RESCINDED

AL 98-9
Subject: Access to Financing for Minority Small Businesses
Date: July 15, 1998

AL 98-9 has been replaced by AL 2003-8

TO: Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel

PURPOSE

This Advisory Letter provides information about issues faced by minority small business owners in seeking access to financing and identifies effective approaches national banks have employed in meeting the financial needs of this growing commercial market segment.

During 1997, the Comptroller met with national bankers, minority small business owners and business development officials in eight cities across the nation to discuss access to credit and financial services for minority-owned small businesses. The OCC conducted the meetings to better understand how bankers can access this growing, profitable market opportunity while also meeting Community Reinvestment Act and Equal Credit Opportunity Act requirements (in particular the provisions permitting creditors to target extensions of credit for "special purpose credit programs" as described in Regulation B). Several recurring themes emerged regarding access barriers, lending programs and marketing strategies in the course of the meetings; the outcomes are presented in this Letter.

BACKGROUND

With a history of successful innovation and job growth, the small business sector represents a significant market opportunity for the banking industry. Although two-thirds employ fewer than five people, small businesses account for more than half the private sector nonfarm workforce. A recent study by the Bank Administration Institute and McKinsey & Company, Inc. found that although small businesses have a variety of financial service needs, only 75 percent use any type of credit product.

Minority-owned businesses represent 12.5 percent of all U.S. firms. With a diverse range of business lines from basic services to technology, these firms are concentrated in the retail and service industries, according to the most recent Characteristics of Business Owners data. The Commerce Department reports that 64 percent of these firms and 52 percent of their gross sales receipts are in the retail and service sectors.

By start-up volume, minority-owned firms are the second fastest growing business segment in the United States, after women-owned businesses. The number of minority businesses increased 60 percent from 1987 to 1992 according to the Department of Commerce and their sales receipts increased 128 percent, growing from $92 to $210 billion. In contrast, aggregate start-ups grew by 26 percent with a 67 percent increase in receipts for the same period.

The Comptroller's meetings provided insight into the barriers business owners feel limit their access to bank relationships and successful programs banks developed to tap the growing minority business market. Comments received at the meetings fell primarily into three categories: Access to Financial Services, Support/Partnership Opportunities, and Equity Investments. The following sections describe the challenges presented by businesses and creative solutions implemented by some national banks to address minority business needs in these three areas.

ACCESS TO FINANCIAL SERVICES

Bank services and locations. As with all businesses, minority entrepreneurs need access to banking services to successfully manage their firms. Minority-owned businesses are heavily concentrated in low-income and inner-city areas and often have a difficult time accessing convenient full-service branches in these geographies. While these businesses may struggle with banking access, they are also poised to take advantage of strategic business opportunities untapped by other competitors.

> Through both brick-and-mortar locations and non-traditional delivery systems, creative bank managers have found effective ways to access opportunities in city cores and enhance bank profitability in low-income and inner city locations. Banks have created profitable alliances by developing account officer relationships with owners and business groups, creating partnerships with community-based business development organizations, and implementing targeted outreach programs.

Barriers to Loan Approvals. Information gaps can present formidable barriers to minority small business owners. They report encountering loan officers who do not clearly explain the information or credit criteria required to approve loan requests or do not thoroughly explain the reasons an application is declined. As a result, many minority small business owners cannot adequately develop businesses plans or loan proposals to obtain financing.

> Bankers can systematically provide information on the benefits and limits of various types of credit and deposit accounts they offer and on the terms and obligations of each. Some lenders provide written materials in the predominant languages of communities they serve.
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> Institutions that provide more complete information on the documentation required to apply for a loan, for instance, and on the credit criteria they use, will likely increase the number of loan applications received from minority small businesses and decrease the time loan officers spend on incomplete applications. In addition, when a loan request is declined, some bankers routinely explain their reasoning and offer suggestions about how to improve the application to qualify for credit in the future.

Banks with lenders of diverse language and ethnic backgrounds can achieve a competitive advantage in understanding the needs of local markets. These banks often staff their small business lending areas with loan officers from diverse backgrounds. As minority communities grow throughout the U.S., institutions employing appropriately skilled individuals that are from the cultural and language backgrounds of those borrowers may enhance their success in the minority small business market. In addition, vesting these individuals with appropriate lending authority can help banks respond to community credit needs and improve efficiency in delivering lending products.

Some well-capitalized national banks use low loan documentation authority for small- and medium-sized business to help expand credit to those businesses, including minority-owned firms. This authority permits many national banks to identify an "exempt portion" of their small- or medium-sized business and farm loan portfolios up to 20 percent of the bank's capital. These loans are evaluated solely on the basis of performance and exempt from examiner classification for inadequate documentation.

