and small businesses operate has changed significantly. These changes in combination with the legislative and regulatory changes have prompted large banks to develop business strategies regarding small businesses, the implications of which are only beginning to be appreciated.

The changes in the marketplace that have had the biggest impact on the ways in which banks relate to small businesses can be organized into four major categories: technology, competition, marketing, and profits.

- Technology

Over the past five or six years, the cost of computing power has dropped to the point that it is readily available to individuals throughout a bank. At the same time, software has made it easy for the non-technical person to use the computer power that is available. One impact of this availability of hardware and software has been to allow bankers to easily aggregate and use large amounts of data. For small business banking, the net effect has been to make it feasible to aggregate data on a large number of individual loans to determine the characteristics and observe the performance of a portfolio consisting of hundreds or thousands of small business loans.

A related impact of the easy availability of computer power is that bankers can aggregate data on the transactions, costs, and fees for all of the accounts associated with an individual client. In other words, it is feasible to quantify and track over time the risks, costs, and profits associated with an entire relationship.
Competition

The second major category of change in the marketplace that has affected the way in which banks do business with small businesses is the entrance of many non-bank competitors. These non-bank competitors compound competition among the banks. Most large banks consider small community banks their most difficult competitors today, but they also face strong, if familiar competition from their industry peers. Until recently, banks had a virtual monopoly on providing financial products and services to small businesses by virtue of a network of branches, a distribution system that ensured proximity to businesses. In addition, the profits from dealing with small businesses were thought to be very thin. Investment bankers and others saw little or no incentive for trying to attract small businesses.

The same technological innovations that have prompted some large banks to view small businesses as an important source of profit have facilitated the efforts of non-banks to compete in the small business market. Moreover, as bankers are quick to point out, non-banks can offer small businesses services without incurring the costs of complying with the federal and state regulations governing banks.

The ultimate impact of competition from non-banks on small business banking, however, is unclear and a matter of intense interest and speculation among bankers. With some notable exceptions, it is generally true that banks and non-banks have adopted opposite strategies in pursuit of profits from small businesses. In general, the strategy of most large banks is to provide a wide range of services to small businesses and owners. On the other hand, the strategy pursued by most non-banks is to efficiently provide a very limited set of products and services. It is not obvious that one strategy or the other is the best way to approach the small business market. The most likely outcome is that a healthy competition between banks and non-banks will ensue. Those small businesses that are particularly concerned about relationship banking will deal with
banks. Those who wish to invest the time and effort shopping for the best deal on individual services, will deal with non-banks.

It is too early to determine how the increased competition will affect the banking industry or the availability of credit for small businesses. The only certainty is that large banks believe that the competition for this business is now, and will continue to be, intense. Bank strategies will be shaped by bank perceptions of the strategies and strengths of non-bank competitors. In addition, bankers believe that their success or failure to profit from small businesses is dependent not only on their business strategies but also on regulations under which they operate and under which their competitors operate.

- Marketing and Advertising

Over the years, banks have not earned a reputation for innovative marketing and advertising. However, as a direct result of the changes in technology and increased competition, large banks are developing marketing and advertising plans targeted to small businesses.

There are several issues associated with increased bank marketing. First, large banks are finding it necessary to conduct basic research on the small business market. Some banks are developing detailed data bases on the characteristics of small businesses within their market area. By combining data from their own records with publicly available records, original research, and surveys, large banks are beginning to build the capacity to prepare detailed profiles of the components of the small business sector of the economy.

The interest in marketing to the small businesses sector is stimulating the creation of products and services specific to the needs of small businesses.
Large banks are experimenting with different marketing techniques to reach business owners in a cost-effective manner. Some banks are adopting mass marketing techniques, including advertisements on radio and in newspapers and regional publications. Mass mailings are also used, although large banks generally use sophisticated mailing techniques to "personalize" the mailing.

Some banks are aggressively building partnerships with community groups to assist in marketing products and services to small businesses. CRA considerations are part of the motivation for banks to work with community groups in this way, but banks are finding that this approach can be effective in locating small growing businesses that otherwise would escape the attention of the bank.

C. Small Business Environment

While large banks are responding to the forces of change wrought by regulation, technology, competition, marketing, and profits, the entire small business environment is also changing in fundamental ways. Three important changes are: 1) the diversity of the small business market is increasing; 2) service and related businesses with relatively small amounts of capital are the most rapidly growing segment of the small business sector; and 3) some businesses are beginning to view financial services as a commodity. We address each of these changes below.

- The business environment reflects society’s cultural diversity

The small business component is the most culturally diverse sector of the economy, reflecting the cultural diversity of the society as a whole. While most pronounced in urban areas, this diversity is found throughout the country.

For several reasons, this diversity has an impact on banks’ small business strategies and programs. In some cases the line of business is so specific and unique to a culture that it is difficult for a banker from a different culture to understand and assess the financial
viability and stability of a business. At the same time, business owners may have a preference for banking with an institution that shares the owner's culture.

Many banks serving large markets are struggling with the task of developing strategies to sell products in a small business market that represents many diverse cultures.

- Many small businesses do not have substantial assets

The largest components of the small business sector are service and retail. Collectively these two categories account for approximately 56 percent of the establishments with nine or fewer employees. Manufacturing accounts for approximately 4 percent of the firms with nine or fewer employees. Typically, the important assets of service and retail businesses are intangibles such as reputation, employees, expertise, and experience. The assets pledged as collateral for a loan are the personal assets of the borrower, such as his or her residence.

Typically, banks making loans in this market base credit decisions on anticipated cash flow. However, it is common practice to take a lien on the residence and other significant assets of the borrower. One requirement of FIRREA is that lenders obtain a professional appraisal of all real estate pledged as collateral. Small business loans are not exempted from the requirement despite the fact that the transactions are not real estate transactions and repayment is not based upon the value of the property. Obtaining a professional appraisal adds time and expense to the loan approval process.

As a result, banks are responding to the requirements in two counterproductive ways. In some instances banks are choosing not to take real estate as collateral, thereby increasing the risk of loss to the bank in case of default. In other cases banks are not making loans that they would otherwise make. This has the effect of reducing the amount of credit available to service and retail sectors.
Small businesses view financial services as a commodity

Some bankers are worried about the long-term implications of a trend they see among healthy small businesses to view financial products and services as a commodity. One key to the profitability of the small business market for large banks is the ability to establish a long-term multi-product relationship. To the extent that the owners of small businesses see financial services and products as a commodity to be shopped for and priced, the bank's strategy becomes progressively more difficult to accomplish.

Many small businesses continue to embrace the traditional approach of establishing a relationship with a bank -- often based upon the proximity of a branch -- and staying with the same institution for all of its financial needs through the life of the business. However, for several reasons, many small businesses are abandoning this approach.

During the late 1980s, many small businesses saw "their" bank acquired by another institution, and long standing relationships disrupted. Some healthy small businesses saw "their" bank call loans or renegotiate loan terms because of problems in the economy unrelated to the business. Some small businesses that felt they had built a partnership with "their" bank saw the bank abandon the partnership. These factors combined with aggressive advertising by banks and non-banks for the business of small businesses have had an impact.

Some small businesses have determined that it is in their best interest to maintain an ongoing relationship with several financial institutions. In this environment, the businesses feel that it is important to shop for all financial products and services, and one of the key distinguishing features among institutions is price.
We anticipate that this study will provide surprising and useful insights to several groups. Federal, state, and local governments administer a plethora of programs designed to stimulate and encourage the growth of small businesses. These programs are based upon a number of implicit assumptions about the ways in which banks, particularly large banks, relate to small businesses and the conditions under which banks deliver services to this market segment. Many of these assumptions have not been tested against bank operating procedures in a number of years. As this section makes clear, the banking operations in 1993 are vastly different than several years ago. The changes are particularly dramatic for large banks. Federal, state, and local programs can benefit from fresh insights into the ways in which changes in the regulations, laws, technology, and competition have altered the working relationships between large banks and small businesses.

III. METHODOLOGY

The objective of this project was to compile and analyze information describing the way in which large banks relate to small businesses in light of the numerous and far-reaching changes in regulations, technology, and competition. In conducting the study, our research methodology has combined traditional data and literature review with extensive personal interviews with individuals responsible for various aspects of the small business programs of 13 large banks across the country. Our research methodology consisted of four processes.

1. The basic question to be addressed through this project is: "How do the economic, structural, and marketing trends influencing the banking industry affect lending to small businesses by large banks, and what do they suggest for small business lending during the balance of the decade?" The first step was to identify relevant literature and organize it in ways that address the problem statement.

2. The second step was to identify data relevant to the project and to organize it in ways which shed light on the research question.
3. The third step was to reach agreement with 13 large banks across the country to allow us to interview a range of people in the bank responsible for all aspects of the bank's small business program.

4. The fourth step was to conduct detailed, in-person interviews with individuals in 13 different large banks. The interview process took approximately two days on site. All together over 50 separate interviews were conducted.

In each institution we spoke with individuals including those responsible for overall direction and policies of the small business program, small business marketing specialists, loan officers, branch officers, and specialists in government lending programs. The individuals and the institutions were extraordinarily generous with their time and forthcoming with information. Through these interviews we were able to assemble detailed pictures of the strategies, objectives, and operating procedures of each institution regarding small business lending. We were also able to gather insights into the evolution of the perception of the bank towards small businesses.

While this methodology has certain limitations, it also has several definite advantages. The limitations are that the research design does not include a scientifically designed survey. Thus, we cannot make quantitative projections from the sample of banks interviewed to the population as a whole. However, the intense two- to three-day interview process we undertook at 13 large banks enabled us to explore issues of organizational structure, marketing, and strategies that never could be investigated in as much detail with a survey instrument. Many of the conclusions reached from these interviews are qualitative in nature, but they are revealing in terms of what they say about how large banks are approaching the small business market, and what they expect to gain from being involved in that market.

The 13 banking companies we interviewed ranged in size from as low as $4 billion in assets to $100 billion. They were spread throughout the United States from California to New England to the Southeast. We believe they are very representative of how most large banks approach
the small business market. The only type of large bank not included in our sample was the large money center, wholesale bank that does not deal with small businesses. The number of these banks is quite small, and they are all located in a few urban markets that also have several large banks that are actively engaged in the small business market.

However, this report should not be confused with a survey. The people interviewed do not represent a statistically valid sample of small business lenders. Individuals were asked different questions. The discussions have not been quantified and aggregated. This report is the distillation of over fifty separate conversations with thoughtful people who have knowledge and experience with a complex topic.

We do believe that the combination of the four steps described above has provided us with a unique and detailed perspective of how large banks currently view the business of small business banking. Through this report we have synthesized the data and information to present the reader with an understanding of this important aspect of banking in today's environment.
IV. THE FUTURE ROLE OF LARGE BANKS IN SMALL BUSINESS BANKING

The small business market is attractive to large banks today, and it is likely to remain attractive for the foreseeable future. This market is attractive in part because banks' perception of risk in small business loans is changing. The primary reason this market is attractive, however, is that it holds substantial profit potential. Banks are able to make good profits in this market. More importantly, they recognize that in order to keep making those profits over the long term, they need to lower costs and improve customer relationships.

At the same time, banking is changing greatly. The industry is consolidating. Large, multi-state bank holding companies are blanketing the country, with one or more competing in virtually every state. Governments, customers, and others who think of banks as independent enterprises covering a small geographic area and facing minimal competition have not noticed the changes and are being left behind as the pace of change increases. The banks themselves are struggling to lead or keep up with the changes.

From all of this, a new model for small business banking is emerging. The banks we interviewed are developing this model. It represents an effort to lead the change and strengthen bank profitability. But it also represents a growing customer focus, a recognition that bank markets have changed in fundamental ways and forever.

Small businesses and small business advocates need to appreciate these changes and stay in step with the industry. In the following pages, we review some of the key areas of changing perception and action by large banks.

A. Risk of Small Business Loans

Large banks have two views on the risk in small business loans. The first is that each of these loans carries relatively high risk. The first set of reasons for this view relates to management. Small businesses tend to be managed by people whose business experience is limited and who
are relatively unsophisticated about managing business finances. This deficiency frequently leads to inadequate business plans, undercapitalization at start-up, inefficient use of working capital, and other common problems during the life of the enterprise. In addition, the managers’ expertise is often concentrated in a narrow technical area. The best doctor, mason, or automobile mechanic is not guaranteed to have even average aptitude for business planning or marketing, two skills that are critical to business success. Similarly, since many small businesses are young, by definition, their managers have not encountered many different economic conditions during their lives. Each upturn, flat period, or downturn in the economy presents challenges of first impression. This inexperience can lead to mistakes, and these mistakes put the bank’s asset -- i.e., the loan -- at risk. Nevertheless, however questionable the small business’ management might appear to be, the serious illness or death of the owner or a key manager could also mean the rapid demise of the business’ prospects. This high dependence on the individual rather than the enterprise also suggests that the asset is at higher risk.

The second area of risk concerns the size of small businesses. Small businesses are more susceptible to adverse market influences than larger businesses. Many small businesses depend on a narrow customer base, which could be rapidly eroded by new competition or a severe change in the ability of customers to purchase goods, such as a plant closing causing immediate unemployment or an end to supplier relationships. Small businesses often do not have the time or other resources to weather these adverse conditions. At the same time, small businesses are severely challenged if there is a dramatic increase in demand for their product or service. By building up for explosive, unsustainable growth, without realizing it a business can develop a cost structure that will produce substantial stress later. Small businesses also face this challenge without the ballast or buoyancy of larger organizations.

Of course, these are long-held perceptions of small business. In one sense, the growth in the number of small businesses during recent years has merely produced more examples of these challenges. As the economy grows and more small businesses are formed, even more of these examples will become apparent. Large banks have and will continue to view each small business loan as carrying more risk than many other types of credit they can extend. Large corpo-
rations, local governments, and home mortgagors are examples of customers who are perceived to present less loan-by-loan risk than small businesses.

The second view large banks hold of small businesses, however, is that a portfolio of small business loans has relatively low risk. Large banks perceive small businesses to be an attractive market and, for some, a market they have not always served effectively. But the way in which large banks think this market should be served is also changing. In the view of a growing number of large banks, the business of lending to small businesses is moving from being perceived as comparable with that of middle market businesses (e.g., those with sales of $10 million to $250 million) and major corporations (i.e., more than $250 million in sales) to being more clearly aligned with consumer lending.

The key factor in this shift is the size of the loans being made. Some banks have established business units that focus solely on making small business loans under a maximum size limit. A typical limit might be $250,000. The rationale is that if a few small business loans turn sour, they will have a relatively minor impact on the bank's performance, much the same as consumer loans. By extension, if more of these loans are in the portfolio, any one loan will have less of an impact on the bank. Therefore, in part due to this perception of the risk in small business loans, large banks are interested now in growing their small business portfolios.

The fact that small business loans have, on average, a higher rate of loss than large business loans does not mean that a portfolio of such loans has a higher risk than a portfolio of large business loans. Through proper pricing, banks can assure themselves that, on average, they will receive adequate compensation for the greater expected degree of loss. A portfolio of small business loans is perceived to have less risk than a portfolio of large business loans of the same size. This is because, to the extent that the loans in the portfolio have returns that are independent of each other, the variance of the returns on the small business loan portfolio will be less than that of the variance of the returns on the large business loan portfolio.
B. Gross Returns on Small Business Loans

This strategic shift away from the focus on loans to a focus on portfolios is an integral part of the effort to increase the return on small business lending. There are a number of other parts as well, not the least of which is loan pricing.

