STUDIES OF SMALL BUSINESS FINANCE

A Report to Congress

PREPARED BY

THE INTERAGENCY TASK FORCE ON SMALL BUSINESS FINANCE

February, 1982

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Bureau of the Census
Small Business Administration
The Honorable Parren J. Mitchell  
Chairman  
Committee on Small Business  
House of Representatives  
Washington, D.C. 20515  

Dear Mr. Chairman:  

Pursuant to Title IV (Sec. 404) of Public Law 96-302, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency in consultation with the Bureau of the Census and the Small Business Administration are pleased to submit a report on small business finance. This report contains several studies on small business financing and recommendations as to the feasibility and cost of further data collection efforts. The Minority Business Development Agency participated in the review of the report.  

Sincerely,  

Paul A. Volcker  
Chairman, Board of Governors of the Federal Reserve System  

C. T. Conover  
Comptroller of the Currency  

William M. Isaac  
Chairman, Federal Deposit Insurance Corporation
The Honorable Lowell P. Weicker, Jr.
Chairman
Select Committee on Small Business
United States Senate
Washington, D.C. 20510

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The Honorable Thomas P. O'Neill, Jr.
Speaker of the House
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United States Senate  
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SUMMARY

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, in consultation with the Bureau of the Census and the Small Business Administration, submit the report, "Studies of Small Business Finance", to Congress as directed by Public Law 96-302. The report, prepared by the Interagency Task Force, covers studies conducted on small-business finance and on the extent to which commercial banks are meeting the credit needs of small business as well as views and recommendations concerning the feasibility and cost of conducting periodic sample surveys of the volume of commercial and industrial loans extended by commercial banks to small business.

The report is divided into four chapters. Supporting materials are included in the report.

The first chapter is an overview of 20 studies prepared for the Interagency Task Force which discuss the small-business finance environment and highlight recent trends in small business financing. The general conclusions are:

- The papers do not provide significant evidence that a substantial gap exists in the financing of small business, although the evidence is not conclusive, i.e., it does not prove that such a gap does not exist.

- There is a greater variety of sources and methods of small business financing now than there was 20 years ago, suggesting that small businesses may have greater access to funds now than at that time.

- Government regulations and public policy decisions often have unintended adverse impacts on small business financing.

The second chapter is a summary of the results of an interview survey of about 250 commercial bank lending officers regarding their bank small-business lending practices, a survey conducted in September 1981 during a period of high interest rates and severe financial stress for the business community. The results should reflect bankers' perceptions of their banks' behavior toward small businesses operating under
relatively adverse circumstances, but do not represent the perceptions of small businesses. The general results are:

- Bankers believe that the commercial banking industry is the major institutional source of small-business credit, with most of the small-business bank credit estimated to be held by banks with less than $1 billion in assets, those often considered to be small and medium-sized banks.

- Based on the bankers' perceptions, banks generally would appear to be making a good effort to respond to the credit needs of their small-business customers.

- In this period of high interest rates, there are many similarities on average among reported characteristics of loans to small and large businesses, including reported typical interest rates charged and loan rejection rates for existing businesses.

- The majority of bankers believe that laws and regulations implemented by the bank regulatory agencies have had no effect on their small-business lending policies; the rest generally believe the effect to have been adverse.

The third chapter is a summary of written comments submitted by small businesses on their experiences with obtaining bank credit and with government loan programs. These comments were solicited by the Small Business Administration under separate legislative authority through a notice published in the Federal Register. The respondent group, which may represent an important subset of the small business, is not representative of the universe of small business and therefore their responses do not necessarily characterize the experience and opinions of all small businesses. The results for the respondent group are:

- Three-fourths of the respondents said that banks are meeting their credit needs, although a third also said that they had experienced difficulties in obtaining bank credit.

- More than two-thirds of the respondents believe that the size or location of a bank affects its willingness or ability to meet their credit needs; the largest respondent group stating a specific preference, 15 percent, preferred a local bank.

- Only two comments or recommendations on how banks can make improvements in meeting their credit needs were common to a number of respondents; 17 percent said interest rates were too high and 13 percent said that bankers should better understand the small firms' business and industry.
The fourth chapter presents the banking agencies' views and recommendations with respect to the future collection of commercial bank small-business loan volume data, specifically the number and dollar amount of commercial and industrial loans.

- The general recommendation is that no massive new data collection effort should be undertaken at the present time; an existing Federal Reserve data collection effort will be modified (subject to OMB approval) to provide periodic estimates of bank credit flows to small business.

- Banks should be encouraged to begin adding borrower size information to their computer files.

- Bank agency staff should study the difficulties, potential cost burden, and usefulness of collecting reliable sample data on bank commercial and industrial loans outstanding to small business and determine whether there is a feasible way to collect such data subject to user need and cost burden considerations.
The preparation of this report was the responsibility of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) in consultation with the Bureau of the Census and the Small Business Administration (SBA).* Continuing oversight of the work was provided by the Interagency Task Force on Small Business Finance whose members from the banking agencies were William A. Longbrake (OCC), Task Force Coordinator, Alan S. McCall (FDIC), Stanley C. Silverberg (FDIC), and Eleanor J. Stockwell (FRB). John A. Dodds (Census) and Gerald L. Feigen (SBA) represented their respective agencies. At various times during the course of the study Robert E. Berney (SBA), Elmer S. Biles (Census), and Bruce A. Kirchhoff (SBA) also served on the Task Force. These individuals provided guidance and direction in planning and conducting the study and made valuable contributions throughout to ensure the successful and timely completion of the report. Peter L. Struck (OCC) gave critical administrative support at many stages of the work.

Several other individuals assisted in one or more ways in the information-gathering activities undertaken by the Interagency Task Force. The aggregate contributions of these individuals proved invaluable in accomplishing the many tasks necessary to bring a report of this nature to completion.

*SBA's participation was represented by the staff of the Office of the Chief Counsel for Advocacy.
For the 20 scholarly papers prepared for the Interagency Task Force, Paul M. Horvitz, University of Houston, contacted the many authors (whose names are listed in the Supporting Materials section), coordinated their efforts and reviewed all of the papers. Within the Interagency Task Force, William B. Whiston (SBA), Charles Ou (SBA) and Eleanor J. Stockwell (FRB) reviewed many or all of these papers. In addition to reviewing and editing many of these papers, Alan S. McCall (FDIC) served as the principal liaison between the Task Force and the authors. Sandra P. Walls (OCC) expertly prepared several of the manuscripts for publication.

Participating in the design of the commercial bank survey questionnaire were Lloyd Arrington (SBA), Michael B. Barton (OCC), Thomas F. Brady (FRB), John A. Dodds (Census), Cynthia A. Glassman (FRB), Bruce A. Kirchhoff (SBA), James W. Lowell (FRB), Lewis Mandell, University of Connecticut, Alan S. McCall (FDIC), Peter L. Struck (OCC), and James Vitarello (OCC). Through the efforts of these individuals, a comprehensive survey instrument was developed.

To conduct the interviews, a special talent commonly referred to as the "art of interviewing" was needed. The interviewers, listed below, all possessed this talent which ensured the success of the survey. Additionally, many of these individuals spent a week or more "on the road" interviewing.

**Interviewers**

- Paul S. Anderson - (formerly) Federal Reserve Bank of Boston
- Constance R. Dunham - Federal Reserve Bank of Boston
- Timothy J. Lord - Federal Reserve Bank of New York
- Lois A. Banks
- John A. Carty
Janice M. Moulton - Federal Reserve Bank of Philadelphia
John G. Bell

Gary W. Whalen - Federal Reserve Bank of Cleveland
Paul R. Watro

Walter A. Varvel - Federal Reserve Bank of Richmond
Kemper W. Baker, Jr.

Jody A. Fletcher - Federal Reserve Bank of Atlanta

Elijah Brewer - Federal Reserve Bank of Chicago
Philip A. Cummins
George W. Cloos
Max E. Ziemer
Jeffrey L. Miller
Sue Ford

Norman V. Bowsher - Federal Reserve Bank of St. Louis

David S. Dahl - Federal Reserve Bank of Minneapolis

Jon W. Faust - Federal Reserve Bank of Kansas City
Ann J. Adair
Dale N. Allman

Don A. Riffe - Federal Reserve Bank of Dallas
Edward L. McClelland

Barbara Bennett - Federal Reserve Bank of San Francisco
Gary Zimmerman

Cynthia A. Glassman - Board of Governors of the Federal Reserve System
Eugenie B. Mallinson
Thomas F. Brady

Eberhard Irmler - Office of the Comptroller of the Currency
Peter L. Struck
James Vitarello

Jay D. Karp - Federal Deposit Insurance Corporation
Alan S. McCall

vi
The bankers who participated in the survey were most cooperative and expended a considerable effort in responding to the questionnaire. The information received was invaluable to the compilation of this report.

