The Aspen Institute

Small Business Rural Banks

Assessing and Strengthening the Link

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Department of Resource Economics
University of Massachusetts, Amherst

Edited by
BARLETT NAYLOR

Prepared with support from
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Executive Summary

Banking deregulation has not dried up credit for small businesses that traditionally depend on locally based lenders. However, securing credit remains a challenge for many emerging enterprises. Some credit types (unsecured and long term debt) present greater access problems. Moreover, there are warning signs, although currently small, that markets increasingly dominated by banks with distant parents could reduce the flow of credit to small business.

This is the principle finding of a unique study of rural bank-business relations in New England. This discussion summarizes the results of a study called, "The Impact of Deregulation on Rural Commercial Credit Availability in Four New England States: Empirical Evidence and Policy Implications," by Deborah M. Markley, Department of Resource Economics, University of Massachusetts, Amherst. The study was completed in May, 1990, and was funded by the Ford Foundation and the Rural Economic Policy Program of the Aspen Institute.

Summary of Results

Among the specific results:

- There is no evidence of widespread retraction of capital from small business because of deregulation in the banking industry.
- Businesses appear to suffer greater credit problems in markets dominated by large affiliated banks than in markets dominated by locally based independent banks, or a mixed market.
- Large bank lenders believe they are losing autonomy for lending decisions. These decisions are increasingly made at regional or headquarters offices. By contrast, small bank lenders report they have greater flexibility in making loan decisions than in the past.
- Small, young firms experience more difficulty in obtaining credit than do larger, more established enterprises. From a banker's perspective, character and cash-flow are the two most important criteria in assessing a loan application. By nature, small firms often lack a history of cash-flow, and have not established a management record.
- Unmet credit needs may stem from weak bank marketing, as many small business entrepreneurs have not even tried to obtain loans. While most banks offer a wide variety of banking and even management consulting services, these are rarely exploited by small business borrowers.

Summary of Policy Issues and Options

- Policy makers and regulators might consider incentives to promote small business lending both by independent and affiliated banks.
- To improve rural credit-making, greater marketing may help emerging business learn of credit opportunities. Regulators can supplement this marketing effort through additional publication of information gleaned from banks.
- Because markets dominated by affiliated banks pose greater challenges for borrowers, regulators may wish to consider avenues to encourage competition from independent lenders.

Small Business and Small Local Banks

At the heart of this study is concern that banking deregulation could harm the *traditional dependence of small business on small local banks* as a source of credit.

Small business is vital to the health of the economy. The majority of all new jobs are created by small business. The Massachusetts Institute of Technology determined that between 1960 and 1976, small firms (those with 20 or fewer employees) accounted for 66 percent of all new jobs.[1] By contrast, in the 1980's, the Fortune 500 was responsible for a net loss in jobs, despite the rise in the stock market. Although the magnitude of employment generated by small business can be debated,[2] in rural communities, the importance of small business is even stronger than in an urban environment, which, by nature, is home to large enterprises as well.

Most small businesses depend on local financial institutions for credit. With the exception of new firms, banks are easily the most important sources of credit for small business. Personal savings and the help of family and friends provides the true "seed capital" of American enterprise (venture capital companies hardly registered in this survey), but bank loans soon represent the lion's share of credit (Table 1).

Correspondingly, most small banks thrive by making loans to small business. Findings in this study highlight this dependence. Firms received less than 6 percent of their debt or equity capital from sources outside the state. Likewise, 97 percent of the commercial borrowers from the bankers surveyed are located in the banks' local market.

Until the 1980's, laws generally promoted this relationship by barring interstate acquisitions, and by preventing many intra-state mergers through anti-trust statutes. Under these laws, the post-Depression population of banks reached some 14,000 by the 1970's.

American history is replete with colorful debate about the suitable structure of banking. From the days of Jefferson and Hamilton, policy makers have wrestled with the advantages of large, central banks as opposed to decentralized, state-regulated banking. Shays Rebellion grew from antagonism over invasive bankers. The Burr-Hamilton duel was fought, in part, over this question. Jackson won the presidency on his pledge to kill what was then the nation's central bank. Those citing the virtues of national banking can point to Northern victory in the Civil War which was aided when a centrally regulated currency was mandated to help the North make good on many debts. The Federal Reserve was created, in part, to thwart the power of robber barons such as J.P. Morgan.