Availability of Adequate Financing.   Some minority entrepreneurs find particular challenges in borrowing to deliver on contracts to provide goods and services to government agencies and large corporations. They often find it difficult to obtain financing unless they have an established business credit history. Business owners facing this challenge report they often use personal credit cards or home equity lines to pay for short-term working capital needs. These types of credit can be expensive, tie up the owner's personal assets, and prevent businesses from developing a separate credit history.   Meeting participants noted they often find a lack of availability of even receivables financing.

Minority small business owners also sometimes report the traditional products and services available from banks meet only some of their needs for credit and financial services. For example, retail and service industry businesses frequently need small loans to finance equipment purchase or working capital needs. They find that standard term loans with low advance rates are not sufficiently flexible to meet their needs. They indicate that small lines of credit, crucial to their ability to grow, are difficult to obtain.

Banks typically require both a primary source of repayment (cash flow) and a secondary source (collateral such as real estate, for example). Some minority small businesses have difficulty in demonstrating multiple repayment sources and thus have difficulty obtaining credit.

Some banks have developed receivable financing products particularly helpful in meeting these needs. For newly established businesses, some bankers have relied on a business owner's personal credit history, rather than on the track record of the business, to establish repayment ability. Other institutions have developed innovative loan structures like small business lines of credit accessed by check drafts.

Banks have also sought out minority small businesses to use as the bank's own suppliers and contractors. In addition to developing relationships giving bank managers perspectives on the operational and financial needs of these firms, this approach also provides business opportunities for particular minority firms in the bank's market area.

Government Guarantee Programs. Minority-owned businesses are more likely to utilize government guarantee programs than non-minority firms. The SBA and other government agencies have decided to increase lending to underserved minority groups over the next three years.

The Small Business Administration (SBA) , U.S. Department of Agriculture, and other federal, state and local government agencies offer significant risk transfer and liquidity assistance to bank lenders. These agencies guarantee loans to minority small businesses, make subordinated debt investments, help financial institutions self-insure small business loan portfolios, and offer other programs that facilitate bank lending to small businesses.

Banks have successfully used these programs strategically to mitigate risks in some loans and expand lending to minority small businesses. Guarantees allow a bank to rely on cash flow rather than collateral. Subordinated debt may shore up an otherwise undercapitalized minority small business borrower. In addition, both the guaranteed and non-guaranteed portions of an SBA loan can be sold into the secondary market.

SUPPORT AND PARTNERSHIP OPPORTUNITIES

Technical Assistance. Small business owners reported lack of access to information and business development assistance as a major hindrance to obtaining credit. For example, accountants willing to provide services on a small scale are particularly difficult to find, resulting in non-standard financial statements which undermine a banker's confidence in business records.

The SBA has made commitments to various organizations to work together in providing financial and technical assistance for African Americans and Hispanics. The effort is meant to encourage bankers to use guaranteed loans as a way of extending credit which would not meet the banks traditional lending criteria.

Many organizations, such as chambers of commerce, educational institutions, and others, offer small business development programs. For example, many banks work in partnership with SBA-sponsored Small Business Development Centers. These partnerships provide loan packaging and management assistance to businesses that banks cannot provide themselves. Many offer instruction in starting and operating a small business and have developed innovative techniques such as mentoring programs and discounted professional services to deliver ongoing management assistance to businesses.

Banks not only refer prospective small business borrowers to these organizations but also support them with donations of time and expertise. Partnerships with these sources of assistance often result in businesses returning to the bank prepared to borrow, reducing screening and marketing costs for the lender.

EQUITY INVESTMENTS

Capital investment is also a key determinant of the viability and growth of small businesses. Meeting participants noted that bank-permissible equity participation in small businesses through a variety of conduits often hastens the success of small businesses.

Banks can participate in equity and subordinated debt investments in minority businesses via a variety of investment vehicles, including Small Business Investment Companies and multi-bank and wholly-owned subsidiary community development corporations. Investments in these partnerships allow participants to pool risks and reach segments of the small business market they otherwise might not serve. Banks also can make qualified investments in minority owned financial institutions that specialize in minority business lending.

Venture capital partnerships have been developed with a special focus on minority and women-owned firms. Typically targeting small to medium sized businesses, these partnerships provide growth and acquisition equity capital for companies with well positioned products or services, competitive advantages, and significant opportunities for rapid growth. Individual investments by banks vary, and investments are often made for three to six year time periods with liquidity achieved by an initial public offering, sale, merger, or recapitalization.

CONCLUSION

The information in this Advisory Letter is based on the experiences of minority small business owners, lenders, and development specialists who participated in discussions with bankers and with Office of the Comptroller of the Currency. In addition, the agency consulted with experts in minority-owned small business lending. It also suggests strategies for banks to consider in developing safe and effective products and practices to serve the financing needs of the growing minority small business market sector.

A distinctive characteristic of effective commercial lenders is a positive, creative approach to minority small business needs. These lenders view each loan request as an opportunity and search for ways to serve minority small businesses in a safe and sound manner that simultaneously meets the needs of the business owner and the bank.

For additional information, please contact your Examiner-In-Charge or Assistant Deputy Comptroller.

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