

Bank Size, Lending Technologies, and Small Business Finance

Allen Berger and Lamont Black

discussed by

Robert Hauswald
American University

World Bank Conference on Small Business
Finance, Washington, DC May 05, 2008

Objective and Findings

- Analysis of large banks' lending to small business: is there a change of paradigm?
- Large banks have no comparative advantage in “hard” lending technologies, but
 - depends on interpretation of “hard” vs “hardened”
 - soft information important in credit decisions?
- Interpretation of results relies on stylized facts
 - “soft” information can flow outside typical bank relationships: local contacts

The Changing Paradigm

- Petersen and Rajan (2002): NSSBF survey
 - find increase in bank-borrower distance, decreasing loan rates
 - “local-information” hypothesis: the “soft” information crucial in this market is local so that borrower proximity matters
 - Degryse and Ongena (2005): no support in Belgian loan data
- Agarwal and Hauswald (2006, 2007): banks harden soft local information through subjective score revisions
 - personal impressions: interpretation is loan-officer specific
 - lending modes compete within same organization as well as across institutions – two lending channels distinguished by
 - soft private (in-person) vs hard public (online) information

The Evolution of SME Lending

- SBL has become incredibly profitable for large banks
 - technology and organization: proprietary credit scoring combined with decentralized credit decisions and pricing
 - large database to calibrate models to market segments
- Anecdotal evidence: two large institutions ranked among the five top deposit collectors by the FDIC
 - hold 30% to 50% of SB market in states they are active in
 - harden soft information through score revisions
 - offer competing online loans to same market: arm's length

Comments: Approach

- Central thesis: only large banks use hard information
 - why keep SME loan officers in branches and collect soft information that leads to subjective score revisions?
 - why do large banks decentralize (certain) credit decisions?
- At odds with other evidence that SME lending relies on soft local information: hardened intelligence
- Focusing on hard information alone leaves out the most intriguing aspects of the market's evolution, i.e.,
- Alternative interpretation of results: large banks
 - have a comparative advantage in hardening soft information which more than compensates for their
 - disadvantage in its collection but advantage in processing

Comments: Identification Methodology

- The crucial step: identify lending technology by
 - bank/firm size: small banks = soft, large = hard information
 - but: why restrict credit scoring to the smallest firms only?
 - clearly at odds with market conventions: Experian SBI
- Technology classification relies on 1998 survey data
 - enormous methodological progress in credit scoring (data availability): proprietary vs third-party credit score models
 - lending technologies coexist: everything gets scored!
- Probit model: bank size on both sides of the equation
 - identification of lending technology in terms of bank size

Comments: Findings

- If large banks do not have comparative advantage in hard(ened) lending technologies where does it lie?
 - might indicate that together with the paradigm the old rigid lending classification requires updating because
 - lending relies on a continuum of simultaneous approaches
 - SBCS: beware of proprietary methodology and subjective revisions of credit scores – a score is never the final word
 - large firms: credit scoring (“hard”) does not work
- Small banks: typically do not use proprietary scoring models but rely on, e.g., various Experian scores
- Analyze the differential use of lending modes, i.e.,
 - should lending technology not be the dependent variable?

More Suggestions

- Given endogenous identification of technology as a function of bank and firm size look for
 - alternative measures of information production such as
- Local vs nonlocal lending
 - flow of information and ease of gathering it affected by distance which becomes
 - proxy for information quality and type: nonlocal = hard
- Judgement lending is probably more than just a residual lending technique: loan interview, contacts
- Relationship lending vs. repeat business
 - fast learning: continuous monitoring and updating