As with these notable events, *banking deregulation has altered the landscape of banking: Fewer banks control a larger share of the national market and even local banking markets have been affected.* Anti-trust enforcement has been relaxed. And most states now permit interstate banking. By 1993, 28 states will welcome banks from any other state. Another 17 states will permit banking from institutions based in states within their region. And, only 5 states will continue to restrict geographic expansion. This collection of changes is referred to as "deregulation" in the rest of this report.

In the four New England states included in this study, these new laws have led to major increases in statewide bank concentration. For small business, however, the more important

1 David L. Birch, *The Job Generation Process*, Cambridge, MA: MIT Program on Neighborhood and Regional Change, 1979.

2 Catherine Armington and Marjorie Olde, "Sources of Job Growth: A New Look at the Small Business Role," *Economic Development Quarterly*, Vol. 6, Fall 1982, 3-7.

concern is how the structure of local banking markets is affected by deregulation. Public policy makers concerned about interstate banking suggested, in part, that affiliates of large banks based in distant cities would be unsympathetic to local credit needs of small business, that the connection between small local banks and small business would be broken. It was feared that branch banks in rural markets would soak up deposits and funnel them to the parent in a big city, which might turn around and lend them out to big-city business or even invest funds in high-yield loans to developing countries.

The importance of this study, then, is rooted in understanding the relationship between small banks and small business, and between small business and the entire economy.

The purpose of this study, then, is this: *To assess overall how banking deregulation has affected the availability of credit to small business, with careful examination of any weaknesses that could be improved through policy changes.*

Table 1
Importance of Local Banks as Credit Providers to Small, Rural Businesses*

	ME	MA	NH	VT
Percent of start up capital				
family or friends	14%	24%	18%	20%
commercial bank	**28**	**27**	**28**	**35**
thrift institution	4	4	7	3
credit union	-	-	1	1
venture capital company	1	2	-	-
finance company	-	-	-	-
personal savings	43	35	39	40
supplier/dealer credit	-	-	-	-
other	10	8	8	2
% equity received from sources outside the state	4	5	6	5
% debt received from sources outside the state	4	4	6	3
Percent of loans received during first 5 years				
family or friends	15	24	20	18
commercial bank	**53**	**47**	**44**	**58**
thrift institution	10	9	11	5
credit union	-	1	2	1
venture capital company	-	-	-	-
finance company	1	1	1	1
personal savings	-	-	-	-
supplier/dealer credit	6	8	10	5
other	5	2	4	2
Percent of loans received up to the present				
family or friends	9	10	5	7
commercial bank	**54**	**53**	**59**	**66**
thrift institution	9	6	16	6
credit union	-	1	-	-
venture capital company	-	-	-	-
finance company	1	1	1	3
personal savings	-	-	-	-
supplier/dealer credit	8	7	7	6
other	4	2	3	4

* Percents may not total 100 due to missing values.

A Note on Methods

This study focuses on a specific aspect of deregulation, relaxed restrictions on interstate banking. Regulatory change has led not only to more multistate banking institutions, but to more urban-based banks operating branches or affiliates in rural markets. This study explores these changes by examining the difference in small business lending patterns between independent and affiliated banks located in rural banking markets. An independent bank is, by definition, based in the local market it services. An affiliated bank is, by definition, a branch or subsidiary of another bank or holding company that is based outside the local market. This study also considers differences in small business lending by type of local market – those dominated by independent banks and those dominated by nonlocal affiliate banks.

differences in s.b. lend'g between banks rural mkts

& between type of local markets (indep-dom + aff-l-dom)

The results of this study are based on survey responses from 114 lenders and 582 business borrowers in rural areas of four New England states: Maine, Massachusetts, New Hampshire, and Vermont.

Unlike most other studies, this one is unique in that it *focuses on both the supply and demand sides of rural credit markets.* It addresses simultaneously the lending practice and policy of local banks as well as the experience of small business entrepreneurs in dealing with those banks.