Cynthia A. Glassman (FRB) was responsible for the timely preparation and processing of the survey data with assistance from Linda L. Hayes, Rivane V. Bowden, Steven R. Schacht, Frances Ann Giacobbe, and Nancy B. Pittman, all of the Federal Reserve Board. Without the valuable assistance and expertise of this group the usefulness of the survey data would have been severely limited. Similarly, Samuel L. Slowinski (FRB), David W. Chapman (Census), and Lewis Mandell, University of Connecticut, provided technical expertise and helpful suggestions on the sample selection procedure, estimation techniques, and the analytical interpretation of the data.

The culmination of these efforts was a paper on commercial bank small-business lending practices written by Cynthia A. Glassman (FRB) and Peter L. Struck (OCC). Rivane V. Bowden provided invaluable assistance in all stages of data and manuscript preparation.

The tabulation of written comments received from the SBA Federal Register notice was prepared by the following members of the Task Force staff: Jules E. Bernard (FDIC), Benjamin B. Christopher (FDIC), Maureen Glebes (SBA), James W. Lowell (FRB), Melanie R. Quinn (OCC), and Stephen P. Stanalonis (SBA). This effort, given the time pressures involved, was performed efficiently and effectively.
The drafting of the report was coordinated by the Interagency Task Force. William A. Longbrake (OCC), Alan S. McCall (FDIC), and Eleanor J. Stockwell (FRB) merit special mention for their substantive input and watchful guidance. Peter L. Struck (OCC) provided valuable administrative and logistical support in this effort.

Bruce A. Kirchhoff, Minority Business Development Agency, reviewed early drafts of the report and his comments are gratefully acknowledged. Shirley Kallek (Census) coordinated her agency's contribution to this report.

Finally, OCC staff were responsible for the actual production of the report. Sandra P. Walls and Lee K. Guy willingly gave of themselves in typing the report through its many drafts. Ellen Stockdale and Elizabeth Ford coordinated the production and distribution of the report. Al Mitchell handled the actual reproduction and assembling of the report and the supporting materials with the able assistance of Tony Wells.
### STUDIES OF SMALL BUSINESS FINANCE

<table>
<thead>
<tr>
<th>Contents</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary</td>
<td>i</td>
</tr>
<tr>
<td>Acknowledgments</td>
<td>iv</td>
</tr>
<tr>
<td>Table of Contents</td>
<td>ix</td>
</tr>
<tr>
<td>List of Supporting Materials</td>
<td>x</td>
</tr>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Chapter 1: Overview of a Series of Papers on Financing Small Business</td>
<td>4</td>
</tr>
<tr>
<td>Chapter 3: Summary of Responses to the Small Business Administration Federal Register Notice Requesting Small Business Comments on Credit Needs</td>
<td>36</td>
</tr>
<tr>
<td>Chapter 4: Feasibility and Cost of Periodic Sample Surveys: Views and Recommendations</td>
<td>39</td>
</tr>
</tbody>
</table>
Series of Papers on Financing Small Business

Role of Small Business in the American Economy
  Lawrence J. White, New York University

Who Finances Small Business Circa 1980?
  Victor L. Andrews, Georgia State University
  Peter C. Eisemann, Georgia State University

Commercial Bank Business Lending by Size of Loan
  Thomas F. Brady, Board of Governors of the Federal Reserve System

Relationship between Commercial Bank Loan Size and Size of Borrower
  Martha S. Scanlon, Board of Governors of the Federal Reserve System

Analysis of the Impact of Firm Size on Business Loan Rates, Operating Costs, and Size of Loan: The Evidence from Cross-Section Data
  Neil B. Murphy, University of Connecticut

American Commercial Banking Structure and Small Business Lending
  Donald T. Savage, Board of Governors of the Federal Reserve System

Changes in Commercial Banking Structure and Small Business Lending
  Bernard Shull, Hunter College

Small Business Access to Capital Markets Through Pension Funds
  Richard Zock, University of Houston

Small Firms' Access to Public Equity Financing
  Hans R. Stoll, Vanderbilt University

Business Development Credit Corporations
  Paul S. Anderson

A Review of the Small Business Administration's Major Loan Programs
  Timothy Bates, University of Vermont

Lease Financing: An Attractive Method of Financing for Small Firms
  Oswald D. Bowlin, Texas Tech University
Credit Cards and the Financing of Small Businesses  
Lewis Mandell, University of Connecticut

Franchising and the Financing of Small Business  
Robert Mittlesteadt, University of Nebraska-Lincoln  
Manferd O. Peterson, University of Nebraska-Lincoln

Equity Participation Agreements and Commercial Bank Loans to Small Business Firms  
David J. Brophy, University of Michigan

Application of the Modern Theory of Finance to Small Business Firms  
John J. McConnell, Purdue University  
R. Richardson Pettit, University of Houston

The Impact of Usury Laws on the Effectiveness and Efficiency of the Operation of Small Business  
R. Richardson Pettit, University of Houston  
John J. McConnell, Purdue University

Credit Rationing and Small Business Finance  
Stuart I. Greenbaum, Northwestern University  
George Kanatas, Northwestern University  
Sudhakar Desmuhk, Northwestern University

The Impact of Bank Regulation on Small Business Financing  
Harry P. Guenther, Georgetown University

Tax Policy and Small Business Financing  
Thomas S. McCaleb, Florida State University

Survey of Commercial Bank Lending to Small Business  
Cynthia A. Glassman, Board of Governors of the Federal Reserve System  
Peter L. Struck, Office of the Comptroller of the Currency

Responses to the Small Business Administration Federal Register Notice Requesting Small Business Comments on Credit Needs  
Staff of the Interagency Task Force on Small Business Finance
INTRODUCTION

In Title IV (Sec. 404) of Public Law 96-302, Congress directed the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency in consultation with the Bureau of the Census and the Administrator of the Small Business Administration "to conduct such studies of the credit needs of small business as may be appropriate to determine the extent to which such credit needs are being met by commercial banks" and present "their views and recommendations as to the feasibility and cost of conducting periodic sample surveys, by region and nationwide, of the number and dollar amount of commercial and industrial loans extended by commercial banks to small business."

In response, representatives of the agencies established the Interagency Task Force on Small Business Finance. The function of the Task Force was to plan, direct, and review appropriate studies of small business finance and prepare a comprehensive report to Congress.

Scope of the Report

In assessing the credit needs of small business and the extent to which they are being met, it is necessary to gauge both the supply of and the demand for credit by the small business community. To achieve this objective, the Interagency Task Force assembled from primary and secondary sources both quantitative data and qualitative information.
However, because the Conference Report accompanying Public Law 96-302 stressed that the agencies not solicit any additional information from small business concerns, this report contains only limited information pertaining to small business demand for credit.

Because the commercial banking industry represents only one source of small business credit, the Interagency Task Force broadened the scope of this report to provide information on many other suppliers of funds to small business. These other suppliers may play a large role in providing credit to certain segments of the small business community.

It should be noted that there are many heterogeneous subgroups within the small business community. The financing needs of these subgroups are not necessarily similar. For example, the so-called "growth-oriented" firms may have a greater need for longer term financing than local, service-oriented small businesses. Although the Interagency Task Force recognized that financing needs may differ, perhaps substantially, among small business subgroups, the report focuses for the most part on the small business community, in general, rather than on specific subgroups.

Organization of the Report

The report consists of three chapters summarizing studies on small business finance, and a fourth chapter of views and recommendations on collecting data on commercial bank small-business loan activity. The first chapter summarizes 20 studies prepared by academicians and Federal Reserve staff. These studies provide an overview of the small business
finance environment and highlight recent trends in small business financing. This collection of studies also serves to update one part of the 1957 Federal Reserve System study on the adequacy of financing for small business.

In the second chapter the results of a survey of commercial bank lending officers are summarized. The lack of comprehensive statistics on commercial bank lending to small business prompted the Interagency Task Force to survey about 250 commercial bank lending officers regarding their small-business lending practices. Conducted in September 1981, the survey provides information on the availability, use and pricing of bank credit.

