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SMALL BUSINESS EVALUATES ITS RELATIONSHIP
WITH COMMERCIAL BANKS

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by

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Abstract

This paper presents the results from two recent surveys of the membership of the National Federation of Independent Business in which the responding firms identified the importance of various non-price attributes of their banking relationship and then rated their major bank performance on these attributes. The analysis shows that banks do best in providing the non-personal characteristics desired in a banking relationship, but have room for improvement on the dimensions involving personal contact. The results also show that banks in rural areas and those in unit banking states have a comparative advantage over urban banks and banks in statewide branching states in providing the non-price dimensions involving personal contact, e.g., knowledge of a firm's business.

Small Business Evaluates Its Relationship With Commercial Banks

Small businesses, unlike large ones, have few alternatives to the commercial banking community for obtaining their required financing. Recent surveys of small business showed that commercial banks provided over 90 percent of the short-term (under 12 month maturity) and almost 70 percent of the long-term (over 60 month maturity) financing for the firms sampled. Banks are thus an important catalyst for a sector of the economy that employs nearly 50 percent of all workers, is recognized as a significant source of new jobs, and produces about half of our Gross National Product.¹

Even though small businesses are "captive" to the commercial banking community, they may represent a potentially profitable market that has yet to be fully exploited. Why? Because small business has a genuine interest in "relationship banking" where price considerations are less important than, say, reliability as a source of credit or the provision of helpful business suggestions.² In an era where extreme competition from loan production offices and foreign branches have squeezed profit margins on lending to national firms, the small business market provides an opportunity for banks to maintain higher margins if they can meet the important non-price needs of these firms.

This paper presents the results from two recent surveys of the membership of the National Federation of Independent Business (NFIB), in which the responding firms identified the importance of various non-price characteristics to their desired banking relationship, and then rated their major bank performance on these characteristics. The surveys, conducted in April 1980 and April 1982, were sent to a random sample of about 8000 firms with 2657 responding in 1980 and 2349 in 1982. About half of the firms had gross sales under \$350,000 per year, employed less than five persons, and had been in business over 10 years. Over half considered themselves to be frequent

borrowers, i.e., borrowed at least once per year. Of those that had borrowed, under one half reported loans under \$20,000, while 10 percent reported loans over \$200,000. These data describing the sample are given in Table 1.³

The data on the desired characteristics in a banking relationship and major bank performance on these characteristics are presented in Table 2. Small businesses first rated the importance of ten characteristics (see Table 1) in their desired banking relationship from 1 (very important) to 4 (not important). Next they ranked their major bank's performance on these same characteristics from 1 (good) to 4 (not good). All of the characteristics (Table 1), with the exception of "Offers the Cheapest Money," represented non-price aspects of a banking relationship, e.g., "Knows You and Your Business," "Offers a Wide Range of Banking Services," and "A Reliable Source of Credit." The 1982 list of characteristics differed slightly from the 1980 list: "Easy Access to Loan Officer" was inserted in place of "Knows Your Financial Needs."

Rankings of Desired Characteristics

The interest rate charged on a loan was not the most important aspect in a small business banking relationship despite record high nominal and real rates at the time of the surveys. "Knows You and Your Business" was most frequently rated very important (67 percent in both surveys), followed by "Reliable Source of Credit" (55 percent). "Offers the Cheapest Money" was the third most important characteristic in the desired banking relationship, rated very important by 50 percent of the firms. Those characteristics least frequently reported as very important to the desired banking relationship were "Providing Helpful Business Suggestions" and "Comes to You with Ideas for Improving Bank Services."

These ratings suggest that the "consulting" aspect of the banking relationship was viewed as less important than the continuity and availability of

credit. And, consulting was less important than the cost of credit. The rating results for desired characteristics in a banking relationship could have important implications for small business lending programs. If small business values certain non-price aspects of the banking relationship, the opportunity exists for banks to shape profitable lending strategies for those that can best provide these services.

Ratings of Performance

Ratings of bank performance differed markedly from the ratings of desired characteristics in a banking relationship. Banks most frequently received good ratings on accessibility ("Convenient Location" and "Easy Access to a Loan Officer"). "Reliable Source of Credit," "One Person Handles Credit Needs," "Knows You and Your Business," and "Offers a Wide Range of Banking Services" also received good performance ratings, although significantly lower than accessibility.⁴ The two characteristics least frequently rated as very important to the banking relationship ("Provides Helpful Business Suggestions" and "Offers Ideas to Improve Bank Service") were also least frequently rated "good" on performance.