New England represents a good test of the impact of interstate banking because geographic boundaries first fell in this region. In 1978, for example, Maine became the first state in the nation to approve full interstate banking. The New England states formed the first regional compact in the nation, permitting bank acquisitions across the borders of the states.

At the same time, the results are limited by a number of factors. As with all such studies, the results are not necessarily applicable to other parts of the country. Another weakness is that the business survey attracted relatively few responses, although businesses that did respond appear to be representative of small businesses in the region. What's more, small businesses that were just emerging, or had failed, could not be included in the survey and the study may underestimate credit problems as a result. In addition, the survey did not address the credit experience of women and minorities, two important variables.

It should also be noted that the survey applies to good economic times. New England was generally thriving during the period of this study. When times get tough, the relation between banks and businesses may sour, creating capital gaps. If lending decisions are made ultimately from outside the local market, sensitivity to individual business needs may be lost.

Finally, while the survey attempted to measure how credit relations had changed, these results cannot definitively show that loan-making remains unaffected by changing banking conditions. In technical terms, it is not a longitudinal study that asked the same question over a ten-year or more time span.

Strengths and limitations of the study noted, the *focus of this discussion is the problems and shortcomings of New England rural credit markets.* Far from being rooted in negativism, this focus, ultimately, can inform public policy makers, bankers, and community development promoters on ways of improving small business.

Discussion of Results and Policy Implications

The Availability Of Credit To Small Business

Generally, *rural capital markets meet the credit needs of many small businesses*. Most businesses that sought some form of credit from a bank succeeded. To the extent that markets have changed in the past five years because of geographic deregulation or general economic conditions, most businesses express positive perceptions of these changes.

From the borrowers' perspective

Entrepreneurs with small businesses reported no serious or widespread problems in obtaining credit in the new banking environment. However, the large number of businesses whose owners had never tried to obtain credit may suggest a bank marketing or information gap (Table 2).

In virtually every category of loan, entrepreneurs reported that they were generally able to obtain the credit they sought. More than four-fifths had little problem obtaining short-term, secured loans, and a nearly equal majority enjoyed the same success with short-term, unsecured credit, often considered one of the riskier forms of credit. These results were parallel in all four states (Table 3).

Table 2
Percent of Business Respondents Who Never Tried to Obtain Credit*

	ME	MA	NH	VT
Short-term, secured	52%	47%	40%	45%
Short-term, unsecured	48	53	52	44
Long-term (1-5 years)	52	47	47	39
Long-term (>5 years)	60	66	58	58
Commercial mortgage	63	65	48	60
Home equity	79	70	72	82
Revolving lines	52	52	49	52
Asset based	87	87	80	79
Equipment	55	54	46	45
Public capital	97	92	93	94

* As a percent of all respondents.

Banking deregulation has not hampered this credit experience, according to business managers. Across the four states, 52 to 62 percent of the business officials felt they received the same or greater personal attention to their credit needs than in the past when independent banks predominated in most markets; those reporting less personal attention ranged from 9 to 12 percent. Another 48 to 57 percent reported that the length of time required to process loan applications was the same or shorter now; those reporting that the loan application process took longer ranged from 11 to 20 percent. And 35 to 50 percent said their bankers offered the same or greater flexibility in loan terms and conditions; those reporting less flexibility ranged from 8 to 12 percent.

It should be noted that businesses reporting they "don't know" about changes in credit availability, processing time, or flexibility were substantial, usually more than 25 percent and as high as 57 percent of the respondents (Table 4).

From the bankers' perspective

Responses from borrowers correspond to the figures collected from bankers. On the supply side, interstate banking seems to be putting the heat on bankers (Table 5).