To permit an assessment of the demand for small business credit, the third chapter presents a summary of written comments submitted by small businesses on the flow of bank credit to them. This information was collected by the Small Business Administration under independent legislative authority.

Finally, the fourth chapter presents a discussion of the feasibility of collecting data on commercial bank small-business lending including both user needs and respondent burden, the costs and benefits of such efforts, and recommendations for their collection.
OVERVIEW OF A SERIES OF PAPERS ON FINANCING SMALL BUSINESS

I. Introduction

Small business plays three key roles in the U.S. economy. First, small business represents a substantial part of the economy in terms of employment and total sales. Second, small firms are a major source of growth and innovation. Third, small business ownership is an important means of economic, social, and personal advancement, and, as such, is a cornerstone of our free enterprise system.

Although small business has flourished in the United States for 200 years, concern has arisen that its record of progress and importance may be threatened by recent developments in technology, the economy, and government policy.

Small business people complain frequently about governmental policies. However, it is unclear whether and to what extent those policies are particularly burdensome to small businesses. The inadequacy of financing, either with respect to availability or cost, is a frequent complaint. Although this has not been the most serious problem--taxes, government regulation, the state of the economy have all been more important at various times--it has been a consistent complaint.

The purpose of the series of papers is to examine several aspects of the adequacy of financing for small business. Although concern about the adequacy of financing has been continuous over the years,
there has been no large-scale study of the problem since the Federal Reserve System study was conducted in 1957 and released in 1958. That study led to legislation that created the Small Business Investment Companies. There have been major changes, however, in the economy and in the financial system since that time. The series of 20 papers represents a partial update of that study.

The first paper is an overview of the current role of small business in the economy. Sources of small business financing—especially commercial banks which are the major institutional source—are dealt with in the first group of papers. Other sources of funds—pension funds, business development credit corporations, the SBA, and the public equity market—are also studied.* However, insurance companies and finance companies are not included in this survey because a wide-scale series of interviews with them would have been required to gather relevant information.

Because of the dramatic changes in financial markets and financial institutions since 1957, another group of papers deals explicitly with important new financing devices—lease financing, equity participations in loan agreements, credit cards, and franchising. Certain characteristics of these devices make them particularly relevant for small firms. Recent developments in finance theory relevant to small business financing are discussed in another paper in this group.

*The bond market is not studied because small business has virtually no access to it.
The third group of papers focuses on broad aspects of the "equity" issue; that is, the fairness or equitableness of the present financial system with respect to small and large business access to financing. Each paper considers whether small businesses are placed in a favorable or unfavorable position as compared with large firms. The issues examined include: the equity of the tax system with respect to the treatment of large and small firms; the relative impact of commercial bank regulation and supervision on banks' willingness to lend to small and large businesses; the effect of state usury laws on the relative cost and availability of credit to different-sized businesses; and whether, in theory, the forces of competition would prevent lenders from discriminating against small borrowers and eliminate any need for governmental intervention in financial markets. Many of the other papers in the first two groups deal, at least in part, with the difficult task of assessing the equity issue.

II. Review of Papers

Despite the broad acknowledgement of the importance of small business in the U.S. economy, and the attention that has been paid to the problems of small business over the years, it remains difficult to measure with any precision the current role of small business in the economy or to assess changes in that role over time. Such measurement is important to any evaluation of the adequacy of financing for small business. If small business has been growing more rapidly than the economy as a whole, that
suggests that financing problems have not posed an insurmountable obstacle; but if small business' role in the economy has been shrinking, then the adequacy of financing must be considered as one possible source of the problem.

Overview of Current Role of Small Business

Lawrence J. White in *Role of Small Business in the American Economy* examines a variety of data sources in attempting to measure the change in the relative role of small business in the economy over the last 20 years. Some measures show strength and growth in the small business sector. For example, the number of firms in the United States has about doubled since the end of World War II. Establishments with fewer than 100 employees accounted for 55 percent of total employment in 1977 (the latest data available and the highest figure in many years).

In contrast with this apparent strength and growth, small business generally appears to account for a somewhat smaller share of sales and employment in individual sectors of the economy than was the case 20 years ago. The decline in inflation-adjusted sales is larger than the decline in employment share. However, the composition of the U.S. economy is shifting away from manufacturing (a sector in which small business plays a relatively small role), and towards retail trade and services (in which small business has a larger share). The net result, White concludes, is that the "relative importance of small business has declined modestly over the past two decades."
To judge whether these trends are likely to continue, it is necessary to know more about the factors that account for changes in the relative importance of small firms in the various sectors of the economy. White's empirical analysis of this issue, while preliminary, does produce some suggestive results. Among other findings, White concludes that small businesses fare best in industries which have low capital-labor ratios, have high transportation and communication costs, or are growing rapidly. He notes that the opposite conditions have prevailed in the aggregate over the last 20 years. Capital-labor ratios have increased, transportation and communication costs have fallen relatively, and the growth of the economy has slowed. The modest decline in the role of small business despite these unfavorable conditions overall is a sign of small business vigor. Although it seems probable that these conditions will not change in coming years, the continued movement of the economy toward an emphasis on services is expected to favor small business.

Sources of Finance

The papers in this group present detailed analyses of several sources of small business finance. Victor L. Andrews and Peter C. Eisemann in Who Finances Small Business Circa 1980? present an overall review of the financing patterns of small business. They find significant differences in the financing of small and large firms. Small firms have higher debt/equity ratios than large firms (65 percent versus 58.8 percent), and rely more on short-term sources of debt (38.1 percent of all sources versus 28.1 percent). Although these figures have changed over time, the
relationship between the ratios for small and large corporations has been relatively constant.

The 1957 study (of which Andrews was one of the authors) concluded that commercial bank loans and trade credit were the most important sources of funds for small firms. These sources continue to be important, although their relative role appears to have diminished. Finance companies and leasing companies have become more important than they were. However, many leasing and finance companies are now subsidiaries of bank holding companies. The role of these institutions is described in more detail in several other papers.

Data on commercial lending to small business are rather limited. A potentially useful source of information is the Federal Reserve's Survey of Terms of Bank Lending (STBL). These data are, in fact, used in several of the papers. The STBL collects information by size of loan (but not size of borrower). Using these data, Thomas F. Brady in *Commercial Bank Business Lending by Size of Loan* finds some clear differences between large loans and small loans. Small loans are more likely to involve collateral, less likely to be made under a commitment, more likely to bear a fixed interest rate, and, under most conditions, more likely to have a higher interest rate. During recent periods of very high interest rates, however, the interest rates on small loans have been lower than those on larger loans.
This information would be directly relevant to this study if it could be assumed that large loans are made to large firms and small loans to small firms. Although it is clear that very large loans can only be made to large firms, small loans may also be made to large firms. Martha S. Scanlon in *Relationship between Commercial Bank Loan Size and Size of Borrower* examines the extent to which loan size can be used as a proxy for size of firm. The correlation between size of loan and size of borrower is not as reliable as would be desired. Although very large loans and very small loans are made to large and small firms, respectively, there is a substantial area of overlap in medium-sized loans. Scanlon does conclude, however, that if information on the size of the commitment were included in the survey, it would be possible to segregate the bulk of the small loans to large firms.

Data discussed by Brady and Scanlon are also of interest because of the information they may provide on the question of whether small firms have access to bank financing on terms comparable to those obtained by large firms. Neil B. Murphy in *Loan Rates, Operating Costs, and Size of Loan: The Evidence from Cross-Section Data* examines this issue directly by looking at a cross-section of loans to assess the relationship between loan size and interest rate. After statistically holding constant the nonprice characteristics of the loans, such as maturity and collateral, he found that large loans had slightly lower interest rates than small loans (a difference of 62 basis points between loans of $100,000 and $1,000,000). However, the data Murphy used were for 1979, a period
which, according to Brady's analysis of STBL data, was one of the few times in which small loan rates were unusually close to rates on large loans. Other characteristics that distinguish large and small loans, particularly fixed rate versus floating rate, were especially important at that time.

Murphy also analyzes the cost of servicing loans of various sizes to determine whether differences in rates paid on small and large loans can be explained on the basis of differences in direct operating costs. Murphy concludes that substantial cost differences exist. Direct operating cost for a $10,000 loan is about 2 percent while the cost for a $500,000 loan is under 1 percent. Cost differences of this magnitude are more significant during periods of low interest rates than when rates are high. These results indicate that when differences in interest rates by size of loan are greater than 1 percent, explanations must be found in factors other than cost differences.

