Journal of Rural Social Sciences

Volume 31
Issue 1 *Volume 31, Issue 1 (2016)*

Article 4

4-30-2016

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F. Carson Mencken
Baylor University, Carson_Mencken@baylor.edu

Charles M. Tolbert
Baylor University

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Recommended Citation

Mencken, F., and Charles Tolbert. 2016. "Restructuring of the Financial Industry and Implications for Sources of Start-up Capital for New Businesses in Nonmetropolitan Counties." *Journal of Rural Social Sciences*, 31(1): Article 4. Available At: https://egrove.olemiss.edu/jrss/vol31/iss1/4

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Journal of Rural Social Sciences, 31(1), 2016, pp. 71–82.
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RESTRUCTURING OF THE FINANCIAL INDUSTRY AND IMPLICATIONS FOR SOURCES OF START-UP CAPITAL FOR NEW BUSINESSES IN NONMETROPOLITAN COUNTIES*

F. CARSON MENCKEN
BAYLOR UNIVERSITY

and

CHARLES M. TOLBERT
BAYLOR UNIVERSITY

Historically, in small towns throughout rural America local banks had formed symbiotic relationships with local businesses. The flow of capital was lubricated by the personal relationships and trust that developed between local banks and business owners. However, over the past 20 years changes in interstate banking laws have led to a flurry of mergers and acquisitions resulting in a national consolidation of bank firms.[1] This consolidation was followed by a proliferation of establishments at the local level, many of which were former independent and regional banks that serviced local businesses (Boot 2011; Devaney and Weber 1995; Berger and Udell 1995; Berger and Black 2007). Issues affecting the sources of financing are of interest to rural sociologists (Green 1984; 1986). At the core of research on civic community and socioeconomic well-being in rural communities is a strong, independent middle class consisting of local leaders, entrepreneurs, and local small business owners (Tolbert, Lyson, and Irwin 1998; Blanchard, Tolbert and Mencken 2012; Tolbert et al. 2002). Entrepreneurs need start-up capital to launch a new business. Likewise, current local business owners need access to capital to keep their businesses functioning, and to expand their operations (Davis, Haltiwanger, and Jarmin 2008; Black and Strahan 2002).

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*Please direct correspondence to Carson Mencken at Carson_Mencken@Baylor.Edu. A previous version of this paper was presented at the annual meeting of the Southern Sociological Society, New Orleans, LA March 2015. Any opinions and conclusions expressed herein are those of the author(s) and do not necessarily represent the views of the U.S. Census Bureau. All results have been reviewed to ensure that no confidential information is disclosed.

[1]The changes in the banking laws were not the only cause of firm consolidation, but they were necessary in order for interstate mergers to play out (Berger and Black 2011).

In this research note we provide descriptive analyses of sources of financing for new business start-ups in nonmetropolitan counties using data from the 2007 Survey of Business Owners and Self-Employed Persons (SBO). We present data on the sources of start-up capital for new business in nonmetropolitan counties and propose that there is a distinct decline in the use of bank loans over the decades. We also document a potential increase in use of riskier alternative sources, including credit cards over the past 30 years. Our analysis is unique in that we use confidential tabulations of the 2007 SBO at the Census Research Data Center to compare nonmetropolitan businesses with metropolitan businesses and publically available national trends.[2]

At issue are the implications of changes in banking laws, such as the 1994 Riegle-Neal Interstate Banking Act, beyond merger and acquisitions, and improvements in communications technology (Whaling 1996; Cetorelli and Strahan 2006), that have led to firm-level consolidation in traditional financial services industry over the last 30 years. While many believe that this has increased access to customers and capital for some, there are potentially significant implications for businesses started by local entrepreneurs (De Young, Glennon, and Nigro 2008; Kilkenny 2002; Shaffer and Collender 2008).

BACKGROUND

The banking industry has been one of the most regulated industries in the United States. Before 1994, local banks were protected against interstate and intrastate competition, as state legislatures decided which banks could establish branches and subsidiaries within the state. At the federal level, the banking industry was governed by two important pieces of legislation: the McFadden Act of 1927 and the 1956 Bank Holding Company Act. These laws put severe restrictions on interstate banking, and the 1956 Bank Holding Company Act required that all bank holding companies (BHCs) fall under the supervision of the Board of Governors of the Federal Reserve System (Omarova and Tahyar 2011).[3] The 1956 legislation was intended to limit the spatial expansion of large banking groups and their

[2]The 2007 Survey of Business Owners and Self-Employed Public Use Microdata Sample file is downloaded at http://www.census.gov/econ/sbo/pums.html. Due to confidentiality, these data are not disaggregated by any level of geography below the state level.