A full 82 percent reported greater competition. Another 75 percent said that in the face of this competition, they made more visits to potential borrowers — 36 percent said they made a "much greater" effort to visit prospective clients. More than four-fifths of banks maintain "officer call" programs or visited commercial borrowers, either existing or potential. How-

Table 3
Credit Experience of Business Respondents*

	ME	MA	NH	VT		ME	MA	NH	VT
Short-term, secured					**Home equity**				
Obtain on terms desired	82%	79%	78%	89%	Obtain on terms desired	64	68	59	80
Obtain on less favorable terms	15	17	17	6	Obtain on less favorable terms	25	26	28	20
Unable to obtain	3	3	5	4	Unable to obtain	11	6	14	-
Short-term, unsecured					**Revolving lines**				
Obtain on terms desired	72	72	70	75	Obtain on terms desired	76	68	63	80
Obtain on less favorable terms	19	14	16	10	Obtain on less favorable terms	17	19	22	15
Unable to obtain	8	13	14	15	Unable to obtain	7	13	15	5
Long-term (1-5 years)					**Asset based**				
Obtain on terms desired	71	76	68	75	Obtain on terms desired	72	47	53	82
Obtain on less favorable terms	23	23	23	21	Obtain on less favorable terms	20	21	21	6
Unable to obtain	6	1	9	4	Unable to obtain	8	32	26	12
Long-term (> 5 years)					**Equipment**				
Obtain on terms desired	69	54	67	68	Obtain on terms desired	73	73	74	81
Obtain on less favorable terms	24	28	16	22	Obtain on less favorable terms	20	21	21	17
Unable to obtain	7	18	16	11	Unable to obtain	6	5	5	2
Commercial mortgage					**Public capital**				
Obtain on terms desired	74	64	61	62	Obtain on terms desired	80	10	50	75
Obtain on less favorable terms	21	27	28	32	Obtain on less favorable terms	-	10	17	-
Unable to obtain	5	9	11	6	Unable to obtain	20	80	33	25

* As a percent of those respondents that had tried to obtain the type of credit.

ever, these visits do not appear to be directed to *small* business since at least 60 percent of businesses surveyed said they *never had a visit* from a banker.

Eighty percent of independent banks maintained trained commercial loan officers; 83 percent of affiliates did. However, since training can be formal, in-house, or through hands-on experience, the quality of lending expertise may be quite variable from bank to bank. And, whether these loan officers have the risk assessment skills necessary to evaluate *small* business loans is an open question.

Generally, these affiliated bankers are competing for the same small business market as are the independents. Some 97 percent of the clients of independent banks are within the local market; 96 percent of the clients of affiliated banks are within the local market. The lion's share of credit at both types of banks flows to firms with less than $500,000 in annual sales.

As a result of this competition, an impressive 93 percent of bankers indicated they were making the same or greater volume of economic development loans as before, and 68 percent said they were making greater loans to small business.

This helps explain why many entrepreneurs seem to be satisfied and even thrive in a deregulated banking market.

Table 4
Business Perceptions of How the Local Credit Market Has Changed Since 1985

	ME	MA	NH	VT
Availability of asset-based loan products				
greater	19%	18%	22%	19%
same	23	13	22	14
less	4	6	7	3
don't know	49	55	48	57
Length of time required to process and decide on loan applications				
greater	16	11	14	16
same	33	37	42	31
less	20	11	15	17
don't know	25	34	27	30
Personal attention to credit needs				
greater	21	16	20	23
same	41	36	36	37
less	9	7	12	9
don't know	25	33	30	25
Flexibility in terms offered on short-term financing from your bank				
greater	19	12	18	25
same	32	27	32	22
less	9	9	8	12
don't know	36	44	40	36
Flexibility in terms offered on long-term financing from your bank				
greater	18	10	20	20
same	29	24	28	29
less	8	10	7	9
don't know	40	49	45	36
Extent to which lending decisions are tailored to your needs				
greater	19	16	20	27
same	29	24	30	23
less	12	11	8	12
don't know	34	41	41	33

Policy Issues

The bottom line, then, is that banking deregulation has not drained capital from rural business. Given the traditional dependence of small business on small local banks and other limitations of this study, however, this relationship should be monitored.

- With the possible onset of recession, regulators and independent analysts should watch carefully for the emergence of capital gaps in markets now changed by interstate banking. The type of information gathered in this study is useful to policy makers as they monitor credit conditions. Regulators need to explore mechanisms for efficiently collecting and disseminating these data on a broader level.