Andrews and Eisemann conclude that leasing and finance companies have grown in importance as a source of financing for small business. They note that this growth may represent a change in the organizational means by which commercial banks lend to small business. The development of bank holding companies and particularly their nonbank subsidiaries, a very minor part of the financial structure at the time of the 1957 Federal Reserve study, represents a substantial change in banking structure. Papers by Donald T. Savage and Bernard Shull describe this and other structural changes and consider what implications they may have
for small business financing. In addition to the acquisition of nonbank financing subsidiaries by bank holding companies, Savage in *American Commercial Banking Structure and Small Business Lending* finds that in many markets small banks are being replaced by branches or subsidiaries of large institutions.

On the basis of a limited number of interviews with commercial banks, Shull in *Changes in Commercial Banking Structure and Small Business Lending* finds it impossible to generalize whether these structural changes will lead to increased or lessened interest in lending to small firms by banks. Further structural change seems probable during the 1980's, and could be significant if the barriers to interstate banking are eased. In public policy debates over the wisdom of easing such barriers, the implications for availability of small business financing are an important consideration. Shull particularly notes that one of the important trends in banking structure in the United States is a greater role for foreign banks. In light of this expansion, Shull feels that the attitude of such institutions toward small business lending should be examined.* The results of Shull's limited interviews [with foreign banks operating in this country] are suggestive, but they indicate to the author the potential value of more broadly based interviews.

* The effect of foreign acquisition on U.S. bank loan portfolios was examined in *Foreign Acquisitions of U.S. Banks*, Staff of the Office of the Comptroller of the Currency (Robert F. Dame, Inc., 1981), Chapter 13, "Effect of Foreign Acquisition on the Balance Sheet Structure and Earnings Performance of U.S. Banks." This study concludes that there is little evidence to indicate that foreign-acquired banks turn away from their local markets.
Four papers deal with other sources of financing for small business. Pension funds, because of their rapid growth, large size, and the long-term nature of their liabilities are an important potential source of both equity and long-term debt funds. In Small Business Access to Capital Markets Through Pension Funds, Richard Zock focuses on the use of venture capital pools by pension funds and the legal uncertainties that have developed for such operations since passage of ERISA. A theme that runs through several of these studies is that governmental regulation, designed to protect financial institutions or their customers, has had the unintended side effect of making the institutions less willing or less able to finance small business. This problem is discussed by Zock. It is also relevant to equity participations, discussed by David J. Brophy in Equity Participation Agreements and Commercial Bank Loans to Small Business Firms, and to Hans R. Stoll's discussion in Small Firms' Access to Public Equity Financing of small business access to public financing, which reveal that several SEC rules make such access more difficult or more costly. The regulatory problem is considered also by Harry P. Guenther in The Impact of Bank Regulation on Small Business Financing. In all of these cases the regulations apply to large firms as well as small, but small business access to financing may be more seriously affected.

Stoll's analysis is an excellent illustration. He focuses almost entirely on the equity market because public debt issues of small firms are rare. The market tends to undervalue stock of small firms because of
the possible costs inherent in a minority stockholder-owner/manager relationship in which the owner/manager has an incentive to act in his interest and not that of all stockholders. Small business owners are not anxious to sell equity at the resulting undervalued price. Other market impediments do exist for an owner who does want to sell equity. If such securities are to be sold successfully, there must be a secondary market. Flotation costs of such issues and the costs of maintaining a secondary market are higher for small firms. Stoll concludes that private placement is the most efficient means for small firms to sell equity.*

The resurgence of the venture capital business is a hopeful sign, as is the development of venture capital pools as discussed by Zock.** Stoll concludes that the development of private placements is significantly impeded by SEC Rules 144 and 146 which regulate transactions in restricted stock.***


*** Rule 146 is included in the proposed SEC Regulation D, paragraph 506.
The situation has "Catch 22" aspects. Small firms can avoid the heavy flotation costs of selling an issue of stock and SEC registration costs by use of private placement. However, the institutional buyer of such an issue will be interested only if it is possible to resell in a reasonable period of time without excessive costs. While recognizing the need to prevent evasion of SEC registration and disclosure requirements, the particular impediment that these rules pose for small business financing is a matter of considerable concern. At present, SEC Rule 146 and other private exemption rules are included in a less costly, more consistent proposed regulation, Regulation D. In addition, the SEC has proposed reduced reporting requirements for small issuers.

In response to the view that there are "gaps" in the availability of financing for small business from the traditional financial institutions and markets, nontraditional sources of financing have been developed at both the state and national levels. In a number of states, the approach has been the business development credit corporation (BDCC). Paul S. Anderson in *Business Development Credit Corporations* reviews the recent experience of BDCCs and compares it with their earlier operation (Anderson prepared the paper on BDCCs for the 1957 Federal Reserve study). A number of new BDCCs have been established in recent years, and the volume of their lending has increased substantially since 1968. Nevertheless, Anderson finds that the market share of BDCCs has declined over recent years because of the emergence of alternative sources of small business credit. He believes that the primary role of BDCCs is to
act as a back-up lender to banks and that they cannot play an important role in closing any "gap" that may exist. BDCCs are not venture capital firms; they make no equity investments and they cannot afford large credit losses. Thus, most of their loans tend to be ones that could be made by commercial banks, finance companies or other traditional lenders.

Timothy Bates in A Review of the Small Business Administration's Major Loan Programs analyzes two major SBA loan programs, the traditional 7(a) loans and the newer "economic opportunity loan (EOL) program." He estimates the number of loans that represents successful grants of credit to firms. This requires estimating loan approvals that are not taken down, loans that represent refinancing of an existing SBA loan, and loans that result in default. The estimates indicate that around 75 to 85 percent of small businesses assisted under the 7(a) loan program repay the loans whereas only 47 to 57 percent repay loans made under the EOL program. Bates concludes that the disparate success rates of the programs are consistent with the legislative mandates for the two programs and indicates that SBA recognized several years ago that the EOL success rate was too low and dramatically reduced that assistance program. It should be noted that the success rate of SBA loan programs is greater in terms of the dollar volume of funds advanced than in terms of the number of businesses assisted.

The papers by Bates and by Anderson both relate to the relationship between traditional financial institutions and those created to subsidize or assist a particular sector of the economy. If financial markets are
efficient, loans involving a normal or reasonable degree of risk will be made by traditional financial institutions. Any loans that cannot be profitably made by such institutions must involve an exceptionally high risk of default. The appropriateness of governmental support for small business financing is a matter of broad social policy. If a government chooses to establish an agency to make loans that otherwise would not be made, it is obvious (assuming efficiency of financial markets) that a high default rate will result. This does not mean, however, that data on defaults are irrelevant. Social policy decisions should be made on a cost-benefit basis, and it is impossible to assess the cost of support programs to provide loans to small business without knowledge of the default rate.

Related to this issue is the question of whether many of the loans guaranteed by SBA would have been made without such guarantees. Bates, on the basis of a very limited number of interviews, concludes that some loans made by commercial banks under SBA guarantees would have been made without the guarantees. (Anderson, as noted above, argues similarly that most of the loans made by BDCCs could have been made by banks or finance companies in the absence of a BDCC.) However, recent experience indicates that a number of banks which make SBA-guaranteed loans sell the guaranteed portion in the secondary market, but continue to service the loan. Most of the banks engaged in this activity would not have the resources to make those loans if there were no opportunity to sell the guaranteed portion. As Bates indicates, the question of whether loans
would be made without the guarantee is an important issue in assessing
the net benefits of the guarantee program.

Recent Developments in Finance

In recent years there have been a number of developments in financial
markets and in finance theory. Several of these may have particular
implications for the financing of small business. Several papers
describe new financing devices and discuss whether they provide
particular advantages to small businesses in gaining access to funds.
The devices examined include: lease financing, equity participations,
credit cards, and franchising. None of these developed primarily in
response to the financing problems of small firms; however, they did
develop in response to market imperfections or transaction costs that may
pose particular problems for small firms.