Large banks continue to price loans on a loan-by-loan basis, and many large banks have developed pricing models to assist them. These models combine a risk factor that is determined by the underwriter with data on the size and terms of the loans, compensating demand deposit balances, and other fee-generating services the small business customer has with, or is bringing to its relationship with the bank. In some models, the output is a comparison between individual pricing for the particular small business' loan and a profitability target or hurdle rate established by the bank. Lending officers are supposed to price the loan at or above this target rate.

In reality, however, banks often deviate from this rate. How much deviation is a subjective decision by the lending officer and others at the bank. Under several circumstances, the price of the loan can be lowered. Examples include:

- if the potential for substantial profit from deposits or other facets of the customer relationship is perceived to be high;

- if there is competition for the customer relationship; and

- if the rate of return on the portfolio of small business loans exceeds its target rate.

Usually, a second loan officer or a more senior lender must concur with the deviation, since a balance is being struck between forgoing revenue and winning new business or keeping a good customer. This competitive influence has been somewhat stronger during the last two years, because loan demand has been low. Although there are some signs that demand is strengthen-
ing, which could ease the pressure to hold down loan pricing, the long-term prospects are for more competition in small business lending. These deviations from the pricing models are indications of large banks' effort to market relationship banking to small business customers.

Banks are also working to improve profits from small business lending by lowering their costs. A number of large banks have established centralized, small business loan processing facilities, where they house credit analysts, underwriters, and servicing support, and where they manage loans from all parts of their geographic market. This part of the model, which we will discuss later in more detail, is designed to minimize the cost of managing a large portfolio of small business loans. By doing so, banks can increase their margins on each small business loan they are making.

As this model is developing, what are banks charging customers for small business loans? The market rate varies, of course, but in our interviews the rate was as high as three to four points over prime and as low as one point over prime. As one gets into the range of larger small businesses and middle market companies, the spread between the cost of funds and the rate charged tends to decline.

We did not conduct a survey to determine small business loan pricing, but generally we found that the higher rates applied in the older, more populated and industrial markets. For banks in the southern half of the United States, the rate tended to be at the low end of this range. This is probably due to a higher cost structure for banks in the Northeast and far West. Salaries and other direct costs for these banks are higher. In addition, some of the cost differential is due to actual or perceived regulatory burdens. For example, banks are understandably concerned about liability for unknown environmental hazards that might exist on the small business' property. Because of its industrial heritage, the risk of this kind of liability is perceived to be greater in the Northeast and far West than in the South, Midwest, or Southwest. Banks want to cover their exposure to this risk, and they do it in part by requiring the small business borrower to pay more.
Loan pricing is designed to provide revenue and profit for the bank. The standard for large banks is approximately 15 percent to 18 percent return on assets (ROA). In terms of their lines of business, credit cards provide among the highest ROA and corporate banking among the lowest. For each bank, small business lending tends to be in the middle of this spectrum. A critical issue, then, is what other businesses a bank is in or is likely to enter. If, for example, the bank has a relatively small credit card portfolio, it might need small business to provide a larger part of its profitability.

In sum, the large banks we interviewed find the small business market to be profitable, to be attractive, and to hold greater potential for the future. Efforts are being made to streamline small business lending functions, to service small business loans more efficiently, and to lower costs in other ways. The motive for these changes is to increase profit. At this stage, large banks are not driven to a large degree by a drive to stave off competitors, but in the minds of some strategists banks should recognize and protect a profitable bank market by serving the market in such a complete way that new entrants will be dissuaded from entering.

C. Non-Credit Related Income from Small Business

As we will see later in this report, the nucleus of the small business banking relationship is the demand deposit, not the loan. Banks' return on deposits is very high today. Deposits yield less than 3 percent for the customer, but the bank can loan them at 2.5 to six times that rate for such things as unpaid credit card balances. Moreover, these deposits tend to be stable during the years when the business is borrowing, when the business thinks it might need to borrow again, and in between, unless there is some dissatisfaction with the relationship or a more enticing offer. At any particular point in time the percentage of small business customers who are borrowing is generally less than 50 percent. As a result, large banks gain most of the profit from their small business relationships from the deposits those businesses keep in the bank.
To get a quantitative picture of the value of deposits we used data from the National Survey of Small Business Finance to determine the ratio of total cash holdings to total loans for different size classes of small businesses. The results are as follows:¹:

<table>
<thead>
<tr>
<th>Asset Size Class</th>
<th>Ratio of Cash Holdings to Total Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>less than $100K</td>
<td>.60</td>
</tr>
<tr>
<td>$100K - $500K</td>
<td>.50</td>
</tr>
<tr>
<td>$500K - $1 million</td>
<td>.41</td>
</tr>
<tr>
<td>$1 million - $5 million</td>
<td>.34</td>
</tr>
<tr>
<td>$5 million - $15 million</td>
<td>.28</td>
</tr>
<tr>
<td>$15 million - $100 million</td>
<td>.13</td>
</tr>
</tbody>
</table>

This data clearly indicates that the smaller the business, the greater the amount of cash -- i.e., deposits -- relative to the amount of money lent to businesses in that size class.

Cash management services are a source of fee income for the bank, but they are used sparingly except among the largest of small businesses. Cash management services are designed to ensure that a small business customer's cash is used to provide a constant return to the customer. So, for example, a lock box service, through which the customer is certain of receiving expeditious processing of checks paid to it, can be an important service for a small business. At the higher end of the small business size scale deposit accounts are often automatically transferred into other accounts that provide a higher return. In this sense, some cash management services cannibalize deposits, but banks strive to price these services in a way that makes them unattractive to customers unless the gain from using them offsets the fee. In addition, banks try to set the fee so that they are compensated for any cannibalization of the deposits.

¹ We are grateful to Professor George Haynes of Montana State University for doing the calculations.
Large banks want to generate fee income in a number of other ways as well. Providing letters of credit, establishing and managing pension or profit sharing plans, and assisting with export financing are a few examples. The banks' goals are to derive more revenue and profit from each customer but also to build the customer relationship in a way that encourages that customer to continue its financial services business with the bank. The effort to achieve these goals also leads banks, small as well as large, to make home mortgages or student loans to the business owner and key managers. Despite the need to build a broad-based relationship with each small business customer, in practice, old habits tend to make some large banks still focus primarily on business lending.

D. Risk/Reward Ratio for a Portfolio of Small Business Customers

As we have stated, as large banks plan their future in the small business market, they are shifting strategic focus from loans to portfolios of loans. They do so with the following rationale:

1. Despite competitive pressures, they can price each loan to cover their average risk of loss on a loan; and

2. The variability of the returns on a loan portfolio will be less, with a greater number of small loans in a portfolio than with a smaller number of large loans.

The majority emphasize the relatively small size of each loan their banks are making. Their experience with credit analysis, underwriting, and servicing these types of loans tells them that only a manageable percentage will default or become seriously delinquent. By maintaining standards in these areas, the bankers conclude that their banks should be able to operate a larger portfolio of small business loans. Further, by expanding and strengthening the customer relationship, banks should be able to increase the profitability of these loans without a commensurate increase in risk. Large banks, then, believe they can reduce overall risk by creating larger small business loan portfolios and increase the reward by reducing the costs associated with operating those portfolios.
Challenges face the industry, however. The first challenge lies in the apparent conflict between building a portfolio of relatively more standardized loans and maintaining customer relationships. The current small business banking culture marries full service bankers with business owners, which is good for relationship banking but not volume. A centralized arrangement of credit analysts, underwriters, and services is efficient but does not help build relationships. The answer is a sales force that can build and maintain a large number of customer relationships while working closely with credit administrators who are processing credit requests.

The second challenge is product strategy. Even with a sales organization in place, a bank must have the right products and services to sell. Relationship banking is not the same as being all things to all customers. Large banks recognize already that some products, such as equipment leasing, might not be appropriate for their markets or their capacities. Large banks have to find ways to identify the mix of products and services that their small business customers want and that they can profitably supply themselves, and find alternative sources or other ways of handling customer needs on products they cannot supply themselves.

The third major challenge is competition. At some point, competitors could drive down pricing, putting stress on the methods for recognizing and covering risks through credit analysis, underwriting, and servicing. Most of the bankers from the large institutions where we interviewed believe today's competition is due to growth in the small business sector, increased recognition of profit potential for banks in the small business sector, and declining demand for loans in the large corporate sector and, to some extent, the middle market sector. At the current time, competition is being made even more intense by the relatively low demand for credit among small businesses. Further, they view competition as coming mostly from other banks, with community banks being particularly difficult competitors because of their ability to focus on a market niche. Community banks have always been active players in the small business market. To the extent that small business customers want relationships with locally based banks, it will take time and effort to lure customers away from banks with whom they have established relationships. With a few exceptions, non-bank competitors are still perceived to be distant threats.
Large banks believe they can meet these challenges. Whether they are correct will be proven only by their success in small business markets. The banks we interviewed have, to date, been quite successful. The basic strategy they are using is to reduce costs while building customer relationships. The goal of this strategy is to reconcile the conflict between managing a centralized portfolio of loans and relationship-based marketing on the one hand, and to hold off competitors by becoming a lower-cost provider of a broad array of financial services on the other.

E. Efficient Ways of Doing Small Business Banking

The basic model for small business banking in the future is emerging today. It has two core components: (a) Credit Decisions and Administration (CDA); and (b) Marketing and Sales (MS). In terms of CDA, the functions are not new but they are reorganized. The Marketing and Sales function is sufficiently enhanced in that it is emerging as a virtually new activity.

The CDA side of the model should be thought of as a strategic refinement of past approaches. Not all of the banks we interviewed use this model. Most of those that do not use it seem to be moving toward something like it, as they learn about what others are doing. In each case, however, banks are trying to respond to the priorities set by their markets. Those that do use this model seem to think of it as a significant change in the way they are doing business with an important segment of their market.

As in the past, CDA still consists of credit analysis, underwriting, and servicing. These functions have not changed significantly. What has changed is the people who do the job, the scope and objective of the job, and some of the tools available for doing it.

In contrast, Marketing and Sales is new. Large banks used to see their market as a well-defined geographic area in which they competed with a regulator-controlled number of other banks. Increasingly, though, the definition of the geographic area is blurring and control of the number of competitors is fading. In this environment, large banks are working to understand their markets, the segments of those markets, and what their customers want from them.
This model enables large banks to reduce costs and improve customer focus. We can see how by looking at the key characteristics of each part of the model.

In CDA, authority and activity are centralized, staff can be organized by product or functional expertise, and information technology can be used to share information almost instantaneously. CDA occurs in a business loan operations facility that is similar to a consumer loan or credit card processing center. These CDA operations are analogous to manufacturing facilities. These centers receive orders for products (loans), and those loans are produced, priced, and shipped to the customer. Top quality, timeliness, and low cost are critical success factors.

In MS, authority and activity are decentralized; the focus is on the market and the customer. A sophisticated marketing organization for a computer company provides an analogy for where large banks want to be. That kind of company understands that its customers have complicated hardware, software, systems integration, and services needs, and that these needs can be met profitably with a creative mix of competitively priced products and services. Customer
needs have to be understood and met on the customers’ schedule, or the customer will find another provider. Market-driven banks understand that their small business customers’ needs are often difficult to understand and meet with attractive products. Top quality, timeliness, and low cost are also critical success factors here.

If this is the emerging model, how far has it emerged today? From our interviews, it appears that more progress has been made on the CDA side of the model. Business loan operations facilities exist in 4 of the 12 banks who participated in this project, and some of those that have not formally designated such a facility nevertheless are adopting many of the key characteristics of the model.

Progress on the MS side is also being made but, for several reasons, its effects are more difficult to see now. First, some of the banks are attempting to convert their branch network into part of their small business sales force. This is a significant cultural change. These banks are asking branch managers to adopt a sales orientation, to be out with customers more, and to push products and services. Pro-active sales activities are new, and it is taking time for the new culture to take hold. Other banks are attempting to build teams of relationship managers, people who have high customer contact but low product authority and who work outside the branch reporting structure. These people are being taken from the ranks of loan officers and branch personnel, and both have cultural adaptations to make. Second, not only is the work new, its effectiveness is hard to measure. Large banks are struggling to identify the best ways to measure their customers’ satisfaction. Third, market analysis and other efforts that help these banks target market segments and individual customers within those segments are pieces of bank strategy, and their effect is seen only over time in improved revenues.

Small businesses require much more direct and personal service relative to large businesses. The types of service required are generally of a lower level of sophistication than that for large businesses, yet large banks must build up a large number of relationships if their service to the small business market is to succeed. For this reason, focused, professional marketing and sales efforts are essential to serving the small business market effectively.
This model should be thought of as a work in progress by the banking industry. It is currently being driven foremost by cost considerations. In order to protect a strategic market, large banks must find ways to serve that market at lower cost. The cost advantages of centralized decision making on loans are clear from experience in consumer lending. What remains is to determine how to achieve those levels of advantage in the small business market and, at the same time, improve customer service. We think the outlook for large banks is consistent with that for most other businesses today, namely, that cost reduction will be a constant business objective. But market and customer focus are not far behind. As long as the small business market is profitable, new competitors will challenge the large banks. Those competitors might continue to be smaller, niche banks, but they will begin to be larger companies from the investment banking, finance company, or insurance sides of the financial services industry that now cherry-pick the small business market while they try to identify ways to overcome the banks’ distribution advantages. The key to who will win out in this battle will depend, at least in part, on the tastes of the customers. As long as some small business customers continue to see advantages to some form of relationship banking, and large firms continue to drive costs down while maintaining their large branch-oriented distribution systems, they will be in a good position to succeed.

F. The New Model and the Old Ways

The old way of doing small business banking relied on loan officers to identify customers, receive their loan application, collect and process the paperwork, analyze the credit, price the loan, and recommend approval to a loan committee made up of senior bank executives. Although this model worked well for a long time, in today’s more competitive environment, large banks have found it to have many weaknesses:

- First, training and continuing education in credit analysis for loan officers is expensive.
- Second, loan officer handling of all the application materials has a high opportunity cost; he or she cannot be meeting with customers or finding new customers while collecting documents and analyzing them.
Third, in each loan officer, the greater the focus on credit analysis, the less the attention on marketing and sales, and vice versa, and both scenarios make loan officers as a group less productive.

Fourth, competitors focusing on marketing and sales are able to move more quickly to recognize products and services their customers want, putting market share and profits at risk.

As we have seen, the new model separates the credit analysis and marketing and sales functions. A CDA-like organization within a large bank can handle efficiently relatively standardized loans in high volumes. Similarly, a large bank can establish a marketing and sales effort that is not dependent on people whose focus is on the quality of the credit. As a result of this reorganization, large banks are beginning to see their cost of small business operations go down and their strength in fighting for market share increase. Both of these efforts will continue, for the small business market has the size and potential profits that large banks cannot afford to lose.
V. EVIDENCE SUPPORTING THE VIEW OF THE FUTURE

A. On-site Interviews

As described above, a central part of this project was to interview executives in large banks who have different perspectives on the small business market. As discussed earlier, we identified 12 large banks who agreed to participate in the project by giving us a wealth of information about how they address this market. Over two days of interviews with each bank, we were able to learn a great deal about how they perceive the small business market, how they organize themselves to work with this market, how they serve the market, and what their outlook for the market is. In the following pages, we will summarize these interviews according to the essential questions of this study.

