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Financial Services and Small Businesses

by Paul R. Watro

An important user of financial services is a group of customers known as small businesses.[1] While it is commonly thought that small businesses depend almost exclusively on commercial banks for financial services, results of a recent survey of Ohio's small businesses cast some doubt on this assumption. The survey results show that small businesses demand and receive a variety of deposit and loan services, not only from commercial banks but also from other sources.

The dependence of small businesses on commercial banks is an important issue. The federal regulatory agencies generally have followed the courts' view that banking is a separate and distinct line of commerce when analyzing the competitive impact of bank mergers and acquisitions. Following the lead of the courts, these competitive assessments by the banking regulatory agencies have concentrated on local customers, especially consumers and small business firms. However, in light of financial innovations, changing regulations, and increased competition for financial services, the contention that banking is a separate line of commerce for local customers may no longer be valid.[2] The third-party payment

1. For purposes of this discussion, a *small business* is defined as a firm with less than $5 million in total assets.

2. For a detailed discussion of the changing financial environment, see Henry C. Wallich and Walter A. Varvel, "Evolution in Banking Competition," *Bankers Magazine*, vol. 163, no. 6, December 1980, pp. 26-34.

Paul R. Watro is an economist with the Federal Reserve Bank of Cleveland. The author wishes to thank the survey respondents for their cooperation; he also wishes to thank Peggy Petricig for her valuable assistance.

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> **The Sample**
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> Questionnaires were sent to 2,420 business firms in Ohio, selected randomly from the *1981 Ohio Industrial Directory* and the yellow pages of telephone directories. Manufacturers with over $10 million in sales or over 200 employees were excluded from the sample, as were firms with block advertisements in the yellow pages or that otherwise were recognizably large. Of the questionnaires mailed, 160 were returned from the post office as non-deliverable. There were 579 responses, or a response rate of 26 percent. However, 51 of the respondents were excluded from the analysis—41 had assets of over $5 million, and 10 did not report their size.
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> The respondents were classified in several ways: by assets, sales, business type, organizational structure, location, and number of years in operation. Nearly two-thirds of the respondents reported assets of less than $500,000, and nearly one-half had sales of less than $500,000. Three out of four respondents operated in a standard metropolitan statistical area. Over 80 percent of the respondents were corporations, while only 14 percent were proprietorships. Three out of four respondents had been in business for over ten years. Many firms reported being involved in more than one type of business; the most common type was manufacturing, followed by retailing.

authority recently granted to all depository institutions and the expanded services (credit cards, trusts, and additional types of consumer loans) given to thrift institutions are confirming the view that nonbank institutions can compete effectively with commercial banks for many financial services, especially consumer loans and deposit services. Powers for thrift institutions have not been expanded to include many services for small businesses, such as commercial checking accounts and unsecured business loans. However, thrifts can provide savings and time deposit services and some types of loans to businesses.

The survey of small businesses was conducted by the Federal Reserve Bank of Cleveland to ascertain the extent to which commercial banks actually faced competition in providing deposit and credit services to small commercial customers (see box). The survey attempted to identify the types of financial services that small businesses required and the sources of such services. This *Economic Commentary* summarizes the survey findings and discusses their implications with regard to the line-of-commerce issue in banking.

Deposits

The survey results showed that small business firms held various types of deposit accounts with financial institutions. Nearly every survey respondent had a checking account, and one out of every six maintained more than one account (see table 1). The majority of the small businesses held savings accounts, and over 30 percent held certificates of deposit (CDs).

Savings and loan associations (S&Ls) competed effectively with commercial banks for deposits of small business firms in local

Table 1 Deposits and Market Share[a]

	Deposits			
	Demand	Savings	Time	All
Respondents with accounts[b]	511	293	162	511
Percentage	97	55	31	97
Total number of accounts	600	342	190	1,132
Market share, %				
Banks	99	68	70	85
S&Ls	1	30	27	14
Other	–	2	3	1

a. The market share was based on the total number of accounts.
b. There were 528 respondents.