Leasing has been in existence as a financing device for many years
and is used by both large and small firms; however, for various reasons,
leasing expanded rapidly in the 1970's. Oswald D. Bowlin in _Lease
Financing: An Attractive Method of Financing for Small Firms_ suggests
that small firms participated fully in the leasing boom of the 1970's,
though data are unavailable for confirmation. Leasing is generally
believed to be based on market imperfections or tax differentials. For
example, a leasing firm may be able to obtain some equipment in quantity
from a manufacturer at a more favorable price than a small firm could,
and that savings may be reflected in lease terms. In addition, leasing
may offer special advantages to small business because lease terms
generally run over several years. Thus leasing may help overcome the particular problem or disadvantage that small firms are believed to have in obtaining financing on an intermediate or long-term basis.

The 1970's also witnessed an explosive growth in bank credit cards. Banks promoted use of credit cards because of their own profit objectives rather than to improve the position of small business. Nevertheless, the development of bank credit cards proved to be of substantial benefit to small firms during this period. Small retailers seized upon the credit card because it was a means by which they could provide credit to customers at a cost that was significantly lower than the cost of operating and financing their own credit department.

Lewis Mandell in *Credit Cards and the Financing of Small Businesses* notes that until fairly recently the small merchant had somewhat of a competitive advantage in this area as most large department stores preferred to maintain their own credit operation and refused to accept bank credit cards. This attitude has changed and most large retailers now accept bank credit cards (and frequently are able to obtain lower rates of discount from the credit card issuers).

Although participants in financial markets were aware of the growth of leasing and credit cards, the general public was more aware of the explosive growth of franchise operations during the 1970's. The growth of franchising has significant implications for small business finance. Robert Mittelsteadt and Manferd O. Peterson in *Franchising and the Financing of Small Business* provide a detailed examination of the
implications of the growth of franchising for small business, both from
the point of view of the franchisor and the franchisee. Although there
is a tendency to think of franchising as a means of facilitating the
entry into business by the franchisee, Mittelsteadt and Peterson conclude
that franchising is a major source of funds to the franchisor (which is
often a small business).

They also examine SBA policy with respect to guaranteed loans to
franchisees. At one time SBA policy was very restrictive, tending to
view the franchisee as part of a large business. Although a somewhat
more liberal policy now exists, it is still difficult to determine
whether a franchisee is an independent small business or part of a large
firm. Mittelsteadt and Peterson argue that the criterion of sharing in
residual profits is not a good one for making such a determination.

Another financing device which developed during the 1960's and 1970's
has significant potential for small business. David J. Brophy in Equity
Participation Agreements and Commercial Bank Loans to Small Business
Firms examines the use of equity participations by commercial banks as a
part of their lending agreement with small firms. Banks may be reluctant
to make relatively high risk loans because they believe that they cannot
charge interest rates commensurate with the risk that are also affordable
by many high risk borrowers. The equity participation allows the bank to
obtain some of the profit that may result if a risk venture is
successful. Brophy argues that the economic merits of this device are
substantial, but that equity participations are infrequently used because
of legal and regulatory uncertainties. He believes that the legal issues have been resolved with respect to national banks, and that greater use of equity participations would be particularly beneficial to small borrowers. The opportunity to gain a large return if the venture is successful may make commercial banks more willing to finance risky small firms than they otherwise would be.

During the period in which these significant developments in financial markets were taking place, there was corresponding progress in the theory of finance. The developments in finance theory over the past two decades have tended to unify the previously somewhat separate fields of business finance, investments, and financial markets. An important part of the progress in financial theory has been the concept of "efficient markets," which is related to the optimal use of available information by market participants. John J. McConnell and R. Richardson Pettit in *Application of the Modern Theory of Finance to Small Business Firms* review the recent theoretical developments and conclude that these developments are relevant to small business. However, empirical testing of the theory generally has been based on large firms.

**Equity Issues**

The final group of four papers deals with various aspects of the question of whether the financial system tends to "discriminate" against small business by denying access to credit on terms that are appropriate to a small business firm's risk characteristics.
The most clear-cut answer is reached by R. Richardson Pettit and John J. McConnell in *The Impact of Usury Laws on the Effectiveness and Efficiency of the Operation of Small Business*. They conclude that usury laws make credit less available to small business than it would be in the absence of such laws. Moreover, usury laws are not likely to reduce the cost of credit for those successful in obtaining funds. The authors do not conduct new empirical work, but rather conduct a careful analysis of empirical work that has been done on the effect of usury laws on mortgage and consumer credit markets. Their analysis provides strong support for the view that the findings of studies of those markets are applicable to the small business situation.

While it has long been believed that usury laws could lead to discrimination against high-risk borrowers, there has been more controversy over whether there are other factors that might lead lenders to avoid small borrowers. In particular, there has been a controversy over whether small borrowers are particularly disadvantaged during periods of high interest rates.

While the literature on this topic is extensive, much of it is lacking in rigor. Stuart I. Greenbaum, George Kanatas, and Sudhakar Desmukh in *Credit Rationing and Small Business Finance* provide a careful theoretical analysis of the issues. They conclude that there are circumstances under which lenders may ration credit to smaller borrowers.

Harry P. Guenther in *The Impact of Bank Regulations on Small Business Financing* takes a somewhat different approach to this issue by focusing
on specific aspects of the financial-institution regulatory system that may produce credit rationing. He argues that bankers and bank supervisors perceive small firms as riskier, even though objective data to support this perception are ambiguous. The perception affects bank willingness to lend to small firms because the supervisory system discourages risk-taking. He concludes that the attitude of the supervisors toward risk does not appear to be affected by the return characteristics of the loan. That is, even if interest rates are sufficient to cover the additional risk, the supervisors may tend to discourage such lending.

Guenther also argues that the absence of a significant correlation between concentration and profitability in banking markets indicates that banks may take some of the benefits of monopolistic power in the form of reduced risk-taking. If the argument is correct, this would work to the disadvantage of small borrowers, although an alternative explanation for the lack of correlation is that some monopolistic power is reflected in a higher expense preference.

Guenther concludes that the Community Reinvestment Act (CRA) may have a beneficial impact on bank willingness to make small business loans. Although the original focus of the CRA was on home mortgage lending, small business lending is a favored activity under the regulation implementing the Act, and many banks reluctant to become heavily involved in mortgage lending may put additional emphasis on small business.
One of the major concerns of small businessmen over the years has been the equitableness of the federal tax system. This issue is related to, but is not limited to, the financing of small firms. Despite the fact that the corporate tax structure provides for lower rates on low income firms, which are usually presumed to be very small firms, and that small corporations can elect to be taxed as partnerships, there has long been concern that other aspects of the tax system treat small firms inequitably. However, it is difficult to sort out the issues. Most taxpayers complain about the tax structure and point to inequities in the way they are taxed. The problem is to determine whether the tax system specifically discriminates against small firms (in its effect, even if not in its intent).

Thomas S. McCaleb in Tax Policy and Small Business Financing contributes a detailed survey of the literature and study of all aspects of the Federal income and estate tax system that relate to the question of the relative treatment of large and small firms. He concludes that the available evidence may not accurately depict the relative tax burden on different-sized firms. Numerous methodological and data problems make the evidence extremely tenuous. Nevertheless, his survey finds very limited empirical support for the view that small business bears a heavier tax burden than large business.* However, he does conclude that

* Several other studies present arguments and evidence that the tax system's impact on different-sized business is regressive. Hans Stoll and James Walter in Tax Incentives for Small Business (Heller Small Business Institute Policy Paper, 1980) and Stephen Vasek in Tax Law
the tax system as a whole tends to discourage risk-taking, and this may work to diminish the role of small business in the economy. His analysis of the role of the estate tax in the sale of small businesses is particularly relevant to the changes in the estate tax contained in the Economic Recovery Act of 1981.

III. Conclusions

The fundamental purpose of this report is to evaluate the adequacy of financing for small business. However, adequacy is difficult to define. It does not necessarily imply that every potential entrepreneur is entitled to the same availability of funds and the same interest rates as a business with an established record of success and substantial financial resources. The issue of adequacy relates to whether there is a gap in the provision of services by the financial system such that small businesses are treated less well by the market than the objective evidence of the riskiness of small business justifies.