1. How Are Small Business Needs Perceived By Banks?

Large banks’ perception of small business needs is that those needs consist primarily of credit and depository services. Term loans, lines, and letters of credit represent the bulk of the credit needs, although a few customers need special products or assistance for exporting. Other products and services are offered, such as cash management services, but the focus remains largely on lending and demand deposits.

The virtually unanimous view is that small businesses represent a highly attractive market for the banks. For the reasons discussed earlier, each small business customer poses risks that are not encountered with larger corporate customers, but the loans to these customers are a relatively small percentage of the bank’s assets, and any reasonable number of problem loans will not threaten the bank. Moreover, the banks recognize that a low percentage of small business customers are actually borrowers at any given time. The participating banks are largely consistent with industry averages. Between 4 percent and 45 percent of their customers are borrowers at any particular point in time. While they are borrowing, the banks want to be sure to follow closely the progress of the business. Some banks are more diligent than others, but all
consider careful monitoring and servicing of the customer account to be a primary function of
the person responsible for that customer.

When small business customers are not actual borrowers, the banks tend to view them as po-
tential borrowers. They want to retain the customer relationship, and demand deposit accounts
are the critical anchor in the banking relationship. The banks understand that small businesses
need these depository services, and that they are heavy users of the branch system because of
this need. This is viewed with some ambivalence, however. The branch system is in place, it
fixed investment, and the more use and fee income it creates, the more likely the bank is to
satisfactory return on that investment. On the other hand, branches are an expensive
system, and they represent costs that the bank would like to be able to avoid. Con-
tinuous heavy use of the branches could slow development of alternative systems. For the fore-
seeable future, the supporters and acceptors of the branch system hold sway.

Although this is the way most of the banks approach the small business market, many of those
interviewed are sensitive to external pressures to make more loans to small businesses. During
the months prior to our interviews, considerable "jaw boning" by the President, the Chairman
of the Federal Reserve Board, members of the Congress, and many others was under way to
try to persuade banks to make more loans to small businesses. In addition, recent regulatory
developments concerning the CRA are making banks more aware of their small business lend-
ing activities and are persuading many to increase those activities. In response, one of the par-
ticipating banks has developed a small business loan program designed to enable the bank to
make much smaller loans than it would normally try to make. Another is increasing as rapidly
as possible its participation in SBA loan guaranty programs.

2. How Are Banks Organized To Meet Those Needs?

The banks we interviewed represent different points in a timeline of the movement toward a
new organizational model for small business banking. As we have discussed, low cost rela-
tionship banking is the balance these banks want to achieve. Where a bank stands on the time-
line seems to be governed by its size and the relative degree of competition in its primary geographic markets for small business.

At one extreme, one of the banks interviewed was moving very aggressively to build a division whose sole function is to process loan applications from small businesses. In this case, the applications are developed by branch managers who meet with the customer. Once developed, the application package is sent to the central processing facility where staff analyze the credit-worthiness of the potential borrower, an underwriter decides whether to make the loan, and administrative support people handle all of the transaction documents and reporting. A leading goal for the bank is to decide on each loan and report to the branch manager who, in turn, contacts the customer -- all within 48 hours. Currently, the loans undergoing this process are for $250,000 and less, but as the facility proves itself, the loan amount ceiling will be raised to $500,000 and perhaps higher.

At the other end of the spectrum, one of the banks interviewed was content to use a time-tested organizational structure. In this case, branch personnel are not involved in commercial lending. The bank has a group of loan officers who work from the main office and a group of "roadies" who travel throughout the bank's markets to generate lending opportunities. In both cases, the loan officer develops the customer application, evaluates the customer's credit worthiness, and recommends approval of the loan. If the loan is ultimately approved, that loan officer then becomes responsible for tracking repayment progress on the loan. These loan officers receive pricing assistance from a credit analysis department, but they can deviate from the pricing model if necessary.

The other 10 banks represent various intermediate points on this timeline. Yet all seem to be moving in the same direction. All are being driven by cost pressures. In the first example, the bank is organizing itself this way because it has long-range experience in working with small business customers and it wants to build its business on this experience. It is foreign-owned and it operates in highly competitive geographic markets alongside money center banks, community banks, and a host of medium-sized banks. It has chosen to become the low cost pro-
ducer in its markets. At least three of the other banks interviewed, all in different geographic markets, appear to be moving toward this strategy. They are using loan operations facilities to process loans; they are creating distinct, standardized products for these customers; and they are using telemarketers to identify and quickly close sales to those customers.

Another important aspect of these banks' organizational structures is the role of the bank holding company. All of the 12 banks are part of holding companies. In most of the 12, we conducted our interviews with the largest and, in terms of policy, the lead bank in the holding company. Yet, in virtually every case, information about the other banks' strategies is flowing among the banks. Executives in the holding companies are working to identify best business practices and to extend those practices to all members of the holding company.

This attention to best practices should mean that banks will adjust their organizations according to successes in the most competitive markets. Initially, the focus is inside the holding company. As the industry continues to consolidate, executives must assimilate new banks from new markets, and they are making organizational adjustments according to what has worked best for them. This is an internal measurement of best practices. Gradually, the internal focus on assimilation will give way to an external measurement. The focus will shift to competitors' strategies. Because of the holding company perspective, and the diversity of markets and competitors it assumes, many of the bank executives we interviewed think that driving down costs will be a long-term imperative for banks and their small business activities.

3. How Do Banks Market Their Services To Small Businesses?

For the most part, the banks we interviewed use a relatively simple marketing mix for the small business market. It is dominated by referrals and institutional advertising. But executives at several of the banks indicated that they are conducting more aggressive prospecting for small business customers, that they are looking at other ways to reach out to the small business market, and that cross-selling is becoming increasingly important to them. Some of the banks we interviewed are innovative by banks' or any other companies' standards.
Profile Characteristics: Successful Large Bank Marketer

- innovative approaches
- extensive market research efforts
- aggressive prospect profile programs
- solid franchise
- competitive markets
- market leadership

All of the banks indicated that they rely heavily on referrals. Accountants and lawyers are the most consistent sources of small business customer referrals, and the banks make special efforts to cultivate relationships with these professionals. One bank, in particular, has created a layer of marketing management in each of its subregions to develop new business. One of the primary responsibilities of these managers is to identify and work with accountants, lawyers, and others who can refer small businesses to the bank.

Institutional advertising is also important to all of the banks we interviewed. On one level, institutional advertising is an extension of the efforts to get referrals. Bank executives are involved in their communities, particularly the business circles of those communities. Through this involvement, they make business people aware of the bank's interest, and they learn about opportunities. On another level, banks use various media to advertise the bank to small businesses. Although some advertising goes on for specific business banking products, e.g., business checking accounts, most of the advertising is aimed at showing the soundness of the bank or the accessibility of its services. In our interviews, the bankers indicated that institutional or image advertising is preferred because it conveys the right image to small business customers and draws them in for discussion about their specific banking needs.

In addition to these marketing activities, in our interviews bankers indicated that they are doing more prospecting for small business customers than in the past. One bank conducted a blitz of its market, which involved loan officers and senior executives canvassing a wide area of the market for small business customers. In this blitz, the bankers went unannounced to all of the
businesses, introduced themselves, and asked for those companies' banking business. Although this sort of blitz does not happen frequently, it was designed to communicate to loan officers at that bank that they need to be out calling on new small businesses. More importantly for small businesses, however, it was designed to be an unequivocal signal that this bank wants their banking business.

Another bank is building a telemarketing operation. This is an effort to use current information technologies to sell relatively standardized credit products to small businesses. This approach enables the bank to reach a very large number of prospective customers who are scattered over a wide geographic area. The bank indicated that this approach was proving to be quite successful, but it is still fairly new. If it proves to be an efficient method and succeeds in developing customers who stay with the bank, it will undoubtedly draw the attention of this bank's competitors.

Some banks are using outside firms to identify and qualify small business prospects for them. In varying degrees, these banks are outsourcing some of the marketing effort, and leaving what they perceive to be the most critical parts of that effort inside the bank. This strategy is designed to help relationship managers, loan officers or business banking officers focus on winning qualified customers' business.

One of the most innovative bank marketing ideas for small business customers is one that a bank clearly borrowed from the airline and other industries. In this case, the bank determines who its best small business customers are. The criteria might include the length of the customer relationship, the number of products and services being used, the size of the loan extended or the deposit accounts, or other factors. For the group of qualifying customers, the bank negotiates agreements with a range of companies that supply goods and services small business customers need. In effect, this is a frequent bank customer's program analogous to the frequent flyer programs of airline companies. If the small business is a good and loyal customer of the bank, it benefits by being able to buy office or janitorial supplies, for example, at preferential rates.
Not all of the banks we interviewed can be considered marketing leaders. But it is important to recognize that some banks are attempting very innovative marketing strategies. The bank that has developed the "frequent bank customer" program is an example of a leading bank. It is innovative, even experimental. It has a market research effort to study its customers' and potential customers' needs, it aggressively prospects for new customer, and it advertises directly to small businesses. This bank operates in very competitive markets. Perhaps most importantly, it has developed a solid small business franchise over many years. In contrast to other banks we interviewed, the bankers at this bank recognize that they are the leaders for small business banking in their primary market, and their driving motive is to keep that lead.

4. How Do Banks Deliver Those Services?

Through our interviews with the 12 banks, we confirmed the fact that large banks use one or two delivery systems for credit products in the small business market. Deposit products are provided through the branches for the most part, and other products are delivered by special product groups within the bank. Product and service delivery is not an area of great innovation, but these banks are attempting new ways to coordinate delivery.

In terms of credit products, the banks we interviewed use one of three approaches. The first approach is through a relationship manager. In some of the banks, this person is a loan officer; in others, a branch manager. For the banks who would be placed relatively earlier on our timeline, the relationship manager is a loan officer. This relationship manager is supposed to be very familiar with the small business' financial services needs, but the focus is on the need for credit. Depository services, as well as other products such as cash management, are recognized as concurrent needs, as other products, such as cash management, often are. As the need for these services arises, the loan officer/relationship manager arranges for them or directs the customer to one of the bank's specialists in that area.
The second approach is for the branch manager to act as the relationship manager. Most of the banks we interviewed do not intend branch managers to be trained extensively in or maintain the skills they have now in credit analysis or underwriting. Those capabilities are being developed in other people in centralized loan operations facilities. Instead, the branch manager/relationship manager is intended to stay close to the customer and close to the market. This type of relationship manager is responsible for expanding the relationship with that customer to new products and services. This relationship is also the primary representative of the bank for developing new customer relationships with individual businesses.

The third approach is a hybrid. The banks that use this approach have concluded that they need business development officers and that their small business customers need relationship managers who have been trained in commercial lending. These people come from the ranks of loan officers, rather than branch managers, and their commercial lending capabilities are maintained at acceptable levels through ongoing training. They are expected to be more familiar with the bank's credit products and the credit qualifications of prospective small business customers than branch managers would be, but not as expert as the bank's underwriters and credit analysts.

Our conclusion from the interviews in all of the banks is that these classifications are temporary, however. Virtually all of the 12 banks have reorganized the way they deliver services to small business customers in recent years, increasing their investment at the same time. In some of the cases, the banks are adapting from prior organizational strengths.

5. What Do Banks Expect To Gain From Meeting These Needs?

It is clear from our interviews that all of the banks see profit opportunity in the small business market. They are reorganizing their efforts and investing more resources in order to maximize their ability to seize this opportunity. We conclude from the interviews that this posture will continue for the foreseeable future.
In terms of the profit opportunity, the banks we interviewed believe that the margins on small business loans are attractive. Some of the banks routinely priced small business loans at 3 points over the prime rate. They bring the rate down only if necessary to win or keep the business from a particular customer, and they raise the rate if necessary to address unusual risk. In addition to revenue from the interest rate margin, there is substantial profit opportunity in the small business' deposits. The goal is to obtain most, if not all, of the deposit accounts and to keep those deposits with the bank. Under these circumstances, the margins on the loans are enough to cover costs and to make the risk attractive, especially when combined with the income derived from deposits.

The banks also consistently believe that having a portfolio of small business loans reduces the risk of lending in the small business market where individual loans may have a high risk of loss. This is born out of their experience in small business lending and, conversely, in their experience in commercial real estate and other product areas. Compared to commercial real estate, a small business portfolio is geographically diverse and the borrowers are in a wide range of businesses. Moreover, the deposit relationship is a constant that tends to make the revenue stream from small business customers more steady and even.

In addition, the banks see the small business market as a way to use their branch networks. Branches are very important in the deposit relationship. Small business customers visit their branch much more frequently than do individual consumers, and the branch gives the bank a continuing, physical presence in the vicinity of the small business customer. As indicated earlier, one of the banks we interviewed thinks of its branch managers as managers of the bank's business within the branch area. Although this is most true with regard to neighborhood branches, it nonetheless indicates that bank branches are important both to small business customers and to the banks that have built them. Bank efforts to penetrate the small business market thus help to increase the return on their investments in the branch network.

The banks also made it clear that their efforts to centralize decision making on small business loans have two objectives. The first is to reduce costs, as we have discussed. The second is to
give their relationship managers more time to spend with customers, which of course means more time building revenue from the small business market.

The large banks interviewed expect to make substantial profit from the small business market. They believe the opportunity is great, and they are working to reduce costs and increase revenue in order to realize as much of that opportunity as possible. By doing this now, they are trying to take advantage of a period of relatively slack loan demand. As the demand picks up, they anticipate that their new organization will be stress-tested and that their competitors will make their own investments in this market.

6. How Do Answers To These Questions Vary Among Banking Organizations?

The 12 participating banks were part of bank holding companies that range in size from approximately $2 billion in assets to well in excess of $100 billion. Most of these holding companies operate on an interstate basis; all of the holding companies owned more than one bank; and most of the banks had networks of about 100 branches or greater. All regions of the country were represented.

As a rule, the banks on the coasts tend to be the more innovative banks in the project, although not necessarily the more profitable overall or in terms of their small business efforts. These banks operate in highly competitive markets. Small businesses have a wide range of banking options, including community banks, other large institutions, and banks of different sizes that are pursuing niche strategies. These banks were also among those most cognizant of non-bank competition.

With a few notable exceptions, the banks in the middle of the country tended to be less far along on the timeline we discussed earlier. In some cases, this is due to their presence in geographic markets that are not demanding high attention from their competitors. In others, it is due to a traditional strategic focus on and success with larger corporate customers. In one such case, the shift from middle market and large corporate customers to small business was slow
and somewhat reluctant. This bank views small businesses as the middle market businesses of the future, and that is a large factor in their increasing attention to this market.

The exceptions among participating banks in the middle of the country are banks that have been aggressive in all aspects of their business strategy. They have been builders of interstate banking operations, and they are moving aggressively to draw small business banking customers from each of their new and existing markets. They are investing heavily in information technology as a means of supplementing traditional distribution systems. These banks know that they have to be aggressive marketers to ensure that they maximize the value from that investment.

7. How Is The Rapid Evolution Of The Financial Services Industry Affecting Approaches To The Small Business Market?

The two most significant trends in the evolution of the banking industry are its consolidation and the formation and growth of large, multi-market bank holding companies. The most important trend in the financial services industry, which, in addition to banks, includes securities firms, insurers, finance companies, leasing companies, and others, is the increasing amount of competition among firms with traditionally different products, distribution systems, and strategies.

