

Moving to Economic Development: A New Goal for SBA Loan Programs

SBA 7(a) Lending Patterns In San Antonio Before And After LowDoc



Woodstock Institute

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by
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Table of Contents

	Page
Introduction	1
Applying Principles of Sound Economic Development to the SBA	2
The Evidence on SBA Lending and Underserved Markets	3
Progress in One Area: Serving Smaller Borrowers	4
SBA 7(a) Lending to Minority-Owned Businesses in San Antonio	6
SBA 7(a) Lending to Minority-Owned Firms After the Introduction of LowDoc	9
SBA 7(a) Lending to Minority and Modest-Income Neighborhoods in San Antonio Prior to the LowDoc Program	11
Impact of the LowDoc Program on 7(a) Lending to Modest-Income and Minority Neighborhoods	14
Moving the SBA Towards Sound Economic Development Practice	17
Policy Recommendations	18

Executive Summary

In the current era of federal spending reductions, policy makers are disproportionately cutting programs intended to serve lower-income families and children, including those that support urban job and economic development. Given such an environment, there is a greater need than ever to ensure that remaining business and economic development programs are directed to serve communities in true need of economic development. Most importantly, the federal government should take steps to avoid subsidizing patterns of investment that work to the detriment of lower-income residents of metropolitan areas.

With a portfolio of approximately \$25 billion, the U.S. Small Business Administration is the largest single financial backer of small businesses in the nation. Since its beginning in 1953, the agency has provided financial assistance totaling more than \$167 billion to more than 1.2 million businesses. The agency's primary small business financing initiative, the SBA 7(a) guaranty loan program, is the most commonly used government-enhanced small business loan product in the U.S. with more than 630,000 loans totaling more than \$70 billion over the program's life. In fiscal year 1994, the SBA guaranteed more than 36,000 loans for a total of more than \$8.1 billion.

Recently, the SBA has come under substantial scrutiny by Congress. Much of this scrutiny has concerned the levels of subsidy required to run the agency's various programs, the performance of its 8(a) minority contractor program, and the possibility of rising loss rates among its loan programs, including some of its newer programs aimed at smaller borrowers. While these concerns may be valid, the more fundamental issue appears to have been taken off the table -- the rationale for government involvement in supporting financing or other activities of individual small businesses.

Applying Principles of Sound Economic Development to the SBA

In all likelihood, the SBA will continue to play an important role in providing credit enhancements for individual small businesses across the country. The agency should remain the single largest provider of such enhancements. Given this continued role, it is important to recognize that the only defensible rationale for federal government involvement in the financing of individual small businesses is an economic development rationale. If policies and programs support the creation and or retention of jobs and economic activity in places and among communities in real need of economic development, then they can be justified.

In recent years, however, some have questioned the degree to which to the SBA serves those segments of the market which have been most neglected by private financial institutions: minority-owned businesses and firms in low- and moderate-income communities. The available evidence shows that minority-owned firms, particularly African American-owned firms, have more difficulty obtaining bank loans than nonminority-owned firms, even after controlling for the education and age of the owner as well as other business characteristics. Moreover, establishments located in minority neighborhoods have more difficulty obtaining credit than those located in nonminority neighborhoods. As a federal agency, the SBA should avoid subsidizing, and work to counter, these lending patterns.

SBA loans, of whatever form, involve the use of government subsidy to benefit private businesses. The public purpose of such subsidy should be clear. Merely subsidizing small businesses, without regard to public purpose is not good policy. For example, if a firm obtains an SBA guaranty that allows it to produce its product at a lower price, the firm's principal competitor may be hurt. Jobs created at the first company may be largely shifted from the competitor firm. If the firm receiving the subsidy is located in a relatively affluent area and the competitor is located in a high unemployment area, the guaranty may have enabled jobs to be shifted from a job-poor area to a job-rich one, an inefficient, inequitable, and probably unintended outcome. From a federal policy perspective, more is required to justify business subsidies than merely pointing to activity at specific firms that would not have occurred otherwise. It is important to look at the results of policies and programs and at which communities are served by these results.

One goal of sound federal or state economic development policy should be the promotion of *efficient* metropolitan economies. Economic development programs, including the SBA 7(a) guaranty, do this if they, in general, further at least one of two outcomes:

- 1) They result in improved business development and employment opportunities for those who are arbitrarily denied access to economic opportunity, including minorities who may face barriers to financing or business relationships. The existence of bias in private markets is inefficient and counterproductive to the welfare of the entire region.
- 2) They result in increased economic activity in locations where there is a greater need for such activity and where other policies have discouraged investment. This means encouraging the development of jobs, stores and service providers in areas that have borne the brunt of suburban sprawl and disinvestment, such as minority and modest-income neighborhoods. Creating jobs in places and for communities that need them, for example, actually fosters a more efficient regional economy.

A second and often compatible goal that sound economic development aims toward is social *equity*. Equitable development promotes a wider distribution of jobs, goods, or services, among families and households, and not simply an overall increase in activity. And many argue that good public policy should prioritize equity above efficiency.

SBA programs can and must be evaluated on the degree to which they foster efficient and equitable economic development, i.e., the economic development of communities that have relatively greater needs for economic activity, including modest-income metropolitan neighborhoods and minority-owned businesses. Programs that primarily foster the expansion of nonminority-owned businesses into distant, more affluent suburban areas, where jobs, goods and services are already in abundant supply, work against efficient and equitable metropolitan economies.