Performance was also analyzed by community size (urban versus rural locations) and by branching restrictions (statewide versus unit) to investigate the claim that more liberalized branching/holding company restrictions result in better service to the banking customer.⁵ Many independent bankers (especially those in rural areas) feel threatened by further deregulation because of their perceived inability to compete with larger banks that may enter their market with new branches or purchases of existing banks. Bankers in unit banking states may also see a potential threat to their markets from large banks in statewide branching states. While these data do not address all the issues involved in the debate over the effect of further bank deregulation on

the quality of bank service offerings, they do provide some insight into which market structures currently provide small businesses with better performance. These data are presented in Tables 3 and 4 in two ways. The first uses the "good" performance ratings, while the second uses the "good" plus "above average" ratings.

In both surveys rural banks more frequently received good performance ratings (relative to banks in urban areas) on almost all of the characteristics.⁶ This superior performance was only statistically significant for "Knows You and Your Business" and "Reliable Source of Credit" using the "good" ratings. For the good plus above average ratings, "One Person Handles Credit Needs," "Knows My Industry" and "Knows My Financial Needs" were significantly higher for rural banks. The persistence of the urban-rural differences in performance is consistent with the generally accepted notion that rural banks have closer relationships with their customers. These urban-rural performance differentials are not attributable to differences in desired characteristics in the banking relationship or individual characteristics of the respondents to the survey.

In the 1980 and 1982 survey, firms located in unit branching states rated their bank's performance significantly better than firms in statewide branching states (using the good ratings) for "Knows You and Your Business," "One Person Handles Credit Needs" and "Reliable Source of Credit." The good plus above average ratings provided mixed results. In 1980 banks in unit branching states were rated significantly better performers for all of the characteristics except "One Person Handles Credit Needs," "Convenient Location" and "Offers a Wide Range of Banking Services." By 1982, however, unit banks performed significantly better on only four characteristics ("Offers Cheapest

Money," "One Person Handles Credit Needs," "Easy Access to Loan Officer" and "Reliable Source of Credit"), two of which were included in the good ratings.

One explanation for the relative improvement in the performance ratings of banks in statewide branching states is related to the average interest rate differential on loans made in statewide and unit branching states. In the 1980 survey, firms with lower contract rates rated bank performance higher; firms in statewide branching states paid higher contract rates of interest than those firms residing in unit branching states. The decline of the unit-statewide interest rate differential in 1982, not surprisingly, was accompanied by a relative improvement in statewide bank performance ratings. Still, the statewide-unit performance differentials persisted across both surveys and again were not attributable to differences in importance in the desired banking relationship or the characteristics of the respondents. The data in Table 4 thus suggest that more liberalized branching laws are not likely to bring "improved" service to small business borrowers; in fact, they suggest just the opposite.

Performance Relative to Desired Ratings

The data in Table 2 provide direct comparisons of what is viewed as important in banking relationships and how major banks performed on these characteristics. A more interesting criterion for performance evaluation is to compare the actual ratings to the desired ratings to obtain a measure of relative performance. Subtracting the percentage of firms rating a characteristic as important from the percentage rating performance on this dimension as "good," this relative performance measure can be interpreted as follows: if the difference is less than zero, bank performance falls short of what small business desires; if greater than zero, performance exceeds what was desired. These data (Table 5), are presented in a format similar to that used in Tables

3 and 4. The first column uses the "best" ratings for both desired characteristics and performance. In the second column, all of the "favorable" ratings are used, i.e., very important plus important for desired characteristics and good plus above average for performance.

The data for all respondents show that banks performed best relative to the desired (using the highest ratings) on "One Person Handles Credit Needs," "Convenient Location," "Access to Loan Officer," and "Offers a Wide Range of Banking Services." Banks did worst on "Knows You and Your Business," "Offers the Cheapest Money," and "Reliable Source of Credit," and all of these differences were significant. With the exception of "Provides Helpful Business Suggestions" and "Comes to You with Ideas to Improve Bank Service" in 1982, all of the performance proportions differed significantly from the desired proportions. Similar patterns were observed when the sample was broken down by community size and branching laws.

Including the "above average" and "important" ratings gave slightly different results. Banks performed significantly better than desired only on "Convenient Location" with no significant difference on "Comes to You With Ideas to Improve Bank Service," "One Person Handles Credit Needs" or "Easy Access to Loan Officer." Thus the differences between those rating a characteristic as "important" and rating bank performance as "above average" were of sufficient magnitude to reduce the relative satisfaction with bank performance on these characteristics.