Table 2 Debt Outstanding

	Number	Percentage
All debt[a]	**376**	**72**
Commercial-bank debt[b]	**333**	**66**
< 10%	101	30
10% to 39%	90	27
40% to 69%	58	17
70% to 99%	30	9
100%	54	16

a. Based on 525 respondents.
b. Based on 507 respondents. Percentages do not sum to 100% due to rounding.

market areas.[3] While nearly every responding firm was a commercial-bank customer, many small businesses also maintained deposit accounts with nonbank institutions. S&Ls ranked second to commercial banks as depositories, accommodating 14 percent of the respondents' total deposit accounts. S&Ls held 30 percent of the savings accounts and 27 percent of the CDs reported by the respondents. Other nonbank institutions, including money market funds, accounted for 1 percent of the small businesses' total deposit accounts.

Credit

According to the survey results, many small business firms apparently did not have any debt outstanding, and some firms that had debt did not borrow from commercial banks (see table 2). Three out of every ten respondents reported no debt outstanding, while over 10 percent of small businesses with debt had no loans from commercial banks. More surprisingly, commercial-bank debt generally constituted a relatively small portion of total debt outstanding of small business firms. For example, nearly one-third of the respondents with debt reported having less than 10 percent of their debt with commercial banks, while only one-sixth of the borrowing firms had all their debt with banks.

The most widely used source of credit among small business firms was trade credit (see table 3). Seventy-six percent of the respondents utilized suppliers as a source of credit.[4] Suppliers use credit as a nonprice inducement in the selling of products to firms, and these terms may vary with the

3. Mutual savings banks do not operate in Ohio.

4. The dollar volume of trade credit held by the respondents is not known. However, according to the Federal Trade Commission, small U.S. manufacturing firms (assets of less than $5 million) held a larger dollar volume of trade credit than bank loans. Suppliers' credit represented 17.2 percent of these firms' total assets in 1978, while total bank loans accounted for 16.5 percent.

Suppliers usually sell products to firms with some flexibility in paying for the merchandise. If the credit terms are 2/10, net 30, for example, the buyer has up to 30 days to pay the bill. If payment is received within 10 days, the buyer enjoys a 2-percent cash discount; if payment is received after the tenth day, the buyer foregoes the cash discount.

competitive conditions in the market. Sellers may extend installment credit, for example, to buyers of machinery and equipment. Since the credit cost is bundled up with the price of the commodity, firms generally have a financial incentive to utilize the full period of the cash discount or credit terms, particularly when credit needs are strong and/or credit terms are high. Of course, trade credit is not a perfect substitute for loans, as it cannot be used directly to pay employees or bill collectors.

Financial institutions ranked second as a source of financing for small business firms. Sixty-seven percent of the respondents had a loan outstanding with some type of financial institution. As expected, commercial banks accounted for the vast majority of these loans; 56 percent of the small business firms had loans outstanding with banks. Savings and loan associations and commercial finance companies together extended loans to about 9 percent of the respondents, while all other institutions had loans with about 2 percent of the firms.

Owners and customers of small business firms ranked third and fourth, respectively, as sources of credit. Thirty-one percent of the respondents obtained financing from owners, and twenty-one percent used pre-payments by customers as a credit source. Other sources, including parent companies and franchise holders, were used by 11 percent of the respondents.

Small business firms had a variety of loans outstanding with financial institutions (see table 4). There were 676 loans extended to the respondents, classified as unsecured, secured, or construction loans. The nonconstruction loans accounted for nearly 90 percent of the loans, which were divided fairly evenly between secured and unsecured loans. The majority of the secured loans were written for one year or longer, while two-thirds of the unsecured loans matured within one year. Although banks extended most of the loans, nonbank financial institutions were relatively active competitors for construction loans and secured loans written for more than one year. Indeed, S&Ls legally are permitted to extend business loans

Table 3 Credit Sources

	Respondents	Number	Percentage
Trade credit (suppliers)	517	392	76
Financial institutions	528	355	67
Commercial banks		297	56
S&Ls		31	6
Commercial finance companies		16	3
Other		10	2
Owners	517	162	31
Pre-payments (customers)	517	106	21
Other	517	57	11

Table 4 Loan Type and Number[a]

	Number	Percentage
Unsecured loans	**279**	**41**
Short-term	182	27
Term	97	14
Secured loans	**306**	**45**
Short-term (accounts receivable)	56	8
Short-term (other)	80	12
Term	170	25
Construction loans	**91**	**13**
Total loans	**676**	**99**

a. *Short-term* indicates loans written for less than one year; *term* refers to loans written for one year or longer.