[3]The Bank Holding Company Act allowed for some flexibility in interstate banking through BHCs, each state had, and significantly enforced, their own regulations which set very strict rules on out-of-state acquisitions. Only a handful of multi-state bank holding companies were in existence in the early 1980s.

monopolization of local credit markets. However, many BHCs managed to circumvent the interstate restrictions. In 1993, 42 states still prohibited interstate banking, but there was considerable interstate banking activity, just done extremely inefficiently (Nippani and Green 2002; Zou, Miller and Malamud 2011).

The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act sought to remove the inefficiencies and ease the interstate banking restrictions. The impact was argued to be beneficial for banks, businesses, and consumers. Interstate branch banking would allow bank holding companies to minimize their geographical risk during spatially concentrated market downturns.[4] Critics of the legislation, namely small, local community banks, feared an oligopoly in the national banking market (DeYoung et al. 2008). Moreover, local community leaders were concerned that local deposits would be transferred out of the communities. Proponents pointed to industry safeguards, such as antitrust laws, state and federal regulator oversight of all mergers, and most important, the Community Reinvestment Act that directs banks to make funds available to the entire community they serve (Johnson and Sarkar 1996; Friedman and Squires 2005).

Restructuring of the banking industry has led to the simultaneous consolidation of banking at the firm level and expansion of financial services at the establishment level (Nicolo et al. 2003; Collender and Shafer 2003; Collender and Frizell 2002; Berger and Black 2007). Between 1984 and 2011, the number of FDIC reported bank firms declined from 14,496 to 6,291, while the number of banking establishments increased from 42,717 to 83,209. There are fewer multisite bank firms, but significantly more branches/establishments, of large banks dispersed throughout the United States. According to the Economic Census, in 2002 the top four commercial banks owned 12.6% of all banking establishments, and by 2007, the top four expanded their ownership to 31.8% of banking establishment. In 2014, over half of all branch establishments in the United States were owned by a bank or bank holding company in another state. The consolidation is also reflected in the deposits controlled by the largest national banks. For example, in Texas the top three banks

[4]In the 1980s banks in Texas suffered during the severe downturn in the oil industry because most of their investments and deposits were directly linked to the industry. A multi-state bank would have investments and deposits spread across many geographies to guard against regional economic crises.

in 1994 controlled 30.4% of total state deposits. In 2014, the top three banks held 47.8% of total state deposits.[5]

The restructuring trend has been particularly troubling for nonmetropolitan America. In 1976 nearly 80% of banking establishments in rural counties were locally owned, compared with only 20% today (see Tolbert et al. 2014). This is an issue for small businesses because the symbiotic relationships between local banks and local small businesses have relied upon relational (soft data) lending practices (Boot 2011; Devaney and Weber 1995; Berger and Udell 1995; Berger and Black 2007). Relational lending is based on long standing relationships between lenders and the small business, and more important, between particular loan officers and business owners. Often, the loan officer draws upon her/his extensive personal and professional community network ties to gather additional information about the business from customers, suppliers. Previous research shows that relational lending is linked to lower interest rates, reduced collateral requirements, and increased credit availability for small businesses (see for reviews Berger and Udell 1995; 2002).

Larger, multi-establishment banks, are not likely to give their local managers much discretion to engage in relational lending. When an outside bank acquires a local bank, the relationship networks are removed, as parent company personnel assume management positions. The commercial loan decisions are based on asset/portfolio/hard data policies and procedures made in, and disseminated from, corporate headquarters (see Brickley, Linck, and Smith 2003; DeYoung et al. 2008; Berger et al. 2005; Brevoot and Hannan 2004). Asset-based lending to small firms is quite expensive for the lender and the borrower, as it requires an intense amount of monitoring by the lender and substantial liquid assets for the borrower. Large, multi-establishment banks give small business loans as conventional loans, Small Business Association (SBA) backed loans, revolving credit lines, and higher interest rate small business credit cards. However, each of these requires a strong hard data portfolio, and SBA backed loans have significant restrictions on how the money is spent.[6]

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[5]In 1994 the top three Texas banks were Nationsbank of Texas, NA; Texas Commerce Bank, NA; and Bank One, Texas, NA. In 2014 the top three banks were Bank of America, NA; Wells Fargo, NA/Wells Fargo Southcentral, NA; and JP Morgan Chase, NA (www2.fdic.gov).

[6]SBA and other government backed loans are used in less than 2% of all business start-ups, urban or rural. There were so few cases of these loan types in the 2007 SBO data that we were not permitted to disclose the frequencies.