The papers in this collection do not provide significant evidence that such a gap exists. The failure to find such evidence, however, does not prove that such a gap does not exist. Most of the papers studied the

Effects on Business Concentration (a report prepared for the U.S. Small Business Administration, February 1981) conclude that the relative tax burden is greatest on the smallest firms. Data presented in Tax Notes (December 1981) on the "1980 Corporate Federal Tax Burden" indicate that the tax burden on medium-size and large corporations is regressive within those size classes. The available studies analyzing the tax burden aspect of tax policy reach conflicting conclusions, and universally suffer from data limitations and methodological shortcomings.
supply of financing. A gap in small business financing implies a demand for loans that is not met but that would have been met by differently structured financial institutions or under a different statutory and regulatory framework. Verifying that some loan demand is unmet would involve a study of the demand side of small business finance. One approach to such a study would be a large-scale survey of small businesses. This would be a major undertaking and was beyond the scope of this report.* An alternative approach would be an econometric study of the demand for small business financing. Such a study was attempted but, because of data and econometric problems, did not permit meaningful conclusions.

Although it is difficult to measure the demand, it is easier to examine the availability of finance for small firms. The papers that deal with innovations in the financial system suggest that whatever the availability of small business financing 20 years ago, the relative position of small business has improved. Some of the developments of most benefit to small business financing have come from private sector profit-motivated developments not specifically aimed at small business.

* The Conference Report accompanying Public Law 96-302 stressed that the agencies, in performing studies of small business finance, not solicit any additional information from small business concerns. However, because of the importance of such information in determining the extent to which the credit needs of small business are being met, the Small Business Administration under separate authority, invited small businesses to comment on their experience with obtaining credit from commercial banks. Because of the voluntary nature of the request, the responses, summarized in Chapter 3 of this Report, are not necessarily representative of the universe of small businesses.
The growth of leasing and credit cards and the participation of pension funds in venture capital pools suggest that small business is likely to have greater access to funds now than at the time of the 1957 study. Lease financing and venture capital pools may have filled, at least in part, the respective gaps in long-term debt financing and long-term equity capital identified by the 1957 study. In contrast, programs specifically designed to aid small business finance, such as SBA loan guarantee programs and the business development credit corporations, may have had less impact than anticipated.

Some further, albeit tenuous, evidence that a gap does not exist in the availability of financing for small business is the (estimated) loan loss experience of a major loan program of the Small Business Administration. The existence of such a gap implies that there is a demand for loans that involve relatively low risk which the private sector of the economy nonetheless is unable or unwilling to finance. It is precisely the function of the Small Business Administration 7(a) loan program to guarantee such loans. If there were a substantial unsatisfied group of small business borrowers unable to find financing because the structure of the financial system does not provide adequately for such needs, then the Small Business Administration should be able to guarantee loans to such firms with little actual loss. In fact, however, the Small Business Administration experiences a high rate of loss, one which the private sector could not be expected to sustain without government assistance.
Such loss experience suggests either that there is not a significant body of low-risk small firms that are unable to obtain financing at rates commensurate with their risk or that SBA's lending criteria have been allowed to deteriorate. In recent testimony before the Senate Committee on Small Business*, SBA Administrator Michael Cardenas indicated that, in fact, there has been a tendency in recent years to place more emphasis on the quantity of SBA loans than on their quality—a situation which the agency has now taken steps to reverse.

There may be a group of small firms that are very risky and willing to pay the high costs commensurate with that degree of risk, but unable to obtain financing. This generally involves equity capital rather than debt financing. The existence of such a gap may be the result of a tax system that discourages risk-taking as McCaleb suggests, or governmental regulation that discourages risk-taking as Zock suggests. Recent changes in the tax law seem to be moving in the right direction for dealing with the tax system problem, and present Labor Department interpretations of ERISA seem to deal appropriately with the governmental problem.

For reasons indicated at the beginning of this Chapter, it may be appropriate public policy to encourage the growth of small business, and to provide funds for small firms on terms that could not be obtained in the free market—even at a net cost to the government. However, there is

only limited evidence to suggest that government support is necessary because of failure of the market to provide financing for small firms on appropriate terms.

Another significant and particularly striking conclusion from the papers is that government regulations often have unintended adverse impacts on small business financing. These impacts are discussed explicitly by Zock and Stoll. In both cases the regulations in question are intended as protection—in one case protection of pension beneficiaries, and in the other case, protection of investors—but they make it more difficult for small businesses to obtain financing. Clearly, there is a trade-off. The authors do not argue that all regulations that impinge upon small business should be eliminated. What is important, however, is that the potential impact on small business be considered and weighed in the trade-off process. The extreme example is usury laws, which are intended to protect small borrowers, but may instead decrease the availability of funds. Congressional concern with such issues has already been demonstrated by passage of the Regulatory Flexibility Act, which requires an analysis of the impact of proposed regulations on small business, and by federal government preemption or modification of usury ceilings on certain types of loans.

The issue is also illustrated by Brophy's and Guenther's analyses of bank regulation. Because "equity participation" seems particularly suitable for small business lending, any regulations or interpretations
that discourage the use of this device would have a negative effect particularly on small business financing.

Perhaps more important than these examples, however, is the fact that broad public policy decisions can have specific effects on small firms, and these effects may not be foreseen at the time the policy is under consideration. Shull and Savage suggest that changes in financial structure also may have such specific impacts, and these possibilities also should be taken into account when policy changes are being considered. Of course, it is not easy to determine in advance what the effects will be. Shull's discussion of the possible impact of the growth of foreign bank operations in the United States is suggestive, but certainly not conclusive.

An important conclusion of these papers is that those interested in the health of small business need to be concerned not only with public policies or legislation specifically targeted at small business, but also with actions that may have unforeseen impacts on small business.
Chapter 2

Summary of the Report on the Survey of Commercial Bank Lending to Small Business

As part of the response to the Congressional concern about the extent to which commercial banks are meeting the credit needs of small business, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation jointly conducted a nationwide survey of commercial bank small-business lending practices. A survey was considered necessary because of the lack of a comprehensive data base on commercial bank small-business lending. The survey focused on commercial banks because they are considered to be the major institutional source of small business financing.

The purpose of the survey was to collect quantitative and qualitative information on banks' small-business lending practices. The format was a personal interview with senior loan officers knowledgeable about small-business lending at the sample banks. Economists from the Federal Reserve District Banks and the Washington, D.C. offices of the three bank regulatory agencies conducted the interviews. The sampled banks were divided into two groups: a general sample of 224 banks representing the universe of 10,309 federally insured commercial banks in the continental United States with commercial and industrial loans of at least $1 million as of December 31, 1980, and a special sample of 25 banks representing the universe of 93 banks owned or controlled by minorities or women.

* The total number of federally insured U.S. banks as of December 31, 1980, was 14,422.
The survey was conducted in September 1981 during a period of high interest rates and severe financial stress for the business community when it was likely that small businesses were cutting back on their spending and borrowing plans. Thus, the results should reflect banks' perceptions of their behavior toward small businesses operating under relatively adverse circumstances. It must be emphasized that the survey results generally apply only to small businesses with which the banks have a relationship and reflect the perceptions of the suppliers of credit--banks--not the users of credit--small businesses.*

The survey questionnaire covered six topics: bank organization with respect to small-business lending; credit availability; loan characteristics; pricing and profitability; government programs; and data availability. Banks were queried on their present practices as well as on observed changes from five years before or over the economic cycle. Responses to the questionnaire were tabulated and analyzed in a variety of ways. In general, universe estimates were computed for the general bank population (10,309) and for the special bank population (93). In addition, where relevant, banks' treatment of large- and small-business borrowers was compared. In many cases, comparisons were made of bank behavior within each of several subgroupings: three bank-size

* No parallel systematic survey was taken of small businesses because of the expressed intent of the Congress that the banking agencies should not solicit information from small businesses.
categories, six bank-organization-structure categories, four state-banking-law categories, three location classifications, and four geographic census region subgroups.

Of primary importance in the survey was the definition of small business with the basic concept being nonfarm firms that are independently owned and limited to local sources of financing. Banks were told to use their own definition if they had one. Based on the responses, more than a third of banks are estimated to have a definition. Among banks having a definition, 75 percent of the definitions are: for sales, $5 million or less; for assets, $2.5 million or less; and for loans outstanding at the bank, $1.0 million or less. Banks without a definition, principally small banks whose business loans are generally to small business, were given a definition by the interviewer: for sales or for assets, $2.5 million or less; or for loans outstanding at the bank, $1.0 million or less.

The results of the survey show that bankers believe the commercial banking industry to be the major source of small business credit. Based on survey responses, business loans outstanding at the general banks as of June 30, 1981, were estimated to be about $360 billion, with a third of this amount going to small business. The bulk of the loans to small business is estimated to be made by small and medium-sized banks. Categorizing banks by location shows that the majority of small-business loans are made by urban banks.
While banks remain the primary institutional lenders to small business, finance companies and thrift institutions also are considered to be active lenders. From the banks' perspective, overall competition for small-business loans had increased compared to five years earlier.