All of the banks we interviewed have been acquirors of banks in recent years, and with each acquisition they have entered new geographic markets. In the early stages of these acquisitions, the strategy has been to let the pre-acquisition management continue to run the bank. As experience between the newly related banks accumulates, however, there is a tendency to extend policies and procedures from one to the other. In most cases, of course, the acquiror's policies are extended to the acquired bank. In order to manage a larger, more diverse enterprise, these banks are making large investments in information technology, in procedures, in marketing programs, and in other aspects of small business banking, and there is an inevitable tendency to want consistency among all of the banks.
Some bankers we interviewed think this trend is bad for small business customers, and most think there is a nostalgic appeal inherent in community banking. Nevertheless, nearly all think that this trend is irreversible. They believe that banks will have to become more focused on the customer, and more market oriented in order to be successful. Their self-image is shifting from local community banks to intermarket enterprises similar to finance companies.

In our interviews, there was a very clear difference in the perception of competition, but this difference was not surprising. This was a difference among bankers, not among banks. The bankers who were most focused on serving small business customers see their competition, now and for the future, as principally the community bank and the banks they think of as peers. Community banks are strong competitors because they focus on a particular segment of the small business market, because the customer can get to see the president of that bank, and because they will make greater adjustments in pricing or service to meet the individual needs of a business. Peer banks, in contrast, are perceived as having none of these competitive advantages.

The bankers who have a more strategic perspective think that the greatest competitive threat lies in non-banks. These companies operate without the fetters of regulation, and they are sophisticated marketers of their products and services who have a culture that breeds competition. Non-bank competitors are already making inroads in these bankers’ markets. The inroads are with wealthy small business owners or with specific types of small businesses. These strategic bankers believe that these non-bank competitors will expand these inroads in the years ahead. As one put it, the non-banks are being held off now, but as soon as they solve the distribution issue, we’ll have to watch out. The interesting question is whether they can "solve the distribution issue" without becoming what banks are moving to be -- locally oriented financial institutions with a large geographic reach who provide a variety of services to businesses near their office locations.
B. Data and Literature

There is a rich body of quantitative literature addressing the issues addressed in this project. The most important is the National Survey of Small Business Finances, a national survey of 3,405 firms with less than 500 employees conducted jointly by the Federal Reserve System and the SBA. The survey data was gathered in 1988-1989. Some of the major findings gleaned from this survey are indicated below:\textsuperscript{2}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Percent of Small Businesses That Use Indicated Financial Institutions}
\end{figure}

\textsuperscript{2} The findings are all taken from "Banking Markets and the Use of Financial Services by Small and Medium Sized Businesses" by Gregory E. Elliehausen and John D. Wolken, Federal Reserve Staff Study No. 160, Board of Governors of the Federal Reserve System, Washington, D.C., 1990.
The average number of financial institutions used is 1.31;

- 50.1 percent of the businesses use only one financial institution;
- 98.2 percent use one or more financial institutions;
- 48.1 percent use two or more;

- Those businesses that use only one financial institution use, on average, .920 local commercial banks, .063 local non-bank institutions, .012 non-local commercial banks, and .004 non-local non-bank institutions;
- Those businesses that use one or more financial institutions use, on average, 1.212 local commercial banks, .314 local non-bank institutions, .094 non-local commercial banks, and .160 non-local non-bank institutions;
Those businesses that use two or more financial institutions use, on average, 1.561 local commercial banks, .588 local non-bank institutions, .183 non-local commercial banks, and .328 non-local non-bank institutions;

The average number of services used from the business's primary financial institution is 2.40;

The percentage of firms that obtain the following services from any financial institution are:

- checking -- 97.0 percent
- savings -- 25.0 percent
- credit of any kind -- 59.0 percent
  - leasing -- 7.4 percent
  - line of credit -- 24.1 percent
  - mortgage -- 15 percent
  - motor vehicle loan -- 25.1 percent
  - equipment loan -- 12.4 percent
  - other loan -- 8.9 percent
- other services -- 59.3 percent
  - transactions -- 47.3 percent
  - cash management -- 15.0 percent
  - credit-related -- 7.4 percent
  - brokerage -- 3.3 percent
  - trust -- 3.8 percent
- The percent of firms obtaining services from commercial banks and non-bank institutions (including thrifts) is as follows:

<table>
<thead>
<tr>
<th>Service</th>
<th>Commercial Banks</th>
<th>Non-Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checking</td>
<td>94.8%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Savings</td>
<td>81.6%</td>
<td>27.2%</td>
</tr>
<tr>
<td>Credit</td>
<td>81.2%</td>
<td>41.5%</td>
</tr>
<tr>
<td>Leasing</td>
<td>31.1%</td>
<td>75.5%</td>
</tr>
<tr>
<td>Line of Credit</td>
<td>92.1%</td>
<td>10.8%</td>
</tr>
<tr>
<td>Mortgage</td>
<td>78.7%</td>
<td>24.0%</td>
</tr>
<tr>
<td>Motor Vehicle Loan</td>
<td>61.0%</td>
<td>46.2%</td>
</tr>
<tr>
<td>Equipment Loan</td>
<td>75.0%</td>
<td>30.6%</td>
</tr>
<tr>
<td>Other Loan</td>
<td>79.8%</td>
<td>23.6%</td>
</tr>
<tr>
<td>Other Service</td>
<td>93.9%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Transactions</td>
<td>95.6%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Cash Management</td>
<td>93.3%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Credit Related</td>
<td>89.2%</td>
<td>13.5%</td>
</tr>
<tr>
<td>Brokerage</td>
<td>12.1%</td>
<td>87.9%</td>
</tr>
<tr>
<td>Trust</td>
<td>95.6%</td>
<td>7.6%</td>
</tr>
</tbody>
</table>

At least four important conclusions can be gleaned from the Elliehausen/Wolken data:

1. Commercial banks are the predominant financial institution serving the small business market;

2. Non-bank financial institutions have penetrated some small business markets but, commercial banks are still the predominant service provider in every market except brokerage and leasing;

3. Small businesses buy a variety of services from commercial banks; the most predominant by far is the checking account;

4. Locational convenience is an important advantage in serving the small business market.
These conclusions are consistent with what large banks told us in our extensive on-site interviews. Most of them sell banking services to small businesses on a relationship basis. That is, they market services and price them to encourage customer loyalty. Although some are worried about non-bank competition, many are not. They believe their biggest competitive threats come from other banks. The anchor service is the checking account. Only a minority of the businesses are borrowing at any point in time, although they all want to make sure they have the ability to borrow when the need arises. Locational convenience is very important to small businesses.

Although this survey is extensive, and the only one of its kind, it is important to remember that it was done in 1988-1989. Much has changed since then, and there are some who believe that commercial banking’s hold on the small business market is weakening significantly. The National Survey of Small Business Finance is currently being replicated by the Federal Reserve and the SBA. It will be important to determine whether 1993 results support the ideas of relationship banking, the predominance of commercial banks, and the importance of locational convenience to the same extent that they were supported by the 1988-1989 survey.

A subsequent analysis of this data yielded some interesting conclusions about the benefits of relationship banking and the reason it is important to both banks and their customers. The three main findings of this study are:

1. Older firms and firms that have had a longer relationship with their bank generally have fewer collateral requirements placed upon them;

2. Secured borrowers are more risky and less profitable than unsecured borrowers; and


3. Larger borrowers are less risky than smaller borrowers (within the range of small businesses surveyed -- i.e., 500 employees or fewer).

The authors measure risk by the premium over prime that is charged to the borrower. Profitability is measured by the pre-tax profit margin of the business.

The authors conclude that the advantages of relationship banking are that it eases the transactions costs of obtaining information about borrowers. In other words, for older firms that have had longer relationships with a bank, banks know much more about their borrower. They feel less need for collateral and can charge the bank a lower interest rate.5.

These findings were corroborated in an interesting study by Mitchell Petersen and Raghuram Rajan.6 Using the same set of data these authors found that:

- The availability of credit from a lender is increased the more time a borrower spends in a relationship with that lender; and

- The availability of credit from a lender increases, the more financial services a borrower purchases from that lender.

The critical assumptions behind these observations, which are supported by the evidence the authors gathered, are that for some types of information, in particular, the information produced by banking relationships, there are economies of scale in information production, and the information gathered is durable and not easily transferred. Many would disagree with these assumptions and argue that increased technological sophistication and the increased effi-


ciency of securities markets makes them no longer tenable. The implication of this view is that
the securities markets will be able to handle much more small business finance in the future
than they have in the past. Providers of securities market finance are generally transaction-
oriented and do not rely on the benefits of relationship finance.

However, it is important to note that even the securities markets recognize the value of rela-
tionship banking. One important study found that the existence or renewal of a banking rela-
tionship had a positive effect on the stock price of the firm with the relationship.7 A similar
effect was found in a study on letters of credit.8 The point is that there are different kinds of
information that are useful in analyzing credits. Some of it is easily transferable. Some of it is
not. Banks build up valuable information on companies with whom they establish relation-
ships, over and above what is available from credit bureaus and public information. The most
profitable thing for them to do with this information is to use it to make a profit off of their re-
lationships.

Another study by Petersen and Rajan examined the effect of market competition on firm-credi-
tor relationships.9 The authors found that, in less competitive financial markets, banks are
willing to subsidize start-up businesses with low interest rates because of the expectation that
those start-ups that are successful will remain with the bank a long time and above market
rates can be charged in later years. In competitive markets, this cannot be done. The authors
do not believe this negates the advantages of relationship banking, but they do say that it pre-
vents the use of any below-market interest rates for start-up firms.

7. See "Borrowing Relationships, Intermediation, and the Cost of Issuing Public Securities." by Christopher

8. "Information Content of Commitments to Lend in the Future: Theory and Evidence on the Gains from Rela-
tionship Banking," by Anjan Thakor and Richard Shockley, Discussion Paper No. 523, Indiana University,

One of the most interesting bodies of data that is relevant for our purposes is the Consumer Bankers Association's small business study. This study was a survey of the members of this Association on their small business activities. The bulk of the membership of the Consumer Bankers Association is larger banks with extensive retail organizations. Thus, the membership is, for the most part, the types of banks we targeted in this study.

The Consumer Bankers Association has 77 commercial bank members, 15 thrift institution members, 2 credit union members, and 86 bank holding company members. The bank holding company members have 488 bank affiliates and 90 non-affiliates.

The 1992 survey was mailed to 600 financial institutions, and 64 usable responses were received. Of these 64 responses, 48 were commercial banks, 11 were holding companies, 4 were savings banks and 1 one was a savings and loan association. The holding companies had an average of 6.8 banks.

Assets of the survey participants totaled $1,070 billion. Thus, the average asset size of the institutions responding was $16.7 billion.

The CBA study indicated significant increased interest in small business banking:

- All respondents said they planned to increase small business banking activity in 1993;
- 74 percent said they planned to increase SBA lending;
- 69 percent said they plan to offer more products and services for small business;
- 38 percent plan to increase advertising and promotion to small business;
- 39 percent plan to increase sales staff devoted to small business;

• 39 percent plan to increase lending to small businesses that are part of their low- and moderate-income target markets;

• 37 percent plan to restructure delivery systems to focus more on small business; and

• 32 percent plan to increase underwriting staff devoted to small business.

Each year it conducts its survey, the CBA presents respondents with a list of 47 products and asks each respondent which product they are offering to small business. This year there were 23 products for which the percentage of respondents who said they were offering the products was at least 5 percent higher than last year. These products were:

<table>
<thead>
<tr>
<th>IRA, Keogh, SEPP</th>
<th>Fed availability for check clearance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lawyer escrow account</td>
<td>Direct payroll deposit</td>
</tr>
<tr>
<td>Sweep account</td>
<td>401K plans</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>Employee stock option plans (ESOP)</td>
</tr>
<tr>
<td>Business revolving credit</td>
<td>Seminars</td>
</tr>
<tr>
<td>Credit card for employees</td>
<td>Investment management</td>
</tr>
<tr>
<td>Business credit card</td>
<td>Insurance</td>
</tr>
<tr>
<td>Asset based lending</td>
<td>Newsletters</td>
</tr>
<tr>
<td>Tailored loan</td>
<td>Home video banking/on-line PC banking</td>
</tr>
<tr>
<td>Commercial home equity loan</td>
<td>Tax planning/filing</td>
</tr>
<tr>
<td>Overdraft protection</td>
<td>Tax preparation</td>
</tr>
</tbody>
</table>

No products had decreases of 5 percent or more. In last year's study, 18 products had an increase of 5 percent or more, and 10 products had a decrease of 5 percent or more.

These statistics all support the qualitative ideas that came out of our interviews. Interest in small business banking at large banks is on the upsurge. The interest takes the form of an increase in the offering of a great variety of products and services all designed to help the small business person manage a variety of tasks and to enhance the value of the entire bank relationship.
The CBA study also had the following information on the underwriting and distribution mechanisms for products and services.

### Availability of Products Through Branches, Dedicated Small Business Units, and Corporate Units

- **Investment and Report Products**
  - Branches: 87%
  - Dedicated S.B. Unit: 43%
  - Corporate Unit: 19%

### Underwriting of Products Through Branches, Dedicated Small Business Units, Corporate Units, and Centralized Service Units

- **Investment and Deposit Products**
  - Branches: 71%
  - Dedicated S.B. Unit: 35%
  - Corporate Unit: 24%
  - Centralized Service Unit: 19%

### Business Services

- **Branches**: 66%
- **Dedicated S.B. Unit**: 59%
- **Corporate Unit**: 36%

### Loan and Credit Products

- **Branches**: 62%
- **Dedicated S.B. Unit**: 54%
- **Corporate Unit**: 36%

### Source: Consumer Bankers Association
Moreover, underwriting and sales functions are separated in 60 percent of the institutions where small business banking takes place through the retail division, but separation takes place in only 39 percent of the institutions that do small business banking through the commercial division.

These statistics also support the qualitative information we have garnered from our on-site visits. The branch function is very important to small business banking at large banks. The commercial lending division is less important. Centralized service units are becoming important because of investments in technology which enable larger banks to take advantage of economies of scale in processing. If one put the different types of banking on a continuum, small business banking would be much closer to retail banking than to traditional commercial banking.

The CBA survey also offers some interesting information on compensation practices:

- 47 percent of the respondents offer incentive compensation for sales staff; in last year’s study, only 41 percent did;
- 69 percent of those offering incentive compensation to sales staff base it on new business in small business services;
- 52 percent base it on asset balances grown;
- 45 percent base it on services fees;
- 14 percent base it on the annual volume of sales calls; and
- Of those that have a separate underwriting staff, only 4 percent are on incentive compensation.
These statistics also support the qualitative notions we have garnered from our on-site interviews. Incentive compensation is important, and its use is widespread and increasing. It is often matched up with a separation of the sales and underwriting functions. Its purpose is to assure maximum possible service and continuity of personnel, something bankers believe small businesses desire. Separation of sales and underwriting functions facilitates having sales personnel spend maximum time in the field with customers. This is an important competitive weapon, particularly against community banks and other large banks.

