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Do borrower-lender relationships still matter for small business loans?

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ABSTRACT

The study uses the 1987, 1993, and 2003 Survey of Small Business Finances to analyze the changes in the role of relationships in determining loan contract terms and credit availability for small businesses. The findings strongly suggest that even though the importance of relationship had lessened in small business lending, a high intensity of relationship, such as sustaining substantial checking or savings account balances with the lender, is still relevant and can benefit the borrower. An implication drawn is that relationship lending can still be an important way for smaller banks to maintain their competitiveness with other lenders.

1. Introduction

This study goes beyond the current literature to identify whether the value of borrower-lender relationships in lending to small business declined over time. Using data from the 1987, 1993 and 2003 Survey of Small Business Finances (SSBF), the paper directly tests which relationship variables—for example, distance, length of relationship, checking and savings accounts, presence of another loan account with the lender—have become less important over the years and aims to comment about the changing role of borrower-lender relationships in determining the loan contract terms and credit availability.

Understanding the structure of lending to small businesses—nonfarm firms with fewer than 500 employees—is important because small businesses account for a majority of businesses in the United States, produce 38% of U.S. gross domestic product, and account for half of U.S. employment. And credit is critical to the ability of these businesses to evolve into bigger firms (Ayyagari et al., 2007; Brown et al., 1990; Elliehausen and Wolken, 1990; Mach and Wolken, 2006; Torre et al., 2010).

Small businesses get about half of their credit sources from debt. Approximately half of the debt is loans from financial institutions, specifically commercial banks (Berger and Udell, 1998). When financial institutions give out loans to firms, larger firms can offer to potential lenders important publicly available financial information such as audited and certified financial statements and other formal or "hard" data. With such information, banks that do not have an ongoing relationship

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with the firm (arm's length creditors) can consider lending to it, as can the capital markets. In contrast, small businesses typically cannot provide the same level of hard information and so present the problem of information asymmetry to potential arm's length lenders (Berger and Frame, 2007; Petersen and Rajan, 1994).

However, a local bank connected to a small business through some ongoing financial relationship, such as a transactions account, is in possession of private information about the firm and is better positioned to understand its risks and its prospects than an arm's length lender. The bank's possession of such "soft" or less formalized information often sufficiently reduces information asymmetry, making the bank an important potential source of credit for the small firm and allowing small business to have access to easier and cheaper credit (Berger et al., 2005b; Chen et al., 2015; Neuberger and Doppner, 2015; Kirschenmann, 2016).

Historically, small banks have been the main providers of relationship-based loans to small businesses (consistent with the findings of Uchida, 2011) because the organizational structure of small banks makes it more convenient to undertake relationship-based small business lending. For instance, unlike large banks, small banks have fewer management layers (Berger and Udell, 2002). With fewer management layers, it is easier for small banks to reconcile differences between the bank's management, shareholders, and borrowers, and it is less costly to conduct the monitoring required by relationship lending. According to Patti and Gobbi (2001), another reason why small banks focus on small businesses for lending is that they do not have the capacity to lend to larger firms.

However, significant legislative and technological changes in the banking sector in the 1990s altered the small business lending market. The Riegle-Neal Act of 1994 allowed interstate branching, and the 1999 Gramm-Leach-Bliley Act removed the remaining Glass-Steagall Act restrictions on permissible banking activities. Banks have thus extended their services to multiple states; and through consolidation, larger banks have increasingly dominated the banking sector and posed tougher competition for small (community) banks (Vera and Onji, 2010).

Broad technological advances during this period also increased competition in small business credit markets (DeYoung et al., 2004). They paved the way for small business credit scoring (SBCS), which assigns a credit rating to a firm on the basis of both its financial statements and its principal owners' financial condition and history. The advent of SBCS provided the standardized hard data to larger banks and nondepository lenders that allowed them to increase their lending to small businesses (Berger et al., 2005a; Carter and McNulty, 2005; Torre et al., 2010). Advances in technology in the form of communications and credit scoring also allowed lenders to overcome the distance related limits to lending and enabled lenders to use SBCS to evaluate small businesses located farther away (Berger and Frame, 2007; Agarwald and Hauswald, 2010; Berger and Black, 2011). As a result, SBCS is estimated to have increased the access of small business to loans under $100,000 by reducing information asymmetry, increasing lending access over greater distances, and reducing the risk otherwise posed by issuing longer-term loans (Berger and Frame, 2007; Berger et al., 2005a; Frame et al., 2001, 2004).

As small business credit scoring techniques have become important and larger banks have entered the market, small business borrowers had easier access to more distant lenders and started borrowing from lending sources other than small banks, such as large banks and nondepository financial institutions, that focus on the hard-information based lending technologies (Berger et al., 2014, 2005a; DeYoung et al., 2011; Vera and Onji, 2010; Petersen and Rajan, 2002). All these developments in technology and geographic expansion have arguably diluted the importance of the borrower-lender relationship in the market for small business credit (Elyasani and Goldberg, 2004; Berger et al., 2011a). Government subsidization of a secondary market for small business loans can also increase the amount of small business loans granted and encourage the securitization of relationship-based loans, which may result in the loss of relationship benefits (Berger and Udell, 2002). These are all indirect evidences that the value of relationships has declined for small business loans.

However, to date the literature has not presented a direct analysis on whether the value of borrower-lender relationships in lending to small businesses declined. This paper attempts to fill this gap in the literature by directly investigating the changes in the role of relationship variables in determining loan contract terms and credit availability for small businesses in 1987, 1993, and 2003. The goal is to see which relationship variables—for example, distance, length of relationship, checking and savings accounts, presence of another loan account with the lender—were no longer important or had a decline in their significance in identifying these loan contract terms and credit availability for small businesses.

The study uses data from the results of the Survey of Small Business Finances (SSBF) conducted in those years.[1] To test which relationship variables are no longer important or whether coefficient magnitudes of relationship variables changed over time, the model interacts relationship variables with time dummies for the three SSBF sample dates and tests for the statistical significance of the time interacted relationship variables along with the statistical significance of the sum of relationship variables and the time interacted relationship variables. In addition to relationship variables, the study also analyzes the changes in explanatory variables that proxy for the hard information used in lending to better understands the changing landscape of hard and soft information. In contrast to some studies (Kirschenmann, 2016; Cenni et al., 2015; Chen et al., 2015; Neuberger and Doppner, 2015; Santikian, 2014; Cole et al., 2004; Cole, 1998; Berger and Udell, 1995; Petersen and Rajan, 1994) that investigate the benefits associated with a small business banking relationship, this study uses multiple SSBF panels and compares different time periods to analyze the changing role of relationship over different time periods. And it uses all the possible relationship

[1] The SSBF, sponsored by the Board of Governors of the Federal Reserve System, is only available for years 1987, 1993, 1998, and 2003 which is a limitation of the data. However, for this study, the survey for 1998 is not used because the sample for the 1998 survey contains firms with new LOCs but not renewals. Thus, this study only compares years 1987, 1993, and 2003. Documentation for the surveys is available at www.federalreserve.gov/pubs/oss/oss3/nssbftoc.htm.

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