The relatively poor performance of banks on offering the cheapest money available is not surprising considering the record high interest rates at the time of the surveys. The good performance of banks having "One Person Handle Credit Needs" but poor performance on "Knowledge of the Firm's Business" is puzzling. Perhaps the lending officer has multi-product responsibilities

(e.g., small business, consumer credit) and the small business borrower feels that not enough time is devoted to the firm's needs. Or, the small business sees a frequent turnover of lending officers and is frustrated by the continual "re-learning" process required by the new officer. Banks have performed well in providing non-personal dimensions of the desired banking relationship, e.g., location and service offerings, even though most small business borrowers did not rank these characteristics as most important in their desired banking relationship.

Conclusion

Small firms value a knowledge of their business plus reliability as a source of credit far above having low interest rates on loans. Providing helpful business suggestions and ideas to improve bank service were least important to small firms in their desired banking relationship, and these characteristics were, not surprisingly, less important than "cheap" loans.

Ratings of major bank performance on these desired characteristics showed marked differences when compared to the desired ratings. Banks were most often rated highest in providing accessibility (locational convenience and access to a loan officer), followed by reliability as a source of credit, one person handling credit needs, knowledge of the business, and a wide range of service offerings. Comparing the actual ratings to the desired ratings for each characteristic, banks did best in offering locational convenience and a wide range of service offerings. Thus, in the opinion of small business, banks did best in providing the non-personal characteristics desired in a banking relationship, but have room for improvement on the dimensions involving personal contact.

The survey results have important implications for small business lending strategies. Small business values certain non-price aspects of the banking

relationship above the interest rate on the loan. If small businesses are willing to pay for these non-price services, the banks that can best satisfy these needs may be able to maintain more profitable, long term business base. Thus the small business market may warrant renewed attention, especially after considering the effect of the increased competition from loan production offices and foreign branches on the profit margins of loans to national customers.

The rating results for community size and branching laws suggest that rural banks or banks in unit branching states may be able to hold their own in the small business lending market should further deregulation occur (e.g., interstate branching). These banks were above average performers in their knowledge of the firm's business and industry and in providing a reliable source of credit, dimensions of service less easily provided by very large banking institutions. Even knowledge of the firm's "risk" gained over time is not easily captured on application forms and may be lost due to the frequent turnover of loan officers. By continuing to do the things they do best, these banks in rural markets or unit branching states have a comparative advantage in the small business loan market.

Footnotes

¹The State of Small Business: A Report of the President, U.S. Government Printing Office, Washington, D.C., March 1983, pages 34, 40, and 49.

²James McN. Stancill ("Getting the Most from Your Banking Relationship," Harvard Business Review, 58 March-April 1980) and E. Peter Gillette, Jr. ("Revitalizing the American Dream: Banking's Commitment to Small Business," Journal of Commercial Bank Lending, June 1982) have emphasized the importance of these non-price factors in choosing a bank.

³The representativeness of these data of the small business community in general have been analyzed by the authors. Although some size, industry, and form of business discrepancies exist between the NFIB membership and data from various government sources, they have little effect on the conclusions reported in this paper when taken into consideration. Even if the distributional differences were large, the 500,000 members of the NFIB represent a significant proportion of the small business population. A detailed analysis of this analysis of the representativeness of the data may be obtained from the authors.

⁴Significance is used here in a statistical sense. Because the surveys reflect responses from only a small sample of the small business population, the "true" population response may differ from those reported in the tables presented in this paper. This deviation of the sample proportions from the true proportion is referred to as sampling variability. For example, it can be shown that for "Reliable Source of Credit" in Table 1 the true population proportion will be included in the interval 55% ± 2% 95 percent of the time; likewise, 50% ± 2% includes the true proportion for "Offers the Cheapest Money" 95 percent of the time. These proportions significantly differ because these intervals do not overlap. If the proportion for "Offers the Cheapest Money" was 53 percent, then it would not differ significantly from "Reliable Source of Credit."

⁵See A. S. McCall, "The Impact of Bank Structure on Bank Service to Local Communities," Journal of Bank Research, Summer 1980, for a review of this literature.

⁶The metropolitan category has very few observations (198 in 1980 and 180 in 1982). With so few observations, the sampling variability is larger and thus in almost all cases these proportions are not significantly different from the "city" proportions.