Lending Differences Between Independent and Affiliated Banks

While loan availability is not a glaring problem in the largest context, there are warning signs that business credit may suffer under deregulation.

From the borrower's perspective

Entrepreneurs reported less success in obtaining credit from markets dominated by affiliated banks than in markets dominated by independent banks. This gap was widest for short-term, unsecured credit.

In markets where only independent banks operate, 46 percent of business entrepreneurs said they were able to obtain short-term, unsecured credit on desired terms. Another 6 percent said they obtained the credit "on less favorable terms." Only 2 percent were turned away. Of this group, a full 44 percent never tried to obtain this type of credit. In markets where only large banking institutions operate, only 29 percent of entrepreneurs reported they were

Table 5
Banker Perceptions of How the Local Credit Market Has Changed Since 1985

	All Banks	ME	MA	NH	VT	Independent Banks	Branch or Holding Company Banks
Competition							
greater	82%	91%	60%	60	93	79	82
same	10	5	10	20	7	11	10
less	8	5	20	13	-	10	8
Variety of Financial Products							
greater	64	59	60	80	50	55	67
same	37	41	30	20	50	45	33
less	-	-	-	-	-	-	-
Alternative Sources of Financing							
greater	47	73	20	33	36	65	38
same	45	27	60	47	57	30	53
less	8	-	10	20	7	5	10
Visits to Potential Borrowers							
greater	75	81	70	60	72	75	74
same	17	18	10	27	7	15	18
less	8	-	10	13	14	10	8
Lending Decisions Removed From Local office							
greater	20	9	40	14	21	-	29
same	58	50	30	67	57	88	46
less	21	27	10	13	21	12	26
Flexibility in Packaging Loans							
greater	38	55	20	33	28	60	28
same	52	41	50	60	57	40	57
less	10	5	20	7	14	-	15
Lending to Small Business							
greater	68	82	70	47	64	75	64
same	25	18	20	33	29	25	25
less	7	-	-	20	7	-	10

able to obtain credit on desired terms; 9 percent said they received less favorable terms; a full 6 percent were rejected; and 54 percent never made an application.

Problems obtaining short-term credit from affiliated banks are important: Small businesses consider these loans, particularly unsecured short-term credit, the single most important credit need faced by their enterprises. In Maine, Massachusetts and Vermont, entrepreneurs placed this type of credit on the top of a list of eight different loan forms. New Hampshire businesses put it second (Table 6).

Table 6
Most Important Credit Need
Identified by Business Respondents

	ME	MA	NH	VT
Short-term loan	39%	39%	30%	28%
Long-term loan	30	25	39	24
Commercial mortgage	28	21	25	26
Revolving line	22	16	30	24
Equipment	16	14	15	24
Home equity	5	8	11	4
Asset-based	4	1	9	0
Equity investment	2	0	2	1

From the bankers' perspective

While the loan menu is roughly the same at independent and affiliated banks, there are two exceptions. These exceptions are notable because of their importance to small business.

First, branches of *larger banks make loans to slightly larger businesses than do independent banks.*

Some 36 percent of the loan portfolio of independent banks is made to businesses with less than $100,000 in annual sales; 24 percent of the portfolio of affiliate banks goes to this size of business. Businesses with $100,000 to $500,000 in sales account for 36 percent of the loan portfolio of independent banks, while they account for 44 percent of affiliated banks'.

Second, and correspondingly, *independent banks seem more likely to make short-term, secured loans to small business than do affiliated banks.* Twenty percent of the portfolio of independent banks is accounted for by such loans, compared to 13 percent at affiliate banks. At the same time, *affiliated banks are more likely to make long-term loans than are independent banks.* And, long-term loans were identified as the second greatest credit need for businesses in Maine, Massachusetts, and Vermont, and first in New Hampshire (Table 7).