One other study relevant to our purposes looked at the sources of small business finance. This study was done jointly by Arthur Andersen’s Enterprise Group and National Small Business United.11 For businesses of under 20 employees, the sources of long-term capital are as follows:

- Banks -- 40 percent;
- Earnings of business -- 17 percent;
- Private sources -- 14 percent; and
- Leasing companies -- 11 percent.

The sources of short-term capital for firms of less than 20 employees are:

- Banks -- 36 percent;
- Earnings of business -- 17 percent;
- Vendors -- 16 percent; and
- Private sources -- 10 percent.

The sources of long-term capital for family businesses are:

- Banks -- 48 percent;
- Earnings of business -- 17 percent;
- Private sources -- 12 percent;
- Leasing companies -- 12 percent; and
- Public markets -- 2 percent.

The sources of short-term capital for family businesses are:

- Banks -- 43 percent;
- Earnings of business -- 18 percent;
- Vendors -- 19 percent;
- Private sources -- 9 percent;
- Finance companies -- 7 percent; and
- Insurance companies -- 3 percent.

This information, which was gathered about four years after the Federal Reserve study, tends to confirm some of the information of that study, and the information we got from our interviews. Banks, along with private sources and the earnings of the business, are the most important sources of small business finance. Although non-bank institutions have made some inroads, they are not nearly as important as these sources.
VI. GOVERNMENT SUPPORT OF SMALL BUSINESS FINANCE

Small businesses are valued by government policymakers as a major factor in securing the long-term health and growth of the U.S. economy. Frequently cited statistics indicating the importance of the small business sector include the following:

- small businesses produce half of the U.S. GDP;
- owners of small businesses control 58 percent of the personal wealth in the country;
- small businesses employ 62 percent of the labor force; and
- small businesses have accounted for over half of the major innovations of the past 100 years including helicopters, and personal computers.

Because of their perceived importance to the economy, governments at all levels have enacted a variety of programs to encourage, protect, and stimulate small businesses. Our interviews, indicate that bankers in large institutions generally recognize five major groupings of government programs:

- the programs of the SBA;
- state administered programs;
- programs of city or local governments;
- programs sponsored by regulatory agencies, particularly Community Development Corporations (CDC) authorized by the Office of the Comptroller of the Currency (OCC); and
- bank initiatives in response to the requirements of CRA.
The bank-related programs administered by the SBA, states, and local governments tend to operate along roughly the same lines. The programs are designed to encourage a bank to provide credit to a specific small firm that would not qualify for a loan under the bank's underwriting standards in the absence of the government support. In the case of the SBA programs, the federal government will guarantee a portion of each loan made to a qualifying business. In case of default, the institution is able to recover a portion of the loss, thus reducing the risk associated with the particular loan.

There are three different ways in which a bank can relate to SBA in obtaining a loan guarantee. First, any bank that has been approved by SBA can work with the local SBA office and obtain a guarantee on a loan to a qualifying business. The process involves submitting the appropriate loan forms to SBA for review and approval and generally takes approximately three weeks for SBA to approve the application. Banks doing a large volume of SBA guaranteed loans can become a "certified" lender, which means that the bank establishes an ongoing SBA lending program and an ongoing relationship with the local SBA office. The bank does most of the underwriting on each loan application, using standards and procedures approved in advance by SBA. The individual loans are submitted to the local SBA office and approval normally takes two days. The third type of bank/SBA relationship is known as a "preferred" lender program. The program is designed for banks that do a large volume of SBA loans. Each preferred lender is given full authority and responsibility for handling almost all aspects of the transaction. This includes making the credit decision, closing the loan, servicing, administration, and -- if necessary -- liquidation. The maximum guaranty for preferred lender loans is lower than the guaranty under the certified lender program. Some banks are both certified lenders and preferred lenders, choosing the loan for a particular borrower depending upon the level of guarantee the bank feels is appropriate.

Most programs funded by state or local governments are designed to induce bank loans to qualifying businesses by directly making a companion loan to the business for a portion of the project. Generally, the publicly-funded loan carries a second or third lien on the collateral. In some cases, the publicly-funded loans carry below market interest rates providing another layer of protection for the bank loan.
With the exception of a small number of programs, such as a program administered by the Michigan Strategic Fund (MSF) whereby a portfolio of qualifying loans is guaranteed, the publicly-funded programs involve a direct loan-by-loan commitment by the public agency and a review and approval of the individual transaction. However, Senator Riegle has recently introduced federal legislation modeled on the Michigan Strategic Fund. Hence, the use of this approach may be expanded.

The other two categories of government programs take a different approach to encouraging banks to provide credit to small businesses. The Office of the Comptroller of the Currency (OCC) permits and encourages banks to establish and capitalize CDCs. CDC is a financial institution specifically designed to originate loans to businesses that would not qualify for credit from a bank. CDCs are not depository institutions and most are non-profit organizations. CDC loans are not subject to regulatory review.

In response to the requirements of the CRA, all large banks have established specific programs to help meet the credit needs of the communities in which they operate. The exact form and substance of these programs is not dictated by regulations, however, most include a component of loans to small local businesses. CRA loans do not carry any form of government guarantee, nor do they involve any government subsidy. However, most bankers consider CRA business loans to be part of the government’s efforts to support small businesses.

How do bankers view government programs to stimulate small business lending? There is no simple answer to the question, but over the course of 50 interviews a general consensus emerged over several key themes.

- Banks use government programs

All of the bankers interviewed were familiar with and used SBA, state, and local programs. At least two banks told us that they would always try to make a conventional loan and would turn to a publicly-funded program only when that was not possible. We
did not encounter any bank that said it discouraged applications involving publicly-funded programs. Some institutions indicated a preference for working with state funded programs, as opposed to SBA programs. This preference was due to the fact that the institution found the people administering the state program to be more knowledgeable about small business financing than SBA personnel. Others felt that SBA personnel were much more helpful than personnel with state programs. At least two banks indicated that some small businesses worried that participating in a government loan program would carry a stigma and negatively affect the bank's relationship with the business. The bankers did not feel that the government programs altered the bank's long-term relationships with the businesses.

- SBA guarantees are effective in stimulating bank loans

It is the unanimous opinion of the bankers interviewed that the SBA and related state and local programs are successful in inducing banks to make loans that they would not otherwise make. In virtually every bank, we were told of specific examples where a loan was approved only because of an SBA guarantee or because of the participation of a state or local development authority in the transaction.

Estimates of the amount of SBA lending in the small business portfolio varied from institution to institution. One institution estimated that up to 30 percent of the small business loan portfolio involved some form of government participation.

- SBA programs can provide a competitive advantage

Several of the banks said that participation in the SBA programs provided a competitive advantage in attracting small businesses. One person said that every "good" small business has four or five bankers knocking on the door, and if his institution can say that it is an SBA preferred lender and has a reputation for serving small businesses it gives his institution an edge even if the business does not need an SBA guarantee.
This individual went on to say that his bank had established a specific objective for each branch to originate a certain number of SBA loans each quarter and that accomplishing the objective was a formal part of each branch manager's quarterly evaluation. Several other institutions also said that initiating SBA loans had been incorporated into the performance evaluation process for certain positions.

- Expertise with government programs is centralized

According to most bankers, neither the SBA programs nor those of state and local governments are easy to use. In general, banks have found it efficient to concentrate the expertise and experience in using the programs in a specific department or set of individuals. Wherever it is concentrated, the expertise is a resource available to any branch or loan center that needs assistance in determining eligibility for a particular program or in packaging an application.

At least one bank has established a formal policy that before a loan application involving a small business that is owned by a women or a minority or is located in certain designated areas can be rejected, a specific office with experience in SBA and state and local small business programs must be given an opportunity to structure a transaction.

However, centralization is not universal, at least one institution has found it efficient to distribute expertise in government programs throughout its offices. This approach requires an investment in training, but the institution feels this approach allows them to provide better service to the small business customer. The institution is a preferred lender.
There are concerns with the operation of the SBA programs

While there is consensus that the SBA guarantee programs are effective in stimulating loans that the bank would not otherwise make, the bankers voiced several concerns about working with the programs.

The most frequently mentioned concern was that SBA offices vary considerably from area to area. All of the institutions interviewed operate on a multi-state basis and thus deal with several SBA offices. We were told that the quality of SBA staff varied in terms of expertise in small business, financing, and in terms of willingness of SBA staff to work with the bank.

This variability in staff capacity carries over to the forms and paperwork needed to obtain SBA approval for loan guaranties and the standards for SBA approval. As mentioned, bankers rank volume and standardization as keys to their profitability in the small, business sector. The process of obtaining SBA approval for a loan and the associated forms and paperwork are not uniform throughout the country. This hinders standardization and thus is a problem for large banks. The larger the bank and the more widespread its market is, the greater the problem.

Several bankers commented that one of the most productive initiatives SBA could undertake would be to provide education and training to owners of small businesses in how to deal with a bank. Many owners need assistance in packaging and presenting the financial condition of their business in a way that is relevant to a bank's credit decision process.

A bank's financial commitment to small business lending is dependent upon the bank's business strategy and the perception of the level of potential profits. As mentioned, many large banks have recently concluded that significant profits are available in the small business market if sufficient volume and process efficiencies can be achieved. Evidence indicates that many non-banks have reached similar conclusions. In general, large banks do not view the
credit risks associated with small business lending as a constraint because there are techniques, including portfolio management, by which the credit risks can be controlled. Thus, government programs to reduce the level of credit risk have little impact on a large bank's commitment to small business lending.

An emerging area of governmental interest in small business loans is the secondary market. Legislative proposals are pending in the Congress to create a secondary market. One proposal would create "Velda Sue," the Venture Enhancement and Loan Development Administration for Smaller Under Capitalized Enterprises. The purpose of "Velda Sue" and the other proposals is to increase the availability of small business loans by enabling lenders to sell these loans to private investors in much the same way that a secondary market has been created for residential mortgages.

Senator D'Amato has introduced a bill that would attempt to create a secondary market without creating a new government agency. It would do this by amending securities laws, banking laws, pension laws, and tax laws in ways that would favor the development of a secondary market among private institutions.

These proposals are not certain to be enacted, and there is already a secondary market for SBA-guaranteed loans. If a government sponsored secondary market were created, there is a question about what impact it would have on large bank lending.
The following table indicates the volume leaders in SBA loans as of September 30, 1993.

<table>
<thead>
<tr>
<th>Rank</th>
<th>State</th>
<th>Lender</th>
<th>Number</th>
<th>$ of Loans (net)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>USA</td>
<td>The Money Store Inv. Corp.</td>
<td>910</td>
<td>338,509,556</td>
</tr>
<tr>
<td>2</td>
<td>PR</td>
<td>Banco Popular de PR</td>
<td>468</td>
<td>81,007,525 - B</td>
</tr>
<tr>
<td>3</td>
<td>USA</td>
<td>ITT Small Business Finance</td>
<td>275</td>
<td>107,445,100</td>
</tr>
<tr>
<td>4</td>
<td>NY</td>
<td>Fleet Bank of NY</td>
<td>200</td>
<td>35,127,920 - B</td>
</tr>
<tr>
<td>5</td>
<td>CA</td>
<td>Government Funding CALBIDCO</td>
<td>175</td>
<td>66,621,996</td>
</tr>
<tr>
<td>6</td>
<td>TX</td>
<td>Bank of North Texas</td>
<td>174</td>
<td>41,500,576 - B</td>
</tr>
<tr>
<td>7</td>
<td>CA</td>
<td>Bank of Commerce</td>
<td>163</td>
<td>55,607,540 - B</td>
</tr>
<tr>
<td>8</td>
<td>CA</td>
<td>Sacramento Commercial Bank</td>
<td>147</td>
<td>44,854,350 - B</td>
</tr>
<tr>
<td>9</td>
<td>CA</td>
<td>Truckee River Bank</td>
<td>132</td>
<td>49,773,650 - B</td>
</tr>
<tr>
<td>10</td>
<td>TX&amp;FL</td>
<td>First Western SBLC</td>
<td>126</td>
<td>65,082,053</td>
</tr>
<tr>
<td>11</td>
<td>WA</td>
<td>U.S. Bank - WA</td>
<td>123</td>
<td>21,619,353 - B</td>
</tr>
<tr>
<td>12</td>
<td>PR</td>
<td>Banco Standunder Puerto Rico</td>
<td>121</td>
<td>20,419,250 - B</td>
</tr>
<tr>
<td>13</td>
<td>HN</td>
<td>First NH Bank</td>
<td>113</td>
<td>29,687,500 - B</td>
</tr>
<tr>
<td>14</td>
<td>NY</td>
<td>Key Bank - New York, NA</td>
<td>107</td>
<td>14,748,320 - B</td>
</tr>
<tr>
<td>15</td>
<td>CA&amp;TX</td>
<td>Heller First Capital Corp.</td>
<td>102</td>
<td>43,509,300</td>
</tr>
<tr>
<td>16</td>
<td>TX</td>
<td>Bank One of Texas</td>
<td>99</td>
<td>23,535,337 - B</td>
</tr>
<tr>
<td>17</td>
<td>VT</td>
<td>Chittenden Bank</td>
<td>99</td>
<td>15,034,208 - B</td>
</tr>
<tr>
<td>18</td>
<td>TX</td>
<td>Questar</td>
<td>98</td>
<td>24,303,050 - B</td>
</tr>
<tr>
<td>19</td>
<td>MA</td>
<td>First Natl. Bank of Boston</td>
<td>96</td>
<td>9,986,705 - B</td>
</tr>
<tr>
<td>20</td>
<td>CA</td>
<td>Bank of Oakland</td>
<td>77</td>
<td>25,127,350 - B</td>
</tr>
<tr>
<td>21</td>
<td>ID</td>
<td>American Bank of Commerce</td>
<td>76</td>
<td>18,000,560 - B</td>
</tr>
<tr>
<td>22</td>
<td>NY</td>
<td>Manufacturers &amp; Traders</td>
<td>74</td>
<td>16,195,158</td>
</tr>
<tr>
<td>23</td>
<td>NY</td>
<td>Marine Midland Bank, NA</td>
<td>73</td>
<td>18,378,550 - B</td>
</tr>
<tr>
<td>24</td>
<td>SC</td>
<td>Emergent Business Capital, Inc.</td>
<td>72</td>
<td>33,020,180</td>
</tr>
<tr>
<td>25</td>
<td>CA</td>
<td>Coast Commercial Bank</td>
<td>71</td>
<td>24,994,250 - B</td>
</tr>
</tbody>
</table>

Note: This is a preliminary SBA ranking and is subject to revision.

The firms in bold are banks. There are 18 of them. Ten are the type of institutions we studied, that is, they are over $3 billion in assets. Seven are community banks under $500 million in assets, and one is a mid-sized bank between $500 million and $3 billion in assets. Banks made 58 percent of the SBA loans made by the top 25 lenders, but only 44 percent of the dollar volume of loans made by the top 25 lenders. Thus, bank SBA loans tend to be smaller than non-
bank SBA loans. This probably means they are lending to smaller businesses than the non-
bank institutions. One additional point should also be noted. Two of the top three volume
lenders are nationwide companies. In contrast, the banks on this list operate in one state. If
the multistate banking operations of the large banks on this list were aggregated, one would
expect the volume to increase.

