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Do small businesses still prefer community banks?

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Abstract

We formulate and test hypotheses about the role of bank type – small versus large, single-market versus multimarket, and local versus nonlocal banks – in banking relationships. The conventional paradigm suggests that “community banks” – small, single-market, local institutions – are better able to form strong relationships with informationally opaque small businesses, while “megabanks” – large, multimarket, nonlocal institutions – tend to serve more transparent firms. Using the 2003 Survey of Small Business Finance (SSBF), we conduct two sets of tests. First, we test for the type of bank serving as the “main” relationship bank for small businesses with different firm and owner characteristics. Second, we test for the strength of these main relationships by examining the probability of an exclusive relationship and main bank relationship length as functions of main bank type and financial fragility, as well as firm and owner characteristics. The results are often not consistent with the conventional paradigm, perhaps because of changes in lending technologies and deregulation of the banking industry.

JEL Classification Numbers: G21, G28, G34

Keywords: Banks, Relationships, Small business, Government policy.

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