Is the demise of local banks and relationship lending correlated with changes in bank loan use for business start-ups? Moreover, should it matter where entrepreneurs get access to their capital? The answer to the latter question is a resounding 'yes.' Research on undercapitalized start-ups shows that they are unlikely to be successful (Avery, Bostic, and Samolyk 1998; Bates 2005). Moreover, access to lower interest bank loans is a stable and reliable source of full capitalization (Robb and Fairlie 2007; Fairlie and Robb 2007; Bolton and Rosenthal 2005). The answer to the first question is one we pursue in the analysis below.

DATA AND METHODS

The data used in the analysis is the 2007 Survey of Business Owners and Self-Employed Persons (SBO), U.S. Bureau of the Census. We use both the PUMS version of the 2007 SBO and the confidential data files at the Census Bureau Research Data Center in College Station, TX. The PUMS do not provide geography below the state level. These RDC data allow us to examine sources of start-up capital in metropolitan and nonmetropolitan counties separately. We present the source of financing for the start-up or purchase of the business. We then disaggregate these data by metropolitan-nonmetropolitan status, and by year the business was started/purchased. If changes in the banking industry have led to a consolidation in bank firms, loss of local banking, and less capital available to small businesses (especially relational capital), then we should see changes in the sources of start-up capital by decade in which the business was started/purchased. We begin with a presentation of FDIC commercial loan data since 1995 to document the decline in commercial lending that is vital to rural America.

RESULTS

The data in Figure 1 show the trends in small business and farm loans, as a percentage of all commercial loans, from 1995 to 2013. These FDIC data show a declining trend in these loans.[7] Moreover, this trend line suggests that restructuring in the financial sector may have led to a decline in access to small business loans, and to the type of capital that is most vital to rural communities (Flora and Flora 2015; Tolbert et al. 2014).

In the 2007 SBO, respondents were asked to identify all possible sources of capital for the purchase or start-up of their current business (these data include

[7] These data were not disseminated by the FDIC prior to 1995.

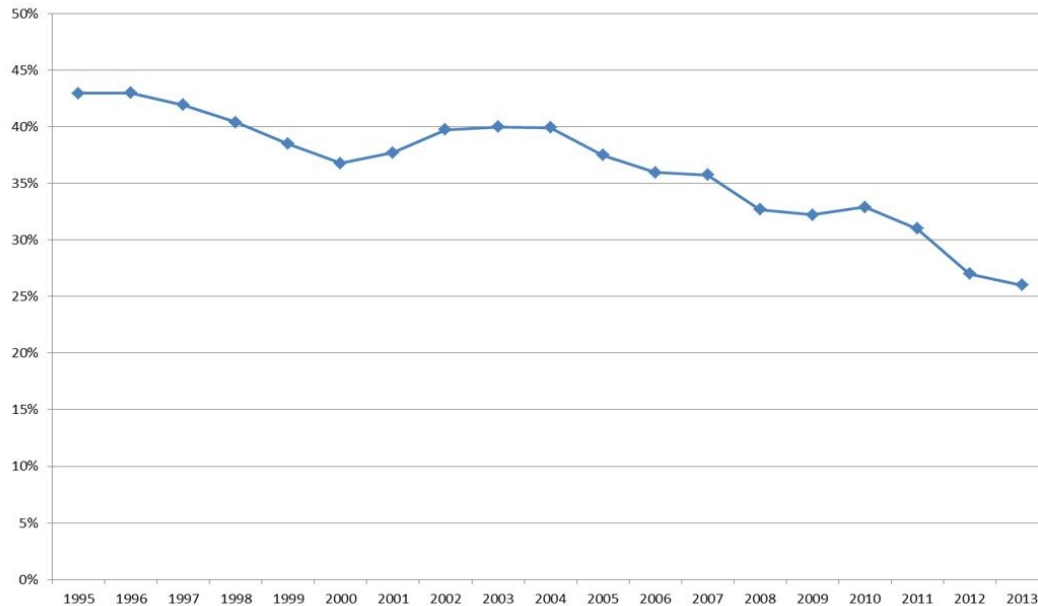

FIGURE 1. SMALL BUSINESS AND FARM LOANS AS A PERCENTAGE OF TOTAL BUSINESS LOANS, U.S. 1995–2013 (Source: FDIC).

franchises, firms, establishments, and sole proprietorships).[8] More than 1.5 million business owners responded in the 2007 SBO. Table 1 presents the information for all sources of start-up capital from the 2007 PUMS file. The modal category of start-up/purchase funds is personal savings (71.78%). However, among other sources, credit cards (11.48%), bank loans (8.62%) and home equity (5.15%) are all categories of note. Respondents are allowed to list multiple sources of funding, and many businesses utilize a combination of these sources. It is also interesting that government loans and government-backed loans make up a very small source of start-up capital. Less than 1% of business owners sampled used either source to start/purchase their current business.