VII. MANAGERIAL AND POLICY QUESTIONS

In the preceding sections of this report, we have discussed the trends affecting small business
banking and the changes that large banking organizations are making to increase their competi-
tiveness in this market. It is clear that this market segment is dynamic and that banks view it
as an area of great and growing opportunity. Large banks are reorganizing themselves in order
to capitalize on this opportunity. We turn now to the implications of these trends for manage-
ment and public policy questions. The answers to these questions, that is, where bank man-
agement and government policy intersect is a fertile point for all parties interested in small bus-
iness.

A. Managerial Questions

1. Marketing Strategies

There are two fundamental factors that determine the form of small business marketing strate-
gies at large banks. First, banks view themselves as selling relationships, not products. Sec-
ond, in order to make money at small business banking, the volume of relationships acquired
must be high.

As reported in Section IV, the key product around which the relationship centers is the de-
mand deposit, not the commercial loan. While virtually all small businesses have a demand
deposit account, our on-site interviews indicate that the number of account holders who are
borrowing at any particular point in time is between 4 percent and 45 percent. Not all small
business customers want relationship banking, but it is probably true that most who go to
commercial banks for services do want it. Surveys indicate that the great majority of small businesses do have relationships with commercial banks and that the demand deposit account is at the center of the relationship.\textsuperscript{12} This means that marketing strategies designed primarily to boost the sales of particular products, other than demand deposits, are not the most efficient way to build business.

The primary role of advertising is to help cement existing banking relationships, and to help acquire new ones. Most banks do not advertise specific products. Those who do, are doing so primarily to emphasize the completeness of the relationships they offer their customers. Almost all large banks use institutional advertising to some extent. To the extent that it is oriented towards small businesses, its main purpose is to overcome a specific image problem many large banks believe they have. This is the impression they believe small businesses have that, as large banks, they do not care about small businesses. A third purpose of advertising is to support the marketing of seminars that are held for customers, and people from whom the banks hope to get referrals of new customers. The most commonly used media for advertising are trade and business publications, and newspapers.

An important goal of small business marketing at large banks is to acquire new customers. Large banks believe they can only make money serving small businesses by standardizing the process of small business banking, and obtaining a large number of customers. The primary method of acquiring new customers is through referrals. The most important source of referrals is existing customers. The second, most important source is influential third parties. The most important of these is accountants, who are closely familiar with the financial needs of many small businesses. The second most important is attorneys. Banks arrange seminars, social events, and smaller meetings with these types of people to keep them informed of what they can do, and encourage them to refer business to the bank. These referral support activities

are supplemented by encouragement of officers to join community groups and participate in service activities which will give them a wide exposure to the community, and contacts to obtain new business.

Some banks supplement these activities by prospecting. For some, this is cold calling, that is calling on small businesses at their place of business to get them acquainted with the bank and the services they offer. One bank was even experimenting with a system of telemarketing. Large data bases were used in conjunction with computer modeling techniques to select businesses to contact. Other banks are using marketing services from outside consultants to identify prospects and help position the bank for a higher hit rate in selling to them.

For the smaller small businesses, the bank branch is an integral part of the system of obtaining new customers. Businesses of this kind visit bank branches frequently; usually more often than consumers. Their needs are more sophisticated than those of consumers and the skill needed by personnel to meet those needs are more sophisticated. Hence, an important organizational problem for large banks is to determine how to staff their branches in an efficient way that will give their small business customers the service they need.

These strategies are all designed to help cement banking relationships with large numbers of small business customers. But more than effective marketing strategies are needed to achieve these goals. Organizational strategies are equally important and to these we now turn.

2. Organizational Structures

The need to achieve a high volume of well-served banking relationships in a cost-effective manner is an important factor governing how banks structure their small business banking operations. To see how this need is met, we will discuss organizational issues in terms of six questions: (a) How are customers served well?; (b) How is volume achieved?; (c) How are costs controlled?; (d) Who approves credit?; (e) What is the role of the branch system? and (f) Where does the small business banking function fit within the organization?
a. How Are Customers Served Well?

As mentioned previously, large banks believe an important problem they have in building up a large volume of small business customers is that small businesses themselves believe that large banks do not care about them and, hence, do not believe they will get proper service. Banks believe this image is not justified, but they recognize that it exists, and is something they have to combat.

There are several ways of combating this problem. Advertising is certainly one. But advertising can only reinforce positive actions that are taken in the marketplace. Hence, large banks spend much time and effort assuring that they can give good service to a large volume of customers.

Another help to achieving this goal is to make sure that products and services are available which, if used properly, can satisfy all customer needs. To make sure they are used properly, customers need much personal attention. This can only be achieved if the jobs of account officers are structured so that they have the time and skills needed to deliver such service, and the incentives to deliver it. Thus, a common characteristic of large bank organizational structures is that business banking officers are encouraged to spend as much time as possible with existing and potential customers. Two things help achieve this structure. First, account officer jobs are structured so that they must do as little back office paper work as possible. Second, incentives are put in place to make sure that the great bulk of time is spent in the field, with customers.

Training programs are structured so that business banking officers know how the products and services offered can meet customer needs, and know how to educate customers about their use. A major concern in seeing that customers are dealing with properly trained personnel involves the use of the branch system. As will be seen below, the branch system is now a major part of the distribution system for small business products and services. Yet, in many ways small bus-
ness needs are more sophisticated than those of consumers. Thus, a major concern of large banking organizations is to make sure that properly trained personnel are placed strategically throughout the branch system to deal appropriately with the needs of small business customers.

b. How Are Costs Controlled and Volume Achieved?

Volume is achieved by two major steps: (1) the building up of large branch networks to reach a large number of small businesses in a convenient manner; and (2) investment in building a high-quality sales and marketing staff that can achieve the volume once the technology is in place. Cost control is achieved by: (1) investment in technology that will assure profitable low cost provision of services when the volume is achieved; and (2) separation of sales and underwriting to achieve focus and efficiency in these two functions.

The investments in technology entail centralization of credit administration to achieve economies of scale. This cannot be done if each loan officer also plays a major role in credit administration. Thus, centralization of credit administration is usually accompanied by a separation of the sales and underwriting functions. The major function of sales people is to acquire new customers and service existing customers. Telephones, fax machines and computers do much to enhance the effectiveness of this separation. With a centralized, efficient credit administration department, and fast and thorough communication with officers in the field, credit applications can be processed quickly, a major prerequisite to giving good service. This arrangement gives credit officers the opportunity to spend much more time with customers, which in turn helps achieve the volume needed to justify the investments in technology and centralization. This type of centralization also helps achieve another major goal of small business banking -- the ability to make judgments about success or failure based on the performance of a portfolio of loans as opposed to the performance of individual loans.
c. Who Approves Credit and What Information is Used in the Process?

The system for approving credit varies among large banking organizations, but the broad outlines of it are similar in all large banks. Higher ranking officers approve larger credits. Rarely do loan committees get involved, although it is not unusual to have a requirement for two officers of a given rank to approve specific types of credits. As mentioned previously, many banks are instituting centralized underwriting systems in which the person who ultimately approves the loan is part of a centralized credit administration department. This type of centralized credit underwriting facilitates significant cost efficiencies in the credit granting process for small businesses. Credits tend to be standardized in format, and a decision is made by the underwriting department based on specific quantifiable criteria. Standardization does not always mean a requirement for collateral, although collateral is frequently useful. Nor does a standardization mean a lack of flexibility in adjusting to particular circumstances. It means, rather, that certain types of information will facilitate quick and easy granting of credit. If the information is lacking, it does not always mean rejection. It only means that the normal channels for approval cannot be used. Standardization facilitates fast customer approval and minimizes the time loan officers must spend doing paperwork.

This contrasts significantly with the situation that existed as little as three years ago. At that time, a survey done for the American Bankers Association in 1988\textsuperscript{13} indicated sequential chains of approval among successively higher ranking banking officers. This approach is almost guaranteed to take large amounts of time, and it was common among both large and small banks. Our results indicate that since 1990 banks have undertaken extensive efforts to streamline and improve the process of credit approval for small business loans. The people at Management Advisory Services who did the ABA survey have confirmed that they have also noticed this trend in dealing with their clients.

\textsuperscript{13} "Efficient Delivery of Banking Services" done for the American Bankers Association in 1990 by Management Advisory Services, Seattle Washington; see especially tables 1-18 through 1-25.
The more important differences between larger and smaller banks in the credit approval process probably are in the information that is gathered in the credit approval process. The approval process in large banks is usually information intensive. More formal analysis is also frequently part of the process. Credit scoring models are used along with independent data from large data bases of vendors who deal with information on small business. Rarely, if ever, do large banks approve loans solely on the basis of "character" or knowledge of the individual applying for the credit.

d. What is the Role of the Branch System?

In one recent survey, 50 percent of the respondents said that the "retail division" had ultimate responsibility for the small business market.14. This certainly indicates that branches are important for small business marketing for many banks. This was confirmed in our visits to 13 large banks. Branch systems played a major role for all of them. Some encouraged the conduct of small business banking at all branches. Some set up special small business centers in specific branches. Some trained all branch managers to deal with small business customers. Others had specific small business banking officers located in branches. All said that reaching certain types of small business customers required activities in the branches. These are businesses who visit branches frequently, usually to make deposits. Some pointed out that market research indicated that small business customers visited branches much more frequently than consumers. This is particularly true of retail businesses and almost all businesses below a certain size. Perhaps the most important reason for the central place of branches in marketing to small businesses is the importance of convenience to small businesses and the concomitant ability of banks with large branch networks to reach large numbers of small business customers.

However, these advantages of branches do not mean that branches are the only means of reaching small businesses. Some of the banks we visited had separate office sites for small business banking officers. One even had a small business group within their middle market group for small businesses between $1 and $5 million in sales. Others are experimenting with telemarketing and the use of business data bases to determine which businesses should be solicited. Despite these variations, it is clear that branches play a central role in marketing to small businesses.

\[\text{e. Where Does Small Business Fit in the Organization?}\]

Retail banking has already been mentioned as the place within the organization where small business is housed. Some banks had a separate organizational structure at the Executive Vice President level for small business banking. Others put some of their small business banking operations in their middle market group. None housed it in the same part of the organization as large business banking. This contrasts somewhat with the findings of the Consumer Bankers Association survey which found that a significant number of banks put small business banking in the commercial lending part of the organization. However, this difference may be more apparent than real. Putting small business banking in a part of the organization called commercial banking is more common for smaller organizations, which were not included in our study, than for large organizations.\footnote{15. "Small Business Study" Op. Cit., p.4.}

Large organizations are naturally drawn to the retail side of the bank for small businesses because there are many similarities between their small business customers and their other retail customers. Indeed, for many small businesses, the personal banking needs of the owners, and the banking needs of the business become closely intermixed. Also, when one looks at the two customer groups from an internal operational point of view, their are many similarities for large banks. Both entail large, diversified credit portfolios. Products tend to be standardized.
for both groups, and credit analysis for both groups frequently involves analytical uses of large bodies of data. Finally, the need to obtain cost efficiencies and volume that were mentioned earlier as characteristics of small business banking for large organizations are also present for consumer banking in these organizations.

3. Competition
   a. Non-bank Institutions

Research has shown that the anchor of the relationships between banks and small businesses is the demand deposit account. At first glance, this would seem to make it hard, though not impossible, for non-bank institutions to compete with banks. However, markets are continually changing. At least three developments are loosening the ties that bind small businesses to banks. Technology is making it easier for non-bank institutions to serve more customers. Customers are becoming more aware of their expanded opportunities, and non-bank institutions are becoming stronger and more aggressive in the marketplace.

The essence of financial services is information -- information about the financial position of customers, information about the services they need, and information about how and where those demands can be satisfied. Since the advent of computers and telecommunications systems, the cost of obtaining, processing, and sending information has been declining significantly. This has greatly expanded the reach of many financial services companies. Financial information data bases enable financial institutions to contemplate extending credit to a much wider range of companies. Credit cards have reduced the number of transactions that flow directly through bank accounts. For some businesses, e.g., physicians and many types of retailers, credit cards have greatly reduced the frequency of direct trips to the bank. What were formerly directly negotiated loan agreements are now standardized, securitized, and sold in the open market. The list could go on, but it should be clear that technological changes have made many segments of the financial services business transaction-oriented. In many cases this transactions orientation favors non-bank institutions who typically do not invest as heavily as banks in the overhead needed to remain a relationship-oriented business.

However, there are many counter trends that reinforce the growth of the relationship-oriented provision of financial services. One of the most important is the growth of the small business sector itself. As the economy grows, new businesses inevitably start up and grow with it. Inevitably, the first financial institution a new business deals with is a bank. This gives banks an advantage over non-bank competitors at cementing relationships and building a profitable customer base. Many small business look on banking relationships as a source of security. Running a small business is a time consuming and engrossing undertaking. Knowing that a banker is there to try to service all financial needs enables business people to concentrate on their primary task of running their business.
A few of the banks we visited were very worried about non-bank competition. However, the more common situation was concern about competition from small banks or other large banks. Of course, this does not mean that the lack of concern on the part of many banks is justified. Unless a bank has done detailed market research on where all types of businesses in their market get financial services, they may not know how successful the non-bank competition is in their market.

Our belief is that relationship banking will continue to be important for large numbers of small businesses for some time into the future. However, we do expect to see continued progress for non-banking institutions in serving certain types of businesses, particularly those whose need for financial services is not driven by the need to be located near a bank branch. Non-bank institutions will also continue to make progress with particular products for which they have natural advantages. Two examples of these are equipment leases and truck loans.

One institutional change could significantly enhance the ability of non-bank institutions to serve small business customers. This would occur if Congress decided to create a special government agency to provide a credit enhancement to small business loans and enable them to be securitized. This would provide a significant boost to the efforts of non-bank institutions to crack the small business market. However, even if this does occur, such an institution would certainly not be closed to banks. In addition, there would still be a large number of businesses for which locational convenience is an important factor. Banks with large branch networks would have a natural advantage in serving this type of market.

Small businesses that succeed become medium sized, and then large. As they grow they become more sophisticated in their financial capabilities and have less need for relationship banking. Changing technologies are probably diminishing the size at which this occurs. A countervailing trend is the growth in the number of new businesses and the growth in the amount of economic activity that takes place in the small business sector. In assessing these two trends, we conclude that there will probably always be a role for banks, and relationship banking, in the small business sector.
b. Small Banks

Where small community banks are thriving and healthy they are a major source of competition for large banks in their attempt to get small business customers. Although community bank competition is not very strong in some areas of the East, it is particularly strong in the West and Mid-West. Where such competition is strong, bankers all gave similar answers as to why. Small business owners have a strong desire to "have lunch with the president of the bank," or play golf with the president or attend some other social event where they can engage the president in one on one conversation. This is more than simply a matter of boosting the business person's ego. People who have built up their own business quite naturally have a strong desire to deal directly with those who can affect their business. They know that when they deal with large banks they are dealing with a person who takes orders from someone else. Of course, as the ABA survey demonstrated, this is also generally true for small banks, where the credit approval process frequently involves more than one person. Nevertheless, this impression accounts for the image among small business people that large banks are "bureaucratic" and "don't care" about small business.