While there are estimated to be some differences on average between reported characteristics of small- and large-business loans, there also appear to be many similarities including reported typical interest rates charged, on average, for all general banks. According to most banks' responses, the nonprice characteristics of loans do not vary cyclically.* Responses to the survey indicate that, in the banks' experience, risks and costs of small-business loans are generally higher and loan profitability per se, lower in relation to large-business loans. However, based on the survey results, no inferences can be made of the relative profitability of the total customer relationship.

The majority of banks believe laws and regulations implemented by the bank regulatory agencies have had no effect on their small-business lending policies. For the rest, the effect generally appears to be adverse. In general, banks reporting an effect find the required paperwork and related costs burdensome. It was also contended that usury laws and the recent changes in the bankruptcy code have tended to make banks more conservative in their small-business lending.

* The interpretation of this finding is unclear because cyclical was apparently interpreted as seasonal by some banks.
Government loan and assistance programs do not appear to be a major factor in bank small-business lending, accounting for an estimated 14 percent of the dollar volume of small-business loans at the general banks. The only programs used widely are those administered by the Small Business Administration. Banks tend to keep most business loan information items in their loan files; much less information is carried on their computers.

A comparison of banks' responses shows differences in small-business lending practices by size of bank; these differences are often also apparent for large-business loans. There generally do not appear to be any systematic differences in the treatment of small-business loans by bank organizational structure or state banking law, although active promotion of small-business lending is reportedly greater for banks with widely dispersed offices as compared with banks in other structure subgroups. Differences among banks by location often appear to be related to size differences. Generally, the small-business lending practices of the special banks are similar to those of the general banks.

The banks' responses to the survey indicate that their industry appears to be making a good effort to respond to the credit needs of their small business customers during this period of high interest rates. This conclusion is based on, among other factors, their reported promotional activities and similarity of loan rejection rates and typical interest rates between large- and small-business loans. It must be stressed however, that the survey results reflect banks' perceptions and not necessarily those of the small business community.
To complement the survey of commercial banks, the Small Business Administration, under authority granted the agency by Public Law 94-305, sec. 202 paragraph 5, invited small businesses to comment on their experiences in obtaining bank credit by answering several questions set forth in a notice published in the Federal Register on October 13, 1981. These questions covered how well commercial banks were meeting small business credit needs, any difficulties small businesses had in obtaining bank credit, and how bank characteristics or specific bank policies appear to affect a bank's willingness or ability to meet small business credit needs. The notice asked also for comments on small business experience with government loan programs and for certain information about the respondents.

Close to 2,000 firms responded to the Federal Register notice. Because respondents were not pre-selected by scientific sampling and since several trade associations actively solicited responses from their members, the 2,000 firms as a group could not be expected to be representative of the universe of small businesses.

Over three-fourths of the respondents are corporations with proprietorships accounting for about one-tenth of the respondents. Manufacturing, retail and wholesale trade are the principal industries represented. More than half of the respondents are larger small
businesses with annual sales of more than $800,000. Less than half have 1 to 20 employees while a third have 21 to 100 employees.

In contrast, almost nine-tenths of the firms in the nonfarm small business universe employ 1 to 20 people and about one-tenth record annual sales in excess of $800,000. The sole proprietorship is the most common legal form of organization among nonfarm small businesses. Further, firms in the highly fragmented service industry account for a large share of the total population. Thus, although the respondents may be representative of an important subset of the small business community, their experience and opinions do not necessarily apply to small businesses in general.

Summary of Responses

Three-fourths of the respondents said that banks are meeting their credit needs. In response to a separate question as to what, if any, difficulties the business has experienced in obtaining bank credit, about one-third said they had experienced difficulties; however, the nature of those difficulties often was not specified.

More than two-thirds of the respondents believe that the size or location of a bank affects its willingness or ability to meet the respondent's credit needs. Half of these respondents provided additional information. More than two-fifths said they prefer to deal with a local bank (with no mention of size), while another two-fifths prefer a small bank and less than one-fifth a large one. A third of those expressing their preference in terms of bank size also mentioned convenience of location.
In answer to a question about experience with government loan guarantee programs, two-thirds of the respondents reported that they no experience with these programs. Those that had such experience were about evenly divided as to whether their opinion of the programs was favorable or unfavorable.

Finally, firms were asked for specific comments or recommendations concerning improvements banks could make in meeting the firm's short-term and long-term credit needs. More than one-third of the respondents did not answer this question. The comments and recommendations received were quite varied, and, despite some multiple responses, only a few recommendations were common to any substantial proportion of respondents. About one-fourth of the firms that answered the question said that interest rates are too high. About one-fifth suggested that bankers should improve their understanding of the industries in which their small-business borrowers are engaged, since greater understanding on the part of the bank could benefit both bank and borrower. Each of three recommendations was made by about one-eighth of those answering the question: The paperwork, delays and red tape in SBA programs should be reduced; banks should be more flexible in dealing with individual small business borrowers, should consider their individual circumstances and reliability, and should not treat them so impersonally; and banks should alter their long-term credit policies.
Title IV (sec. 404) of Public Law 96-302, in accordance with which this report is submitted, requires that the banking agencies present to the Congress their views and recommendations with respect to "the feasibility and cost of conducting periodic sample surveys, by region and nationwide, of the number and dollar amount of commercial and industrial loans extended by commercial banks to small business."

Although commercial banks are probably the major institutional source of small business funds, information is limited regarding the credit they extend to the small business sector. Policymakers, researchers and others have expressed a need for at least sample data in this area, not only to strengthen their analysis of small business financing but also to aid in evaluating the role of commercial banks as small business lenders and in assessing the need for government-assisted loan programs.

It is essential, of course, that the benefits of any data collection effort justify its costs. It is equally important that efforts to reduce costs and respondent burden, particularly with respect to established data collection procedures, not ignore the very real benefits such information may provide. As in other areas, perceived needs for information on bank lending to small business must be weighed against the usefulness of the information and the burden on respondents of providing
it. In the 1940's and 1950's, the Federal Reserve conducted several very
detailed surveys of business loans at member banks, which provided
information both on borrowers and on loans outstanding. Such surveys are
very costly and time-consuming, however, and the statistical detail
required for an in-depth survey is a heavy burden on respondents.
Moreover, there is considerable question as to how useful such surveys
are: they provide information as of one day only, and for outstandings
only. Information on a continuing basis—covering both outstandings and
new loans made—is certainly more useful.

Furthermore, a compilation of commercial and industrial loans at
banks does not address the major question—the extent to which banks are
meeting the credit needs of small business. It simply measures the
quantity of commercial and industrial credit supplied, without regard to
the quantity demanded or to the supply of and demand for other types of
small business credit from the banking sector (e.g., mortgages, personal
loans, credit from bank holding company nonbank subsidiaries).

It should be noted that the banking agencies, like other federal
executive departments and agencies, are subject to the statutory
constraints of the Paperwork Reduction Act. Under this or other
statutes, they are required to make reductions in the reports they
request from the private sector, and to be especially mindful of the
reporting burden they impose on small entities (which would include small
banks).
In view of these considerations, we do not recommend any massive new data-collection effort. We believe that the appropriate compromise between meeting the needs of users and limiting the burden on respondents is to adapt and expand somewhat a number of ongoing sample surveys such as the Survey of Terms of Bank Lending and the Senior Loan Officer Opinion Survey on Bank Lending Practices.

Technical Considerations

Before examining these ongoing programs, it may be useful to discuss two troublesome factors which probably will continue to prevent development of information on small-business bank loans that is complete and unambiguous.

First, few banks currently keep records on the size of their business borrowers in readily retrievable form. The personal-interview survey of commercial banks, the results of which are summarized in Chapter 2 of this report and discussed in detail in the paper by Cynthia A. Glassman and Peter L. Struck Survey of Commercial Bank Lending to Small Business (which is included in the Supporting Materials), indicated that most banks have considerable detail in their individual loan files on each loan and each business borrower. (About 95 percent of banks are estimated to have borrower assets and annual sales in their loan files; only 29 percent have number of employees in their loan files.) However, although an estimated half (or somewhat more) of all banks have information in their computer on various loan characteristics, less than 10 percent have borrower assets or sales, and virtually none has number
of employees, in a computerized file. Thus, although many banks have
detailed data in their loan files, few are able to retrieve it easily.