Table 2 shows the trend in source of business capital start-up by the decade the business was started. For those businesses in the 2007 SBO PUMS started before 1980 approximately 13% used a bank loan. For those businesses started since 2000, less than 7% used a bank loan. Moreover, for those businesses that began before 1980, only 4% reported credit cards as a source of capital, compared with 13.9% of businesses started after 1999. The percentage of businesses using home equity loans as start-up capital has doubled over this period.

[8]Franchise owners constitute less than 2% of all businesses in the data set.

TABLE 1. SOURCE OF START-UP CAPITAL CURRENT BUSINESS, ALL COUNTIES (N=1,541,265).

	PERCENTAGE
Personal Savings	71.8
Home Equity	5.2
Credit Cards	11.5
Government Loan	0.5
Government-backed Loan	0.5
Bank Loan	8.6
Loan Family/Friends	2.0
Venture Capitalist	0.2
Grant	0.2
Other	1.7
None Needed	20.4

SOURCE: 2007 SBO PUMS.

TABLE 2. PERCENT OF BUSINESSES BY SOURCE OF START-UP CAPITAL BY DECADE BUSINESS WAS STARTED.

	PRE-1980	1980S	1990S	SINCE 1999
Bank Loan	13.0	11.5	9.7	6.9
Home Equity	2.7	4.0	4.9	6.1
Credit Cards	4.0	7.4	11.8	13.9
Family Loan	2.0	2.2	2.2	2.0
Personal Savings	69.9	74.3	75.4	71.6

Table 3 presents that 2007 SBO confidential tabulation data, disaggregated by the geography of the county in which the business is located. These data show that the trends are very similar for metropolitan and nonmetropolitan businesses over the last 30 years. Bank loans as a source of start-up capital has declined significantly across the decades in both contexts, while credit card use has increased significantly. The use of personal savings to start/purchase a new business is still

TABLE 3. PERCENT OF METROPOLITAN AND NONMETROPOLITAN BUSINESSES BY SOURCE OF START-UP CAPITAL BY DECADE BUSINESS WAS STARTED.

NONMETROPOLITAN BUSINESSES				
	PRE-1980	1980S	1990S	SINCE 1999
Bank Loan	21	20	18	12
Home Equity	3	4	5	6
Credit Cards	4	6	11	14
Family Loan	3	2	2	2
Personal Savings	59	62	64	61
METROPOLITAN BUSINESSES				
	PRE-1980	1980S	1990S	SINCE 1999
Bank Loan	12	11	9	6
Home Equity	3	4	5	6
Credit Cards	4	8	12	14
Family Loan	2	2	2	2
Personal Savings	64	68	68	65

Source: 2007 SBO Confidential Tabulations.

an important component of the equation, and the rate of personal savings use has remained steady across time and space.

The main difference between metropolitan and nonmetropolitan businesses is the use of bank loans. Businesses in nonmetropolitan settings use bank loans as start-up capital at nearly twice the rate as metropolitan businesses. This is intriguing for two reasons. First, bank loans may have been more prevalent in nonmetropolitan communities because of the normative practice of relational lending, and that small communities are better contexts in which relational lending can be possible (Elyasiani and Goldberg 2004; DeYoung et al. 2008). The anonymity of large urban settings hinders the development of the types of relationships that can make relational lending a greater challenge. Second, these data suggest that bank loans have historically been a more important source of start-up capital for nonmetropolitan businesses, perhaps because businesses in these

communities have less access to other sources of capital that are more common in metropolitan settings (wealth, inheritance, etc. see Fairlie and Robb 2007).

CONCLUSION

In the wake of the Great Recession the banking industry continues to restructure and reassess how to provide lending services moving forward. What we are concerned about is the trending decline in the use of bank loans for new ventures since the passage of the Riegle-Neal Banking Act. The loss of relational lending, which sustained lending between local banks and local small business start-ups, has the potential to significantly limit future start-ups in rural America. The inability of entrepreneurs to fully capitalize their new ventures could reduce the importance of the small business sector and the independent middle class, which is vital to forming and sustaining civil society in rural America (Flora and Flora 2015; Lyson and Tolbert 2004).

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