Large banks are moving towards reforming their small business service delivery systems in ways that will correct this problem. They are streamlining the approval process to decrease response times. They are also streamlining the business banking officer's job to enable that person to spend more time with customers. Finally, they are investing more time and effort in the training of banking officers so that those people can convince small businesses that their capabilities and service offerings are more valuable to their business.
### FUNDS LENT TO SMALL BUSINESSES BY SIZE OF BANK AND SIZE OF SMALL BUSINESS (%)

<table>
<thead>
<tr>
<th>Bank Size (assets)</th>
<th>0-4</th>
<th>5-24</th>
<th>25-99</th>
<th>100-500</th>
<th>ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-&lt;$500 million</td>
<td>5.66</td>
<td>14.22</td>
<td>9.08</td>
<td>2.76</td>
<td>31.72</td>
</tr>
<tr>
<td>$500 million-$3 billion</td>
<td>2.28</td>
<td>7.57</td>
<td>7.63</td>
<td>6.72</td>
<td>24.21</td>
</tr>
<tr>
<td>over $3 billion</td>
<td>2.67</td>
<td>5.47</td>
<td>12.40</td>
<td>23.55</td>
<td>44.09</td>
</tr>
<tr>
<td>ALL</td>
<td>10.61</td>
<td>27.26</td>
<td>29.12</td>
<td>33.04</td>
<td>100.00</td>
</tr>
</tbody>
</table>

### FUNDS LENT TO SMALL BUSINESSES IN A GIVEN SIZE CLASS BY SIZE OF BANK (%)

<table>
<thead>
<tr>
<th>Bank Size (assets)</th>
<th>0-4</th>
<th>5-24</th>
<th>25-99</th>
<th>100-500</th>
<th>ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-&lt;$500 million</td>
<td>53.35</td>
<td>52.16</td>
<td>31.18</td>
<td>8.36</td>
<td>31.72</td>
</tr>
<tr>
<td>$500 million-$3 billion</td>
<td>21.49</td>
<td>27.78</td>
<td>26.21</td>
<td>20.35</td>
<td>24.21</td>
</tr>
<tr>
<td>over $3 billion</td>
<td>25.13</td>
<td>20.06</td>
<td>42.59</td>
<td>71.28</td>
<td>44.09</td>
</tr>
<tr>
<td>ALL</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

SOURCE: Federal Reserve, National Survey of Small Business Finance

An important question for this study is the relative importance of small, medium, and large banks in serving small business. The tables above, which were computed with the assistance of John Wolken of the Federal Reserve Board, give information relevant to this question. The information is from the National Survey of Small Business Finance. Of all the small businesses surveyed, large banks provided 44 percent of their loans, mid-sized banks 24 percent, and small banks, 32 percent. For businesses with less than 25 employees, small banks provided more of the credit than large banks. However, the businesses with 25-to-500 employees borrowed much more than those with less than 25 employees. These larger small businesses were served to a much greater extent by large banks than small banks. On balance, this data indicates that there is a healthy competition among all sizes of banks for the small business credit dollar.
A recent report by the General Accounting Office misinterprets the results of the National Survey on Small Business Finances to come to a somewhat different conclusion. This report says:

"Information (on small business lending by banks) that does exist showed that smaller, local banks are an important source of financing for many small businesses.

In spite of the heavy reliance on small banks by small businesses...."

It supports this conclusion by a footnote which reads in part:

"According to the National Survey of Small Business Finances conducted from 1988 to 1989 for the Federal Reserve and the Small Business Administration, most small and mid-sized businesses depend primarily on local commercial banks to meet their credit needs17.

The statement in the footnote is correct. The statement in the body of the text is ambiguous at best. As the data on page 77 demonstrates, small- and mid-sized businesses rely to an even greater extent on large banks for credit than they do small banks, although the degree to which they rely on small banks is not insignificant (44 percent of the credit provided by large banks, 32 percent by small banks).

When a respondent to a survey says that he or she relies primarily on local banks for credit, there is no justification for assuming anything at all about the size of the bank. A small busi-

ness that obtains credit through the services of a banker stationed in an office that serves its local market is dealing with a local bank. This is true for banks with less than $500 million in assets, and it is equally true for banks with over 100 billion in assets with offices nationwide that serve many local markets.

A recent study by the Dallas Federal Reserve Bank confirms the conclusions derived from the data presented above. This study uses data on the size of a business loan as proxy for the size of the business. It estimates that banks with over $1 billion in assets supply 50 percent of small business credit supplied by banks. This is consistent with our estimate that banks with over $3 billion in assets supply 44 percent of the bank credit supplied to small businesses.

However, the Dallas Federal Reserve Bank Study claims that small banks are more "active" small businesses lenders than large banks. Active lenders are defined by ranking banks according to the ratio of small business loans to total assets. As small banks will not make large business loans, this definition of activity skews the result towards small banks. Table 3 indicates that if activity is measured directly by the amount of small business loans granted, large banks are the most active. However, the activity of small banks is also quite large.

Both of these studies indicate that small banks are holding their own in competition with large banks in the race to get the business of small businesses. We expect this to continue indefinitely into the future. We also expect the consolidation of the banking industry to continue indefinitely into the future. For several reasons, these two trends are not incompatible.

First, even as banks merge and go out of existence, new community banks will be chartered, will grow and be successful. Patterns of chartering of new banks in the past indicate the chartering will take place in dynamic areas that have strong economic growth. These are also the areas that have strong small business growth. It might be noted that California and North

Carolina have a long history of statewide branching and large banks existing side-by-side with strong, healthy community banks, and strong small businesses. This co-existence has been primarily due to the strong economic environment in both states.

A second reason why we expect the good health of community banks to continue is because most of the mergers in the consolidation movement will be between large banks and mid-sized banks. Although there will occasionally be mergers, merging with a large number of small banks is an expensive way for large banks to grow. The transaction costs of a large number of mergers with small banks are simply too high.

When the consolidation movement finally settles down, there will be a healthy community banking sector serving those small businesses that prefer community banks, and a large bank sector serving those small businesses that prefer the large bank mode of operation. This does not mean that the transition period will not cause problems for some small businesses. In mergers occurring today, new lending policies are often implemented and the acquired bank frequently loses personnel. This means that comfortable banking relationships may be severed. As large banks grant more of the small business credit than small banks, and large banks are more likely to be parties to mergers, the small business customers of large banks are at greater risk for this type of problem. Small businesses can do two things to protect themselves against this problem. First, they can develop alternative relationships with other large banks which can be used as back-ups. Second, they can develop relationships with smaller banks who are less prone to this type of difficulty. However, it is important not to overestimate the difficulties from severed bank relationships caused by mergers. As a group, large banks are very interested in the small business market. If a small business is managed well, it is doubtful that it would be unable to obtain good service from a bank, large or small. However, small businesses must remember that new relationships take time and effort to develop.

In many quarters there is a fear that the consolidation movement in banking will mean the end of small banks and that this will hurt small businesses because only small banks serve small businesses. This proposition is wrong on several counts. First, for the small business sector as
a whole, large banks provide more credit to smaller businesses that smaller banks, although the amount provided by smaller banks is significant. For the very smallest small businesses -- i.e., under 25 employees, small banks provide a greater proportion of the credit, although the amount provided by large banks is significant. Second, for reasons stated above, the consolidation movement will not swallow up small banks. Small banks will continue to grow and prosper.

It is also important to remember that all banks, large or small, are subject to the Community Reinvestment Act (CRA). As a result of this law, they are required to show special attention to the needs of minorities, women, low income individuals, and small businesses in the local markets they serve. Every area in which a bank has a branch or an office would be a local market for CRA purposes. The institutional and regulatory mechanisms associated with the CRA should offer protections for small businesses against those few banks that are inclined to neglect small businesses in their local markets.

The consolidation movement will help the small business sector as a whole. It will do this by making banks stronger competitors and by letting larger banks restructure themselves to provide more service at lower costs; however, small businesses do need to prepare for the transitional problems.

c. Other Large Banks

Other large banks are a major source of competition for almost all banking organizations who wish to engage the small business market. This is particularly so if they have large branch systems in similar markets. Many of the banks we visited felt the reforms they were instituting in their small business service delivery systems were unique. Our impression was that they were all moving in broadly similar directions with similar goals. This means that large banks will continue to compete with each other for the business of small businesses for the foreseeable future -- a good situation for small business.
B. Policy Issues

1. Supervisory Treatment of Small Business Banking Activities

Before the advent of federal deposit insurance, the main purpose of supervision and examination was to protect depositors. There has been much debate over whether the motive was to protect depositors per se, or to protect the economy from the destructive consequences of bank runs that occur when depositors at failing banks feel unprotected. The distinction is not important for this discussion. After deposit insurance, the main purpose was to prevent depletion of reserves in the deposit insurance fund and, ultimately, losses to the taxpayer. The important point in either of these scenarios is that it is losses on the bottom line of the bank’s balance sheet that cause the problem.

An examination of the sources of profitability that banks see in small business lending will provide clues as to how small business banking should be regulated. The general model of small business banking towards which large banks are moving was described in Section IV. The risk of loss on a small business loan picked at random is almost certain to be higher than the risk of loss on a middle-market or large corporate loan. One can deduce this simply from the fact that so many small businesses fail in any given year. But this higher rate of loss is offset by the fact that interest rates on small business loans are usually higher than on middle market and large corporate loans.

A further offset comes from the fact that a portfolio created from a given amount of money invested in small business loans is almost always less risky than a portfolio created from the same amount of money invested in middle-market or large corporate loans. The reason, according to the banks, is that such a portfolio will have greater diversification and be less volatile. A caveat is that this assertion is only true if the correlations among the returns of the large number of loans in the small business portfolio is relatively small -- in other words, if the returns are independent of one another. A portfolio of 10 large corporate loans from different industries and different areas of the country may have less volatility than a portfolio of 100
small business loans from the same geographic area whose returns are highly correlated because they are all dependent on the same local economic conditions. For large banks that cover large geographic areas, there is probably substantially less risk in a small business portfolio than in a large business portfolio of the same size.

A final offset to the higher risk of individual small business loans is that any portfolio of small business customers as a group, typically has a higher ratio of deposits to loans than large business customers. Indeed, at any particular point in time, many small business customers do not borrow at all. The percentage who do borrow is typically below 50 percent. This means that small business customers are furnishing large amounts of deposits that can be used for other purposes than making loans to small business -- e.g., shoring up capital and liquidity. The provision of a wide variety of fee-based services is also a large element in the relationship strategy banks try to implement with small businesses. It brings in fee income which enhances the profitability of the relationship, and it enhances customer loyalty which solidifies the relationship.

To the extent that this model has been put into place in banks, all of the factors mentioned above should be taken into account when evaluating the riskiness of small business banking. From our conversations with bank regulators, it is clear that this is not being done today. To have a sensible and complete approach to the regulation and supervision of small business banking, supervisors must inspect and evaluate all sources of profitability. It is, after all, only the lack of profitability that causes banks to fail.

Sources of profitability that should be considered when evaluating the riskiness of small business banking at a particular institution include:

1. The risk of loss on loans;

2. The ability to price to offset the risk of loss on loans;
3. The variability of the bank's portfolio of small business loans relative to its rate of return;

4. The ability to gather deposits from small business customers thereby gaining an additional source of profitability; and

5. The ability to sell other ancillary products to small business customers thereby gaining another additional source of profitability.

2. Regulatory Burden

Banking is a highly regulated industry. As such, the burden of its regulations is inevitably passed on to its customers. An important question is whether these regulations affect small businesses more than large businesses. There are at least three conceivable ways this could happen. Firstly, a regulation is sometimes structured so that a fixed cost per transaction is imposed on the bank. As smaller businesses are more likely to have smaller transactions than larger businesses, this type of regulation hurts small businesses more than large ones. Secondly, regulations may impose a fixed cost on the bank in which case the cost imposed per dollar of assets is smaller for large banks. These kinds of regulations hurt those small businesses that deal with small banks more than those that deal with large banks. Thirdly, if the totality of the regulatory burden is large, it may significantly impact the general cost of doing a commercial banking business. This may hurt small businesses more than large businesses because small businesses have fewer alternative sources of finance.

Loan documentation requirements are examples of one type of regulation whose effect varies with the size of the customer. Loan documentation requirements are, for the most part, a fixed cost associated with each loan. For a given sized loan portfolio, if the portfolio is made up of small business loans, aggregate documentation costs will be much higher than for a portfolio of the same size made up of large business loans. Other regulations that have similar effects are Equal Credit Opportunity Regulations (Reg B) and real estate appraisal standards. The
essential characteristic of regulations whose burden declines with the size of the transaction is that the regulation imposes a fixed cost on the bank that is incurred with each transaction. Many regulations are structured in this manner. They impose significant burdens on small businesses.

Regulations whose impact varies with the size of the bank generally have a fixed cost element which is imposed on the bank as a whole. This can be spread over a larger volume of business for larger banks. Hence the burden is greater for smaller banks. Examples of these types of regulations include the requirements for quarterly reports of condition and income, requirements for independent audits, and requirements for written policies for particular types of activities.\textsuperscript{19} It is frequently said that regulations that have a heavier impact on smaller banks than larger ones also have a greater impact on smaller businesses than larger ones. The reason usually given is that the commercial lending departments of small banks deal almost exclusively with small businesses. But the impact on the small business sector as a whole depends on whether small business deals more with small banks than large banks. Table 3 on page 7 is relevant to this issue. Small businesses of 500 employees or less, borrow more from large banks than small banks. But the very small businesses of 25 employees or less borrow more from small banks than large banks. On balance, there is a healthy competition between large and small banks across the size spectrum. The most that can be said about regulations that impact more heavily on small banks than large banks is that they give large banks a competitive advantage. This may cause some small businesses to prefer large banks over small banks.

The extent to which the totality of the regulatory burden is hurting small businesses is more difficult to analyze. The Federal Deposit Insurance Corporation Act of 1991 asked the Federal Financial Institutions Examination Council to study the regulatory burden placed on banks\textsuperscript{20}. This study concluded that the total regulatory burden was somewhere in the range of 6 percent

\textsuperscript{19} An excellent compendium of both types of regulations is given in "Summary of Bank Regulatory Requirements" American Bankers Association, Washington, D.C., 1993.

to 14 percent of non-interest expenses without allowing for the opportunity cost of holding non-interest bearing reserves. This suggests a number somewhere between $7.5 billion and $17 billion in total cost for the year 1991. One difficulty with expressing the problem in a simple number like this is that the burden may be multi-dimensional. Much comment from the banking industry suggested that the cumulative burden is greater than the sum of its parts. In addition, comments from the industry suggested that the pace of regulatory change imposes significant burdens on banks. Each new regulation requires one-time startup costs. As more regulations are imposed at a faster pace, these costs begin to mount. Finally, the large body of regulations imposes specificity and standardization in compliance. This inhibits the flexibility financial institutions have in responding to customer needs. All of these factors influence the regulatory burden.

In recent years, bankers and certain elements in the small business community have claimed that there has been a "credit crunch," and that one of the things aggravating the ability of small businesses to get needed credit was the regulatory burden placed on the banking industry. They have pointed to the declining amount of money being borrowed as evidence of this. But this is not conclusive evidence. Loans might decline because of higher costs imposed on the institutions granting credit or because of a lower demand for credit by the institutions borrowing. Almost all of the bankers we interviewed said that the most important factor influencing the demand for credit from small businesses was the general state of the economy in the areas in which they operated, or, more specifically, their sales.