It would be very time-consuming and therefore costly for a bank to
search its individual loan files in order to match loan and size-of-
borrower information for periodic surveys. Although it is true that most
banks participating in the personal-interview survey provided information
on the number and dollar amount of their loans outstanding to small
firms, this was a one-time survey and, more importantly, banks were told
that best estimates were acceptable. A solution to this problem of data
availability would be the incorporation of borrower information into
banks' computer files, but this would be very expensive for banks.
Incorporating the information over time when computer input required
reprogramming for other reasons would take years and still be costly.

Second, there is no consensus on how to define a "small" business.
The lack of agreement relates both to the appropriate measure of size and
to its upper bound. Among banks themselves, more than half apparently
have no definition of small business. Those that do have one use annual
sales as the size criterion more often than any other measure. However,
some observers consider total assets a better criterion than sales
because assets show less seasonal and cyclical variation. Others have a
strong preference for number of employees. This measure is useful for
some purposes since it is neutral with respect to inflation and to
industry differences in capital/output ratios; it is less so for bank
loans and other financial measures.
With respect to the upper bound which separates small businesses from larger ones, opinions vary. Some observers, for example, define as small any business with up to $25 million of assets, or up to 500 employees; others choose much lower limits. Banks that define small business in terms of total assets typically set the upper bound at no more than $2.5 million.

Thus, there is at present no single definition which would conform to bank practice, let alone satisfy all users of banking data. One alternative for resolving this problem would be to allow banks to use their own definition, if they have one, for any reporting of their loans to small business—no matter what criterion or upper limit the bank uses—and to provide other banks (i.e., those without a definition of their own) with an arbitrary definition. The disadvantages of this method, of course, are that reporting would be inconsistent from bank to bank and generally would not cover some firms which many observers consider to be within the small business sector. Its obvious advantage is the very practical one of comparative ease in reporting.

Another alternative would be to select some one criterion, together with a full set of (asset, sales or other) size classes. Banks then would be requested to provide information for all sizes of businesses, not just for small ones. This method would allow users of the data to draw their own lines of demarcation between small firms and larger ones, but would impose a substantial and costly reporting burden on the banks.
A quite different method would be to collect information for all (or a sample of all) loans by size of loan rather than size of borrower. This method, although still posing certain problems of interpretation, provides a reasonably close approximation of borrower size (see the paper by Martha S. Scanlon, Relationship Between Commercial Bank Loan Size and Size of Borrower in the Supporting Materials). In addition, respondent burden would be relatively light; 59 percent of all banks (96 percent of large banks) apparently have loan size in their computers.

Reporting of Flow Data

We feel that data on new loans made to small business are at least as important as data on loans outstanding, and they can be provided at less cost. We feel also that it is useful to have, in addition to the basic number and dollar amount of small-business loans, periodic statistical, or even qualitative, information on lending terms and other factors associated with the extension of bank credit to small business.

The Federal Reserve already collects data which are believed to approximate the gross flows of bank credit to small business, if size of loan is used as a proxy for size of business. The Survey of Terms of Bank Lending (STBL) provides, separately for short-term and long-term loans, national estimates of the number and dollar amount of new commercial and industrial loans made during the first full business week of February, May, August and November. In addition, it provides national estimates of average maturity, average interest rate charged and other loan characteristics for such loans (see the paper by Thomas F. Brady,
Commercial Bank Business Lending by Size of Loan, included in the Supporting Materials). The estimates are based on data reported by a stratified random sample of about 340 member and nonmember banks of all sizes. The survey data can be used for national estimates only. The sample would need to be very much larger to permit reliable regional estimates, and we do not recommend such an expansion in the sample at this time. We believe it would be better to improve the national survey and to evaluate the usefulness of the improvements before considering the burdensome expansion in the sample that would be required to yield valid regional estimates.

A shortcoming of the STBL as an indicator of the flow of bank credit to small business is that the survey data are reported by size of loan, not by size of borrower. As noted in the Scanlon paper, the relationship between the two is reasonably close for the smallest and largest loans. Although inferences about size of borrower can be drawn from size of loan, an unknown number of loans of small size are, in fact, loans to large business—most likely because they represent either small takedowns of large loans made under commitment or portions of a large loan arranged in participation with other banks.

To facilitate identification of these small loans to large borrowers and their elimination from the STBL results for purposes of small-borrower analysis, two new questions are being added to the survey and these changes will be implemented as soon as possible, assuming approval by the Office of Management and Budget. The new items are: 1) If the
loan was made under commitment, enter the amount of the total commitment; and 2) If the loan is a participation, enter the total amount of the participated loan. In using the results of the revised STBL to estimate new loans to small business, the intent is to eliminate only those small loans where the total commitment or participated loan exceeds some pre-determined size, not all loans made under commitment or participation. We feel these changes in the STBL will significantly improve the reliability of loan size as a proxy for borrower size.

Qualitative Information on Flows

A vehicle also exists which can be used to collect qualitative information on those occasions when supplementary or specialized information on bank lending to small business is needed. This is the Senior Loan Officer Opinion Survey on Bank Lending Practices (LPS). This survey is conducted as of the 15th day of February, May, August, and November and consists of telephone interviews by officers at each Federal Reserve Bank familiar with bank lending practices with senior loan officers at 60 large banks. (The nature of the survey does not lend itself to use by a large, stratified sample of banks.) Each lending officer is asked six unchanging "core" questions about the anticipated strength of demand for commercial and industrial loans, and about changes in the bank's policies with respect to: standards of creditworthiness to qualify for the prime rate and for a given spread over prime; commercial and industrial lending to new and nonlocal customers; compensating balance and fee requirements for commercial and industrial loans; and willingness to make installment loans to individuals.
The LPS also may include "supplementary" questions which can apply to all borrowers or to some subset of borrowers (for example, small businesses). They vary in number and content, depending on the nature of current concerns about loan markets and lending practices. The most recent LPS included supplementary questions on the bank's response to the deterioration, if any, in the financial condition of an above-normal proportion of existing and new business customers, the industries in which such deterioration was concentrated and the impact of bond-issue postponement by customers on credit demands at the bank. Although the number of banks participating in the LPS is relatively small, and responses are qualitative rather than quantitative, this quarterly survey has produced useful information. We recommend that the supplementary section of the survey be used on occasion when it appears appropriate to seek information on matters of current concern about banks' response to credit demands from small firms.

**Reporting of Loans Outstanding**

Although it would be relatively easy to use existing channels for collection of more and/or better sample information on the flow of bank credit to small business, this is not the case for data on loans outstanding. We recognize that there is much interest in information on outstandings, but collection of reliable data would require considerable advance planning. The following major, interrelated issues would need to be addressed.
Should data be collected from a sample of all banks, or just from large ones? Responses of commercial banks to the recent survey of their small business lending indicated that the median ratio of small-business loans to all business loans at small banks (assets of less than $100 million) was 95 percent. Exemption of small banks would reduce significantly the reporting burden on the banking community, but might raise questions about the reliability of regional and nationwide estimates.

Is it feasible to develop a simple and meaningful question on small-business loans outstanding based on size of loan? This approach would involve the problem of small loans to large business. Responses to the new questions on the STBL should help in assessing the magnitude of this problem. Use of loan size as a proxy for borrower size also would require determining an appropriate upper-size limit of loans which were to be reported as loans to small business. On the other hand, if use of loan size is considered not feasible, use of borrower size would raise all the unresolved definitional problems discussed earlier and currently would greatly increase respondent burden.

Should information on the number and amount of loans outstanding be collected by adding these items to some existing sample survey (perhaps as a periodic supplement), or by developing a new and separate report? Use of an existing data-collection mechanism might be simplest, but introduction of a new report would more readily permit requesting this information from a bank sample specifically designed for the purpose.
Because of the difficulties involved in collecting reliable sample data on commercial and industrial loans outstanding to small business and the potential for imposing significant cost burdens on respondents, but also recognizing the need for useful data, we recommend that staff at the banking agencies address the issues raised above and determine whether there is a feasible way to develop reliable sample data that does not impose an unreasonable burden on respondents.

Finally, looking further ahead, we recommend that staff of the banking agencies develop a proposal which would encourage banks to put information on borrower-size on their computer when each commercial and industrial loan is extended. In time, this should not only permit collection of data on extensions by size of borrower but also lead to a computerized file that would allow collection of data on loans outstanding at reasonable cost to respondents.