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Small Business Research Summary

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How Did the Financial Crisis Affect Small Business Lending in the United States?

By Rebel A. Cole, DePaul University, Chicago, Illinois. 56 pages.
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Introduction

Small businesses are a source of economic strength to the nation; they provide economic opportunities to diverse groups of people and bring innovative products and services to the marketplace. As an economic engine, they typically create new jobs, but since the housing bubble burst during 2007-2008 they have struggled to maintain their foothold. Their success depends upon their access to credit, and they rely heavily on depository institutions for their financial needs. Lax underwriting standards saddled U.S. banks, large and small, with levels of nonperforming loans not seen since the banking crisis of the late 1980s. Anecdotal evidence suggested that small businesses, which largely rely upon banks for credit, were especially hard hit. The purpose of this study is to understand how bank credit, in general, and bank credit to small businesses, in particular, were affected by the financial crisis. This study is part of an evolving discussion among researchers and policymakers. It is one perspective on the issue, and others may have additional views and findings.

Overall Findings

The report shows that the decline in bank lending was far more severe for small businesses than for larger firms. Bank lending to small firms rose from $308 billion in June 1994 to a peak of $659 billion in June 2008 but then declined by almost 18 percent to only $543 billion in June 2011. Bank lending to all firms rose from $758 billion in 1994 to a peak of $2.14 trillion in June 2008 and then declined by about 9 percent to $1.96 trillion as of June 2011.

Highlights

- The analysis showed a significant positive relation between a bank's level of capitalization and business lending, especially lending to small business. In other words, the report supports the position that higher capital standards would improve the availability of credit to U.S. firms, especially to small firms, and it refutes banking industry claims that higher capital standards would reduce business lending and hurt the economy.
- The research showed a significant negative correlation between bank profitability and business lending. Unprofitable banks tended to increase their lending and their risk exposure so as to exploit the subsidy from their deposit insurance.
- The author compared business lending by banks that received TARP funds (Troubled Assets Relief Program) and those that did not, and found that the decline in bank lending was far more severe to small businesses than to larger firms. For example total commercial & industrial (C&I) lending declined by 18 percent for large firms versus 20 percent for small firms. Among banks participating in TARP, the decline was even greater; small C&I lending declined by 31 percent and only 10 percent at non-TARP banks over the 2008–2011 period.
- Small business loans from banks receiving TARP funds grew more slowly than those from non-TARP banks (7.0 percent vs. 8.4 percent) and their allocation of assets to small business loans actually decreased by 1.9 percent, while those of non-TARP banks increased by 1.9 percent.
- Bank size had a significant negative effect on business lending.

- The study found a significant positive relation between young banks (less than five years old or "*de novo*") and business lending. This new evidence complements existing studies of lending by *de novo* banks and suggests that regulators should enact policies to encourage the formation of new banks as a way to increase business lending.

Scope and Methodology

The author analyzed bank data from numerous sources for the period 1994–2011. The quarterly Call Reports from the Federal Financial Institutions Examination Council (FFIEC) were the primary source. To account for the effect of mergers, information from the FDIC's Institution Directory was used to identify the acquirer and the target. Data on TARP came from the U.S. Treasury, and the consolidated Bank Holding Company (BHC) Report from the Federal Reserve Bank of Chicago. The TARP data was matched to the BHC data, and then merged with the FFIEC data to obtain the final TARP sample for analysis.

Both univariate and multivariate tests were used to show how the financial crisis affected bank lending to small businesses. The study utilizes a fixed-effects regression model that exploits the panel nature of the dataset to explain three different measures of small business lending, which were: (1) change in value of small business loans, (2) change in the ratio of small business loans to total assets (3) and the natural logarithm of the dollar value of small business loans. Several control variables were used, including financial health variables (asset quality, earnings, total equity), bank size, and amount of outstanding loans.

This report was peer reviewed consistent with the Office of Advocacy's data quality guidelines. Information on this process can be obtained by contacting the director of economic research at **advocacy@sba.gov** or (202) 205-6533.

Additional Information

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