In 1992, The National Federation of Independent Businesses published a survey that bears on this question. The survey was sent to 15,001 business owners, and 5,020 usable responses were received. The respondents were asked to rank 75 small business problems in terms of importance. The top three problems were the cost of health insurance, federal taxes on business incomes, and cash flow. Yet, obtaining long-term business loans ranked 46th, and obtain-

ing short-term business loans ranked 53rd. This picture is certainly more consistent with the view that the decline in the level of borrowing by small business is due to a low level of sales and not a lack of availability of credit.

This conclusion does not mean that the regulatory burden placed on banks does not hurt small businesses. If the regulatory burden were lifted in a significant way, one might indeed see a significant increase in small business lending. But it does mean that small businesses do not view credit availability as a major problem at the current time. To the extent that there has been a decline in their borrowing in recent years, it is most likely due to the state of the business cycle.

3. Regulatory Restrictions on Banking
   a. Branching

Convenience of location is important for small businesses in determining the bank with whom they choose to do business. Although the importance of this factor varies with the type of business, it is especially important for any business that receives daily payments. As banks switch to the model of small business banking we have described the ability to branch will become even more important.

In the 1980s, changes in the restrictions placed on multi-bank holding companies were significantly liberalized. This enabled banking institutions to greatly expand their geographic reach. But the maintenance of the holding company structure continued to impose significant costs on those institutions. Thus, the ability to branch interstate has become a significant issue.

To serve small business markets successfully, large banks need to be able to serve large volumes of customers at low cost. Unrestricted branching would facilitate this in two ways. First, it would eliminate the artificial costs imposed on companies through the multi-bank holding company mechanism. Second, and at least as important, it would facilitate an efficient expansion of the geographic reach of banking organizations. This in turn would give banks the
ability to provide locational convenience to a larger number of businesses and thereby build up the scale of operation needed to serve small businesses efficiently and profitably.

b. Powers

The essence of the relationship style of business banking that many large banks are pursuing is to be able to meet many different needs of businesses. The more powers businesses have to meet those needs, the better off they, and the better of their customers will be. Insurance and investment banking are two examples that come immediately to mind. The general point is that restrictions on what banks can do for their business customers, or the efficiency with which they can do it, restricts the profitability of serving small business markets.

c. Capital Standards

In the current regulatory capital standards, incentives have been put in place which favor investment in mortgages and government securities over commercial loans. To the extent that a bank’s commercial lending policy includes active attention to small business lending, small businesses are hurt by such policies.

Capital standards that do not vary for different types of risk do not have a negative effect on small business relative to other types of bank customers. If capital standards are too high, all bank customers are harmed by the excessively tight regulation. If they are too low, no harm is done as long as all institutions are well managed. It is when risk-based capital standards are applied that more specific effects might follow. For example, if judgments are ever made about the riskiness of different types of assets, and capital standards devised accordingly, small businesses could be hurt significantly. For reasons already explained, one cannot judge the riskiness of small business assets in isolation. If this is ever done with respect to small business loans in the determination of risk-based capital standards, small businesses will suffer. However, all of the banks we visited said that capital standards were not in any way inhibiting to their doing a profitable banking business with small businesses.
d. Appraisal Standards

Since FIRREA, appraisal standards have been a significant problem for banks who wish to lend to small businesses. It is not uncommon for small businesses to own the building in which their business is domiciled. Some entrepreneurs also frequently own other commercial buildings as well. For these people, the pledging of these assets has become increasingly difficult as standards have been tightened. Bankers have told us that both commercial and residential standards have been problems inhibiting their making of loans to small businesses. Regulators are aware of this problem. They have put two proposed regulatory changes out for comment: (1) A proposal that the current maximum for which licensed appraisers need not be used be increased from $100,000 to $250,000 for both residential and commercial properties; (2) a proposal that a special exemption of $1,000,000,000 be created for commercial properties for which the repayment of the loan is not based on the sale or rental value of the property. No final ruling on these proposals has been given, and trade groups for appraisers are objecting to the proposal. The American Bankers Association has supported both proposals and, in addition, suggested that the limit for commercial properties be raised to $500,000. Their concern is that appraisals on commercial properties are much more expensive than appraisals on residential properties and, hence, are the most significant part of the problem. Promulgation of all three of these proposals would be a significant boon to small businesses.

To try to quantify the importance of this problem we calculated the ratio of real property to total assets for different size classes of firms in different industries. The results are shown in the table below.\textsuperscript{22} For five out of seven of the industries there is a drop of 10 basis points or more from the smallest to the largest size class. The two exceptions are mining and real estate and insurance. Mining is probably dominated by equipment which is not generally pledged as

\textsuperscript{22}The data is from the 1988 National Survey of Small Business Finance. We are grateful to Professor George Haynes of Montana State University who did the calculations. The measure of real property used is actually real estate, depreciable and depletable property. This is the measure that was collected in the survey, and it is the number businesses must report on their federal tax returns.
collateral. Insurance and real estate are businesses which are usually housed in rental properties. This data indicates that, for a great number of small businesses, real property that could be pledged as collateral is more important the smaller is the business.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>Less than $100K</th>
<th>$100K-$500K</th>
<th>$500K-$1M</th>
<th>$1-$5M</th>
<th>$5-$15M</th>
<th>$15-$100M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>0.60</td>
<td>0.52</td>
<td>0.78</td>
<td>0.52</td>
<td>0.65</td>
<td>0.57</td>
</tr>
<tr>
<td>Construction</td>
<td>0.55</td>
<td>0.50</td>
<td>0.33</td>
<td>0.32</td>
<td>0.32</td>
<td>0.24</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.45</td>
<td>0.45</td>
<td>0.36</td>
<td>0.32</td>
<td>0.32</td>
<td>0.31</td>
</tr>
<tr>
<td>Transportation, Communication, and Public Utilities</td>
<td>0.72</td>
<td>0.65</td>
<td>0.55</td>
<td>0.54</td>
<td>0.54</td>
<td>0.47</td>
</tr>
<tr>
<td>Wholesale and Retail</td>
<td>0.41</td>
<td>0.42</td>
<td>0.34</td>
<td>0.30</td>
<td>0.30</td>
<td>0.25</td>
</tr>
<tr>
<td>Insurance and Real Estate</td>
<td>0.53</td>
<td>0.55</td>
<td>0.62</td>
<td>0.52</td>
<td>0.52</td>
<td>0.48</td>
</tr>
<tr>
<td>Services</td>
<td>0.55</td>
<td>0.51</td>
<td>0.45</td>
<td>0.46</td>
<td>0.46</td>
<td>0.28</td>
</tr>
</tbody>
</table>

The Dallas Federal Reserve study cited previously, gives further evidence on this question for the small business community as a whole. That study estimates that loans secured by non-farm non-residential property represent 46 percent of the dollar volume of small business loans made by banks. 23. Liberalization of appraisal requirements on commercial property would be quite important to banks and their small business customers. For smaller small businesses, residential property is frequently used to secure loans. Thus, liberalization of these requirements would also be important.

4. CRA

For the most part, bankers view CRA as a burdensome regulation with which they have learned to live. All of the banks we interviewed are proud of their CRA record and believe they are serving their communities well. However, some did complain that their record in serving small businesses was not adequately taken into account by regulators. Their concern

was that the population of low- and moderate-income individuals is easier to categorize quantitatively, and that the CRA population of individuals receives more attention than the CRA population of small businesses. Banks also expressed concern that, as non-bank competition becomes more intense in certain areas, the fact that many of these institutions are not subject to CRA will become a competitive disadvantage for banks which could inhibit their service to small business markets.

VIII. SUMMARY OF RECOMMENDATIONS AND CONCLUSIONS

A. Banks

The simplest and most important conclusion of this study is that large banks are very interested in doing business with small businesses. Their presence in the small business market is large and growing. Their approach to the small business market is evolving towards a marketing and organizational approach that is unique to large banks, and efficient in providing service to small businesses.

The model towards which they are evolving is one which is based on high investments in technology and the achieving high volume to control costs by taking advantage of those investments. The branch distribution system is critical to this approach, although it is not the only distribution mechanism being used. The marketing approach used is to build up a sales staff which has the training and ability to spend almost more of its time with the customer. Many banks are structuring sales incentive programs to prompt their staffs to give better service to small business customers and to reduce turnover in the staffs of people who serve small businesses. Some form of separation of the sales and underwriting functions facilitates this approach. It prevents any conflict of interest from arising from having people under a sales incentive program also bearing the ultimate responsibility for approving a loan. It also allows the centralization of underwriting to take advantage of investments in technology and control costs. Finally, it relieves the sales staff of much of its paperwork burdens and allows sales people to spend more time with their customers.
Large banks recognize that they cannot profitably serve small business customers in the same way they do large corporations. This model will enable them to provide cost-controlled, efficient service that focuses specifically on the needs of small business. They also recognize the competition from community banks and the positive role played by these institutions in serving small businesses. They believe this approach to the small business market will enable them to meet this competition to the benefit of themselves and small businesses.

B. Policy Makers

An individual small business loan is, on average, more risky than a large business loan. Yet, compared to large businesses, the small business sector is the growing, profitable and dynamic sector of our economy. Thus, if sensibly managed, small business banking should be safe and profitable. In analyzing the risk of small business banking, large banks look at the risk of their small business portfolio, not just the risk of individual loans. A portfolio of loans of a given size will be much more diverse and less risky if it is composed of small business as opposed to large business loans. This is particularly true for banks that can diversify their portfolios through the geographic reach of a large branch system. Regulators and supervisors need to take this ability into account in judging the riskiness of small business banking. If they do not, small business will suffer as a result.

Elimination of branching restrictions would be a significant step towards allowing banks to serve small businesses more efficiently. This would come about in at least three ways. First, branching restrictions impose many artificial costs on banks which raise the overall cost of delivering banking services. Second, by lowering the cost of extending branch networks geographically, large banks would be able to build up the volume in their small business portfolios that is needed to serve small banks efficiently. Finally, removal of restrictions on branching would facilitate geographic diversification which would lower risk.
Many fears have been expressed about the effects of eliminating branching restrictions on small businesses. For the most part, these fears are groundless.

One of the most widely voiced fears is that small banks will be "gobbled up" by large banks, and that small businesses will be hurt by this because only small banks serve small businesses. This study has demonstrated that large banks provide more credit to small businesses than small banks. Within the different size categories of small businesses, small banks provide a greater proportion of the credit to the smaller small businesses (less than 25 employees), although the amount provided by large banks is significant. Overall, large banks provide 44 percent of the credit to small businesses, and small banks provide 32 percent. The balance is provided by mid-sized banks. Competition among the different sizes of banks for the businesses of banks is quite healthy.

There is no reason to expect that the end of branching restrictions will mean the end of small banks. California and North Carolina, both geographically large and diverse states, have allowed state-wide branching for most of the twentieth century. Community banking has flourished in these states. In the post-World War II era, many states, including New York and Florida, had eliminated branching restrictions within their borders, and community banks have competed successfully in the new environments. In the last 15 years, many states have allowed interstate banking within their borders through the holding company mechanism. Although the total number of banks has decreased in this environment, community banks have continued to compete effectively.

A second fear that has been expressed about consolidation is that large banks will not have the flexibility needed to handle the needs of small business. The achievement of a high volume of business to take advantage of economies of scale is a major goal of large banks in serving the small business market. Achieving volume necessarily involves some degree of standardization. Large banks strongly assert that they have the flexibility needed to serve all types of small businesses who are credit worthy. Even if they do not, experience indicates that there will always be a significant community banking sector to compete for this type of business.
Of course, for businesses that are not creditworthy, consolidation, or the lack of it, will not solve the problem.

One thing that mergers and consolidation do is disrupt banking relationships. Loan officers are transferred, or lose their jobs, and new officers are assigned to accounts. In addition, the lending standards of merged institutions change. This does not mean the new institutions will not be interested in small businesses. In all likelihood, they will. It does mean that small businesses will have to be aware of these trends and be willing to work at forming new relationships.

A third policy issue that is important for small business is that of appraisal standards for both residential and commercial property. These standards were drastically tightened by FIRREA. Small business owners frequently use homes and commercial property they own as collateral for loans to finance the growth of their business. Regulators are currently considering loosening these standards in order to help the growth of small businesses. Implementation of these proposals would be very helpful to small businesses.

More generally, the regulatory burdens placed on banks inevitably get passed on to their customers. Particularly harmful to small businesses are those regulations that impose a fixed burden per transaction and, therefore, make smaller transactions more difficult to do. Appraisal standards are only one example of this type of regulation. In assessing the effects of bank regulation, particular care should be taken to examine these kinds of regulations.

C. Small Business Administration

One of the most important points to come out of our interview process relative to the SBA itself was the discrepancy in feelings about the different SBA regional offices. Some felt their local SBA offices were a great help; others did not. There was also a perception of a lack of uniformity among the standards and procedures used by the different offices. This is a partial explanation of the differing attitudes among large banks as to the usefulness of SBA guarantee
of small business support agencies at the state and local government levels. Some preferred working with their state and local agencies; others much preferred the SBA. A third reason occasionally given for some hesitancy to deal with the SBA guarantee programs was the paperwork difficulties involved in packaging an application.

None of these comments should be taken as indicating that bankers are against the SBA. Almost all we talked with understood its role and were supportive of it. For each of the complaints listed above we experienced almost exactly opposite comments from other bankers. For example, some thought that packaging of loans was not a problem, particularly with the packaging consultants they could hire. As already mentioned, some also spoke very highly of their SBA regional offices. And others spoke very highly of the SBA relative to the programs of their state and local governments. The picture is mixed, and we believe it would be useful for the SBA to try to gain a better understanding of the reasons for these variations. A good way to gain such an understanding is to undertake some case studies of why some banks do well with SBA programs and some do not; why some regional offices have good reputations, and some do not; and why some state and local programs are successful relative to the SBA, and some are not. Finally, it should be noted that if one looks at the top originators of SBA-guaranteed loans, banks have a strong presence. Their SBA-guaranteed loan customers tend to be smaller small businesses than those of the non-bank institutions.

D. Small Businesses

Small businesses rely heavily on banks. They need to understand the changes going on in the banking industry and what they mean for small business. The increased interest in the small business market among large banks gives opportunities to small businesses. But it also presents challenges. Banks value banking relationships because a long, stable relationship with a customer gives a bank more information about a customer than it could get from public sources. Businesses that have long, stable relationships with banks generally have greater availability of credit and have to pledge less collateral for loans. Sacrificing such a relationship to do business with a new bank, or to buy services from non-bank financial institutions
may mean the business has to give up some of these advantages. On the other hand, it may mean a business can get more services or get them for a cheaper price. In addition, when a bank is acquired by another bank its customers may be giving up some of the advantages of relationship banking anyway. This will be particularly true if those businesses have to deal with new personnel.

While these challenges may be difficult to deal with, it is important to realize that, from the point of view of small businesses, the general trends in the financial services industry are quite positive. Small businesses can deal with more efficient large banking organizations who are competing more with other large banks for their business. These banks are also facing increased competition from community banks and non-bank institutions. This situation can only help aggressive small businesses who understand what is going on in their marketplace.


Dallas Federal Reserve Bank, Financial Industry Issues, Dallas, Texas, third quarter, 1993.


Mullins, David, Jr., Vice Chairman, Board of Governors of the Federal Reserve System, Testimony before the Committee on Small Business, United States Senate, Washington, D.C., March 4, 1993.


U.S. Chamber of Commerce; "Where I Stand" poll on Obtaining Credit by Nation's Business Washington, D.C., September, 1992.