One explanation for these portfolio differences may come from the differences in decision-making criteria between independent and affiliated banks. *Affiliated banks rely less on character and more on cash flow than do independent banks, criteria that may work against young firms.*

While 47 percent of affiliated banks cite cash flow as the single most important criterion in making loan decisions, only 35 percent of independent banks use cash flow as their number one criterion. Because young, start-up firms have little history of cash-flow, this might make it tougher to convince an affiliated bank to lend than an independent bank. Likewise, 10 percent of affiliated banks cited management capacity as the top criterion in accepting an application, compared with 5 percent among affiliated banks. Likewise, 34 percent of affiliated banks said that limited management experience is the most important reason to reject a loan application, compared with 15 percent of independent banks.

Since start-up firms often have little management history, this criterion can be another stumbling block with affiliated banks. Moreover, among affiliated banks, 7 percent cited collateral and 8 percent cited capitalization as the top criteria in accepting a loan application. None of the independent banks used these factors as the first criteria. Again, this weighs against a young firm's ability to obtain credit from an affiliated bank.

However, there is some evidence that *affiliated banks may be more sympathetic to young firms than are independents:* Only 16 percent of affiliated banks said that the fact that a firm was new was the most important reason for rejecting a loan application; a full 28 percent of independent banks cited this reason. Some entrepreneurs will face credit constraints, par-

Table 7
Profile of Bank's Commercial Borrowers and Commercial Loan Portfolio

	All Banks	ME	MA	NH	VT	Independent Banks	Branch or Holding Company Banks
Location of Borrower							
Within Market	97%	98%	98%	94%	98%	97%	96%
Outside Market	3	2	2	4	2	2	3
Out-of-state	—	—	1	1	—	—	1
Size of Borrower							
Start up	7%	6%	5%	6%	8%	5%	7%
< $100,000 Sales	28	42	18	22	23	36	24
$100,000 - $500,000 Sales	41	30	53	38	49	36	44
$500,000 - $1 Million Sales	17	16	20	23	13	15	19
$1 Million - $5 Million Sales	6	5	4	8	5	6	5
> $5 Million Sales	1	1	—	2	2	2	1
Industry of Borrower							
Resource Based	16%	29%	4%	10%	8%	14%	17%
Manufacturing	12	7	18	11	14	10	13
Retail	30	21	47	32	26	34	27
Wholesale	7	7	7	5	8	7	6
Construction	14	11	7	20	17	14	13
Business Services	11	13	9	9	10	13	9
Personal Services	10	8	6	13	14	7	11
TCU*	3	4	2	1	3	2	3
Type of Loan							
Asset Line	5%	3%	3%	10%	5%	6%	5%
ST, Secured	15	17	20	11	13	20	13
ST, Unsecured	12	15	10	9	11	12	11
LT (1-5 years)	22	22	32	17	21	20	23
LT (> 5 years)	17	17	11	14	26	15	18
Revolving Line	15	10	12	25	13	14	15
Equipment	13	14	9	14	13	11	14
Industrial Revenue Bonds	1	—	2	1	1	—	
Size Loan Outstanding							
< $10,000	11%	18%	8%	8%	10%	10%	12%
$10,000 - $25,000	16	26	15	8	14	20	15
$25,000 - $50,000	16	16	21	12	17	17	16
$50,000 - $100,000	26	17	33	27	31	23	27
$100,000 - $500,000	23	20	16	31	23	26	21
> $500,000	8	7	4	14	5	5	9

* Transportation, communication, and other utilities.

Table 8
Most Important Criteria in Commercial Loan Decision Making

	All Banks	ME	MA	NH	VT	Independent Banks	Branch or Holding Company Banks
Accepting a Loan Application*							
Character	48%	45%	50%	53%	43%	50%	46%
Cash Flow	43	50	40	27	50	35	47
Management Capacity	8	–	10	7	21	5	10
Collateral	5	–	10	7	7	–	7
Capitalization	5	5	–	7	7	–	8
Industry Conditions	5	5	10	–	7	11	3
Rejecting a Loan Application*							
Poor Earning's Record	33	36	20	27	36	26	36
Manager Has Only Limited Understanding of Business	28	23	30	27	29	15	34
New Firm	20	23	10	13	21	28	16
Inadequate Equity	16	14	30	13	14	5	22
Poor Quality Application	7	5	20	–	7	11	6
Inadequate Collateral	5	5	–	7	7	5	5
No Relationship With Bank	–	–	–	–	–	–	–

* Percent of bankers ranking each criterion as "most important."

ticularly from independents, simply because they are start-up firms (Table 8).