NOTE: Percentages may not sum to 100 percent due to rounding.

only if they are secured by real estate. Nonbank financial institutions—primarily S&Ls and commercial finance companies—accounted for nearly 25 percent of the construction loans and over 15 percent of secured-term loans held by the respondents.

Other Services

Many small business firms required financial services other than deposits and loans. Credit cards and leasing presumably served as substitutes for loans: credit card service became an alternative for debt financing accounts receivable, and leasing was an alternative for borrowing to finance equipment purchases. Over 30 percent of the respondents accepted or used credit cards, and over 15 percent leased equipment.[5] Banks dominated the credit card business, but they faced significant competition from commercial finance companies in the leasing business. Although banks accounted for one-half of the respondents' equipment leasing, commercial finance companies ranked a close second, with nearly 40 percent of this type of business. Unlike loans and deposits, banks competed with nonbank institutions for leasing on a more regional basis. Nearly 50 percent of the equipment leases were obtained from institutions located more than 20 miles away from the firm's operations, and over one-half of these leasers operated over 100 miles away.

Other services required by small businesses included cash management, trust, coin and currency, lockbox, and night depository. Nearly one-half of the respondents used financial institutions as a source of coin and currency, and over 25 percent utilized lockbox and night depository services. Less than 10 percent of the respondents used cash management and trust services. As expected, commercial banks were by far the primary suppliers of these services, and no more than 3 percent of the respondents obtained any of these services from more than one institution.

Implications and Conclusions

The survey information indicated that small businesses did not rely exclusively on commercial banks for either deposit or credit services. In fact, trade credit was the most widely used credit source for small businesses. While trade credit is not a perfect substitute for bank credit, failing to take account of such credit grossly overstates the importance of commercial banks in the small-business loan market.[6]

On the deposit side, commercial banks also faced considerable competition for small commercial customers. S&Ls legally were prohibited from providing checking or transaction accounts to commercial customers, but they still held a sizable portion of the small businesses' total deposits and time and savings deposits. Given the realities of the marketplace, thrift institutions generally—and S&Ls in particular—must be considered as effective competitors for small-business deposit accounts.

5. Some respondents apparently used credit cards in making purchases, such as gasoline for company-owned delivery trucks; others presumably accepted credit cards in payment for merchandise sold.

6. Commercial banks accounted for nearly 90 percent of the loans extended to the respondents. If one loan were added for each of the 392 firms that reported using trade credit, the total number of small business loans would increase from 676 to 1,068, thereby reducing the percentage of commercial-bank loans to less than 60 percent. If small businesses obtained credit from more than one supplier, the decrease would be greater.

Commercial banking currently is considered as a separate line of commerce by the courts, and this requires regulatory agencies to assess the competitive effects of a banking consolidation by focusing the analysis on commercial banks. However, given the changing financial environment suggested by these survey results, it may be necessary for regulators to broaden their assessment of competition by giving greater weight to nonbank competitors. Although these findings may not be representative for individual markets, the evidence clearly indicates that commercial banks do not have a monopoly on small-business deposits or loans. Failing to consider significant competitors of commercial banks when analyzing the effects of proposed bank mergers and acquisitions may lead to unwarranted conclusions about the actual competitive conditions in the marketplace.

One approach to analyzing banking competition would be to consider thrift institutions as full competitors of banks for consumer and small-business deposits and consumer loans. While thrifts do not appear to be effective competitors for non-construction small-business loans, it would seem imperative to include trade credit in this product market. While more empirical work is necessary, some conservative estimate of the share of small-business credit held by suppliers would appear to improve the analysis of competition in this product market.

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Federal Reserve Bank of Cleveland
Research Department
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