Table 1

Survey Sample Characteristics

	Percent of Firms ¹			Percent of Firms	
	<u>1980</u>	<u>1982</u>		<u>1980</u>	<u>1982</u>
<u>Gross Sales</u> (Thousands \$):			<u>Industry:</u>		
Under \$50	8%	8%	Construction	15%	15%
\$50-99	11	11	Manufacturing	12	12
100-199	17	15	Transportation	3	3
200-349	15	15	Wholesale	8	8
350-499	9	10	Retail	33	33
500-799	9	10	Agriculture	5	5
800-1499	12	12	Financial	8	7
1,500-2,999	7	8	Service	10	11
3,000 or more	9	10	Professional	6	6
<u>Fulltime Employment:</u>			<u>Borrowing Frequency:</u>		
One	10%	7%	At least once/year	56%	52%
Two	10	9	Infrequent	35	41
3-5	29	28	Non-borrower	8	6
6-9	18	18			
10-14	10	11	<u>Loan Size:²</u>		
15-19	5	5	Under \$5,000	14%	13%
20-39	9	9	5,000-9,999	16	15
40 or more	9	8	10,000-19,999	18	21
			20,000-39,999	26	17
<u>Years in Business:</u>			40,000-69,999	12	11
1-2	9%	6%	70,000-99,999	4	4
3-4	12	10	100,000-149,999	5	6
5-6	9	9	150,000-299,999	5	6
7-10	16	16	300,000-999,999	4	5
11-16	12	12	1,000,000 or more	1	2
16-20	10	9			
over 20	32	37			

¹Does not add to 100% because no answers are omitted.

²Reported percentages are conditional on the respondent reporting a loan.

Table 2

Desired Characteristics in a Banking Relationship and
Major Bank Performance: All Respondents

Characteristics	Percent Reporting									
	Very Imp/ Good		Important Above Average		Not Very Important/ Below Avg.		Not Important/ Not Good		No Answer	
	80	82	80	82	80	82	80	82	80	82
Knows You and Your Business:										
Desired Characteristic	67%	68%	21%	22%	3%	3%	1%	2%	8%	6%
Bank Performance	46	46	28	29	12	13	5	5	9	7
Provides Helpful Business Suggestions:										
Desired Characteristic	24	21	32	33	20	24	11	13	12	9
Bank Performance	20	18	25	27	27	28	15	17	13	14
Offers the "Cheapest Money":										
Desired Characteristic	17	50	28	30	9	8	4	3	12	9
Bank Performance	26	22	33	34	15	21	11	12	14	12
One Person Handles Credit Needs:										
Desired Characteristic	40	40	35	37	11	11	4	4	11	8
Bank Performance	44	44	30	32	8	8	6	5	12	10
Convenient Location:										
Desired Characteristic	39	30	37	39	11	20	3	6	10	7
Bank Performance	52	55	28	27	6	7	3	2	11	9
Easy Access to Loan Officer:										
Desired Characteristic	na	42	na	41	na	6	na	3	na	8
Bank Performance	na	50	na	32	na	5	na	4	na	10
Reliable Source of Credit:										
Desired Characteristic	54	55	30	31	3	4	2	2	11	8
Bank Performance	46	48	29	28	8	9	5	5	12	10
Knows Your Industry:										
Desired Characteristic	29	27	32	32	19	23	7	9	13	10
Bank Performance	24	21	27	29	22	24	13	15	15	12
Ideas to Improve Bank Service:										
Desired Characteristic	19	17	33	34	23	26	11	12	14	11
Bank Performance	14	15	21	23	27	26	22	24	15	13
Knows Your Financial Needs:										
Desired Characteristic	34	na	38	na	10	na	5	na	13	na
Bank Performance	26	na	31	na	18	na	11	na	14	na
Wide Range of Banking Services:										
Desired Characteristic	34	32	38	42	12	15	4	3	12	8
Bank Performance	42	47	33	32	8	8	5	3	12	10

na = not asked.

Source: "Credit, Banks, and Small Business" (April 1980, 1982). National Federation of Independent Business.