Still, another disturbing feature at affiliated banks is the *loss of autonomy in loan-making.* Affiliated banks report that the home office has reduced their autonomy in deciding to give credit to local business. In Maine, for example, with the longest interstate banking history, a full 40 percent said that lending decisions were removed from the local office to a "greater" or even "much greater" extent (see Table 5).

Similarly, in markets dominated by affiliated banks, 35 percent of the bankers reported that lending authority was now more removed from their desks than in the past. In markets dominated by independents, only 11 percent of banks suffered this same loss of autonomy.

Where branches are operated as elements of a network, as opposed to self-contained deposit-gathering and loan-making establishments, these results suggest some dangers for local business. Savings might be absorbed through the branch, and funneled to outside investments. Although evidence from this study does not support this view, the problem could be severe in an economic downturn, when a borrower needs patience from a lender. Larger branch banking systems are likely to be more sensitive to regional economic conditions, readily transferring capital to more profitable opportunities outside the local market. Indeed, a greater percent of affiliated bankers cite local business conditions as a constraint on small business lending than do independent bankers.

Policy Issues

Because there is concern about small business credit access from affiliated banks, appropriate policy response might be considered.

- One regulatory tool already on the books is the Community Reinvestment Act. It requires banks to service their local markets. Accordingly, under current law, regulators can enforce this service requirement by rejecting applications by one bank to merge with or acquire a bank in another market. This represents a direct tool to encourage appropriate lending patterns. This tool can also prevent mergers that serve to absorb savings and divert them outside the market.

  At the same time, enforcement of the Community Reinvestment Act has proven spotty. Rejections are rare despite clear evidence from other studies that many banks have failed to serve their markets.

- New regulatory standards might be introduced. For example, evidence in this study shows that small business credit problems are more apparent in markets dominated by affiliated banks. As a consequence, with a change in law, bank regulators could restrict acquisitions that lead to this market structure.

  Affiliated banks are not alone in their apparent failure to respond to small business credit needs. Evidence of reluctance to lend to a new firm, particularly by independent bankers, may reflect limited capacity to evaluate risk.

- To address this capacity, regulators could encourage risk-analysis education programs for lenders. Programs such as the Minnesota Bankers' Association's Enterprise Network represent a starting point for analyzing and developing effective technical assistance models for small rural bankers.

Marketing Mismatch

More pronounced than any warning signs about credit for small banks, this study shows a mismatch between banking services and bank marketing. A remarkable number of small business entrepreneurs have never tried to obtain credit of any kind. Nearly half of all small business entrepreneurs have not tried to obtain short-term credit of any kind from a bank. A similar percentage haven't explored one- to five-year loans. And more than 60 percent have never tried to obtain business loans of more than five years.

Table 9
Percent of Banks Providing the Following Services to Business Clients

	All Banks	ME	MA	NH	VT	Independent Banks	Branch or Holding Company Banks
Payroll	80%	95%	80%	47%	93%	70%	85%
Cash Management Accounts	69	64	90	53	79	30	88
Financial Counseling	75	73	60	80	86	90	68
Referral to Technical Asst. Agencies	82	86	80	87	71	85	80
Management Counseling	23	14	50	20	21	30	20
Asset Based Lending	67	77	60	60	64	45	78
Equipment Financing	97	100	100	100	86	95	98
Leasing	38	32	30	47	43	25	44

Most banks, independent and affiliated, offer an array of services that could be useful to small firms. A full 80 percent offer payroll services. Another 69 percent offer cash management accounts that help a small business insure that its money is well invested, yet available for immediate needs. Ninety-seven percent offer equipment financing (Table 9).

Many banks offer consulting help to small business borrowers. Most banks offer financial counseling, including 90 percent of independent banks, while a small number even offer management counseling.

A staggering percentage of entrepreneurs, however, were unaware of these services. Roughly 70 percent were unaware of payroll services and a like amount were unaware of cash management or equipment financing help (Table 10).

