These studies found that small business borrowers of the chartered banks pay higher interest rates than large borrowers even though the loans appear to be essentially the same in other respects.

There are a number of reasons given for this. In the first place, the fact that small borrowers tend to take out small loans while large customers borrow large amounts significantly alters the per dollar costs of handling a loan. Competition ensures that banks tend to pass on to the consumer whatever advantages there are in administering larger loans. Furthermore, small businesses tend to be higher risk customers than larger firms, particularly if they are new or young firms. Other reasons for the greater risk premium attached to smaller loans are the greater variability in small business profitability and the higher leverage which characterizes such firms. Not all of this risk can be compensated for by, say, higher collateral requirements.

These factors are well known and accepted as reasons for justifying higher loan rates to small firms when compared to larger firms. The issue to be pursued then is whether all of the difference in lending rates can be so justified, or whether large borrowers are being subsidized by small borrowers.

According to the recent Canadian study referred to, about three-quarters of loans to large firms were in the prime to prime plus 1 category, while most loans to small businesses fell in the prime plus 1 to prime plus 2 category. Allowing for differences in risk, location, and variables relating to bank branches, this study concluded that small firms (annual sales less than $500,000) tended to pay between 42 and 64 basis points (i.e. 0.42 per cent and 0.64 per cent) more for loans than large firms. Intermediate-sized firms (annual sales up to $2 million) tended to pay a smaller premium (26 to 46 basis points) for their loans. Differences in risk and business location could explain, at most, 25 per cent of the variation in interest rates by firm size.

To find another explanation for this difference, the authors examined administrative costs of lending. They found that, considering everything to do with administration of loans, the larger the loan size, the greater the ease of handling, whether in monitoring, obtaining information, or dealing with irregularities like overdrafts and delayed interest payments.

Although this particular study is not as quantitative in nature as some other discussions of administrative costs, it does lend support to the general conclusion that the difference in administrative costs can reasonably account for the observed interest rate premiums paid by small borrowers. It provides no evidence to suggest that smaller borrowers subsidize larger ones, and even suggests that small borrowers may not pay the full cost of their loans[19] However if this latter phenomenon does exist, market competition should ensure that it is short lived.

The American studies on small business finance arrive at largely similar conclusions to those found for Canada. On the basis of 1979 data, it is shown that administrative costs vary significantly according to loan size.[20] It costs 2.20 per cent per year to administer a $10,000 loan, 1.35 per cent for a $100,000 loan and 0.96 per cent for a $500,000 loan. For larger loans, these unit costs fall much more slowly. Nevertheless, different administrative costs explain 39 basis points of interest rate difference between $100,000 and $500,000 loans, and 78 basis points of interest rate differential between a $50,000 and $500,000 loan.