Table 3
Major Bank Performance by Community Size

Characteristics	Percent Reporting							
	Rural ¹		Small City ²		City ³		Metropolitan ⁴	
	80	82	80	82	80	82	80	82
Knows You and Your Business:								
Good	51	51	49	45	38*	37*	41*	44
Good + Above Average	77	79	76	74	70*	69*	73	74
Provides Helpful Business Suggestions:								
Good	23	20	21	17	16	15	17	17
Good + Above Average	48	45	45	45	38*	42	46	45
Offers the "Cheapest Money":								
Good	29	23	27	22	22	21	23	19
Good + Above Average	60	54	62	57	57	58	62	56
One Person Handles Credit Needs:								
Good	45	46	44	44	42	42	47	45
Good + Above Average	76	79	76	75	71*	73*	76	77
Convenient Location:								
Good	56	59	51	54	51	54	49	46*
Good + Above Average	81	86	82	84	79	80	79	74
Easy Access to Loan Officer:								
Good	na	52	na	48	na	49	na	52
Good + Above Average	na	83	na	81	na	81	na	85
Reliable Source of Credit:								
Good	51	52	46	47	42*	45*	43	44
Good + Above Average	77	78	77	76	74	74	76	77
Knows Your Industry:								
Good	28	24	23	20	19*	17	17	17
Good + Above Average	55	53	52	48	44*	46*	49	52
Ideas to Improve Bank Service:								
Good	15	16	16	13	10	13	13	15
Good + Above Average	37	37	36	36	32	40	35	38
Knows Your Financial Needs:								
Good	29	na	26	na	21	na	25	na
Good + Above Average	61	na	58	na	52*	na	57	na
Offers Wide Range of Banking Services:								
Good	42	50	45	46	43	46	42	46
Good + Above Average	74	79	78	83	78	79*	79	77
Number of Cases	1070	971	809	695	495	463	198	180

¹Up to 15,000 population

²15,000 to 100,000 population

³100,000 to 1,000,000 population

⁴over 1,000,000 population

*Significantly different from the "rural" percentage at the 5 percent level.

na = not asked.

Source: "Credit, Banks, and Small Business" (April 1980, 1982). National Federation of Independent Business.

Table 4

Major Bank Performance by Branching Laws

Characteristic	Percent Reporting					
	Unit ¹		Limited ¹		Statewide	
	80	82	80	82	80	82
Knows You and Your Business:						
Good	50%	49%	47%	47%	42%*	42%*
Good + Above Average	80	77	74	74	70*	73
Provides Helpful Business Suggestions:						
Good	24	19	20	18	17	16
Good + Above Average	49	47	45	43	40*	43
Offers the "Cheapest Money":						
Good	28	25	25	23	24	18
Good + Above Average	64	61	61	56	54*	52*
One Person Handles Credit Needs:						
Good	48	50	43	42	41*	42*
Good + Above Average	72	80	73	76	68	73*
Convenient Location:						
Good	53	54	54	57	51	54
Good + Above Average	81	83	81	84	78	81
Easy Access to Loan Officer:						
Good	na	52	na	49	na	49
Good + Above Average	na	85	na	81	na	79*
Reliable Source of Credit:						
Good	50	53	47	49	42*	44*
Good + Above Average	80	81	76	76	71*	72*
Knows Your Industry:						
Good	26	24	24	20	21	19
Good + Above Average	57	53	51	49	47*	48
Ideas to Improve Bank Service:						
Good	16	15	13	16	13	13
Good + Above Average	40	39	35	36	32*	37
Knows Your Financial Needs:						
Good	29	na	26	na	23	na
Good + Above Average	66	na	56	na	51*	na
Offers Wide Range of Banking Services:						
Good	43	49	44	47	41	46
Good + Above Average	78	80	75	79	74	79
Number of Cases	710	640	951	843	908	858

¹Includes both limited and statewide holding companies.

*Significantly different from the "unit" banking percentage at the 5 percent level.

na = not asked.

Source: "Credit, Banks, and Small Business" (April 1980, 1982). National Federation of Independent Business.

Table 5

Actual/Desired Performance Differences: All Respondents

<u>Characteristic</u>	<u>Percent Reporting</u>			
	<u>Good-Very Important</u>		<u>(Good + Above Average)- (Important + Very Important)</u>	
	<u>80</u>	<u>82</u>	<u>80</u>	<u>82</u>
Knows You and Your Business	-21%*	-22%*	-14%*	-15%*
Provides Helpful Business Suggestions	-4	-3	-11*	-9*
Offers the "Cheapest Money"	-21*	-18*	-16*	-24*
One Person Handles Credit Needs	4*	4*	-1	-1
Convenient Location	13*	25*	4*	13*
Easy Access to Loan Officer	na	8*	na	-1
Reliable Source of Credit	-8*	-7*	-9*	-10*
Knows Your Industry	-5*	-6*	-10*	-9*
Ideas to Improve Bank Service	-5*	-2	-17*	-13*
Knows Your Financial Needs	-8*	na	-15*	na
Wide Range of Banking Services	8*	15*	0	0

*Significantly different from zero at the 5 percent level.

Source: "Credit, Banks, and Small Business" (April 1980, 1982). National Federation of Independent Business.

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