Bankers seem to agree that the small business market is larger than their current loan portfolios would suggest. A full 90 percent of all banks said they could increase their small business lending. The constraints were divided between poor loan applications (28 percent), poor business climate (31 percent), and lack of capital and deposits (33 percent). For most independents, small business lending is constrained by their small size and dependence on local deposits. For most affiliates, poor business climate was the important limitation on small business lending, corresponding to the ease with which they can attract deposits and lend outside the local market.

Marketing may not be the only problem. One disturbing possibility is that business managers never tried to obtain credit because they were, in fact, "discouraged borrowers". They may have a need for credit, but for some reason, felt that bankers would not help them.

An additional piece of evidence that points toward this possibility comes from this: Many entrepreneurs cited a lack of credit as a reason for their decision not to expand. While as few as 4 percent of the entrepreneurs in Vermont cited this reason, in Maine, fully 23 percent did not

Table 10
Availability of Business Services Through Primary Commercial Lender*

	ME	MA	NH	VT
Payroll Services				
don't know	70%	64%	74%	74%
offered	21	23	18	11
used	4	5	2	10
Cash Management				
don't know	70	62	66	70
offered	21	23	27	21
used	5	8	2	5
no response	3	9	6	5
Financial Counseling				
don't know	54	52	52	55
offered	27	25	28	16
used	16	18	15	24
Referral to Technical Assistance				
don't know	74	77	75	80
offered	19	13	17	13
used	3	1	3	2
Management Counseling				
don't know	78	81	78	78
offered	15	9	14	13
used	3	1	3	5
Asset Based Lending				
don't know	68	62	65	71
offered	19	19	10	9
used	9	10	20	15
Leasing Operations				
don't know	89	85	84	86
offered	6	6	9	9
used	1	0	1	0

* Percents may not total 100 due to missing values.

grow because of perceived credit limitations. To put these figures into context, New England entrepreneurs more often blamed themselves. In Maine for example, 27 percent point to "limited management capacities." Risk was another notable constraint, cited by as many as 41 percent of the Vermont business managers. Still, tight credit, especially given good economic times, suggests a policy concern (Table 11).

Policy Issues

Given this glaring gap between the services banks offer and small business knowledge about banking services, there seems to be a decided need for greater marketing. If these banking services positively influence a business's access and use of capital, then rural economies may benefit through increased job creation and business retention. While simple business incentives may be enough to encourage banks to address this problem, regulatory incentives may accelerate the process.

- Specifically, regulators could improve their examination of, and therefore encouragement of marketing efforts and provision of services important to small business as part of Community Reinvestment Act reviews.
- In addition, regulators could gather information about commercial lending at the local level and make it publicly available. Community groups dedicated to the promotion of rural credit could leverage this information, effectively serving as commercial marriage brokers.

Table 11
Reasons Business Respondents Decided Against Business Expansion

	ME	MA	NH	VT
Percent of respondents deciding against expansion	33%	33%	41%	31%
Reasons:				
Limited by Mngt. Capacities	27	30	27	22
Expansion too risky	17	25	27	41
Credit not available	23	14	18	4
No economic reason	9	12	4	-
Other	24	16	20	30

Conclusions

Even with deregulation, the link between small business and small banks is strong. However, the quality of this link in terms of both services and credit access may be changing. Deregulation has not had a decisively negative impact on small business access to credit in the New England region. But, this study provides warning signals that small, young firms face difficulty acquiring credit from both independent and affiliated banks. And, certain types of credit are less available to small businesses.

Greater access problems in local markets dominated by affiliated banks suggest the need for continued vigilance on the part of regulators in monitoring the impact of acquisitions on small business credit and bank services. And, in recognition of the importance of small businesses to rural economies, public policy should strengthen the link between local independent banks and entrepreneurs by expanding the risk-taking capacity of these institutions and encouraging their active partnership with other organizations dedicated to promoting rural economic and small business development.

For more detailed information about the study on which this policy report is based, contact Dr. Deborah Markley, Department of Resource Economics, Draper Hall, University of Massachusetts, Amherst, MA 01003.

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