Recent cost-cutting proposals and actions by the SBA and Congress must also be examined within this framework. Increasing up-front fees and decreasing the portion of loans guaranteed may be appropriate policy, but such changes should be evaluated, in large part, on the degree to which they support financing of minority-owned businesses and businesses in modest-income areas, and not simply on their impact on overall lending. Overall, the agency must concern itself less with the minutiae of subsidy rates that have negligible effects on the U.S. budget and instead focus on redirecting its programs to appropriate economic development targets.

SBA 7(a) Lending and the LowDoc Program

Over the last 22 months, the SBA has introduced an important new program, the low-documentation or LowDoc program, as a way of increasing the number of loans it guarantees for under \$100,000. Because many minority-owned businesses are very small and need small loans, the program was also touted by former SBA Administrator, Erskine Bowles, as a tool for serving underserved markets, particularly minority-owned firms. The LowDoc program has been widely used and has substantially increased 7(a) lending volumes, so any examination of SBA lending patterns in recent years needs to consider the effect of this program.

Judged solely on the number of 7(a) guaranties for smaller loans being made and delinquency and losses thus far, the LowDoc program appears to be a success. In fiscal year 1994, the number of SBA 7(a) loans increased nationally by 36 percent over 1993, with LowDoc loans accounting for more than 16 percent of the loans, even though the program was not introduced in most areas until late in the year. The average size of 7(a) loans dropped from more than \$245,000 in the first six months of fiscal 1994 to less than \$164,000 in the second six months, after LowDoc had been widely introduced. In the first six months of fiscal 1995, more than 55 percent of 7(a) loans were LowDoc loans, and so were for amounts under \$100,000.

While the LowDoc program appears to be meeting the agency's goal of increasing the number of loans to smaller borrowers, the question remains as to whether the 7(a) program is serving minority-owned businesses adequately, and whether businesses located in low- and moderate-income metropolitan neighborhoods are being well served.

Findings from San Antonio

The LowDoc program was piloted in the SBA's San Antonio, Texas district. In order to determine the impact of the program on financing of businesses in urban markets, SBA data was obtained for 7(a) lending, including LowDoc loans, for the San Antonio area from one year prior to the program's introduction in November, 1993, through one year after its introduction.

Data from San Antonio show that, prior to the LowDoc program, minority-owned businesses obtained a larger share of 7(a) loans than their corresponding share of very small firms in the area, based on the U.S. Census 1987 Survey of Minority Owned Business Enterprises. While minority-owned businesses constitute 26 percent of the firms in the San Antonio area, minority firms received 32 percent of 7(a) loans. But the introduction of the LowDoc program actually decreased the percentage of loans going to minority-owned firms from 32 percent to 29 percent. While minority-owned firms saw the number of loans increase by 75 percent, nonminority-owned firms saw the number of loans increase by 106 percent. When measured by dollars of lending, minority firms saw 7(a) loans increase by only 8 percent, while lending to nonminority firms increased by 31 percent.

The distribution of SBA lending in San Antonio is skewed away from lower-income and minority neighborhoods. This bias was significant prior to LowDoc and was aggravated after the program's introduction. In the year before LowDoc, nonmanufacturing firms in lower-income zip code areas received 39 percent of the 7(a) loans and 43 percent of loan dollars, despite these zip codes having 55 percent of the nonmanufacturing establishments and 54 percent of the sales and receipts, per the 1987

U.S. Economic Census. In the year after LowDoc, the pattern worsened, with firms in lower-income zip codes obtaining only 34 percent of loans and 33 percent of loan dollars. In the year after the introduction of LowDoc, SBA 7(a) lending to all firms, including manufacturers, increased in lower-income zip codes by only 38 loans, or 44 percent, while increasing by 131 loans, or 110 percent, in upper income zip codes. More than 75 percent of the increase in loans accrued to upper-income areas.

In comparing the changes in 7(a) loans in minority versus nonminority zip codes, the bulk of the increase in 7(a) lending occurred in nonminority zip codes (those with less than 25 percent minority populations). Lending increased by only 34 loans, or 52 percent, in minority areas and by 145 loans, or 110 percent, in nonminority areas. This means that approximately 80 percent of the increase in loans went to nonminority areas.

Overall, the evidence from San Antonio is convincing. The LowDoc program has actually resulted in larger benefits for nonminority-owned businesses and businesses in more affluent, nonminority neighborhoods than for minority-owned businesses and firms in modest-income and minority neighborhoods.

Moving the SBA Towards Sound Economic Development Practice

Despite the rhetoric often surrounding the future of the SBA, the agency's activities, like those of any government agency, must ultimately be evaluated based on how they affect communities and individuals and not on how they affect private businesses. Merely increasing the number of loans the agency guarantees to small businesses is not a sufficient measure of success. In fact, if a program subsidizes the inefficient migration of economic activity out of central cities, or out of minority communities, the program is inconsistent with the principles of efficient and equitable economic development stated above.

While evidence from San Antonio suggests that the SBA had to some degree countered private-sector bias in the case of lending to minorities prior to the LowDoc program, data from the year following the program's introduction suggest that the agency may be losing its commitment to minority business development. In terms of geographic patterns, the San Antonio data suggest that the agency has underserved modest-income and minority neighborhoods, even after accounting for the distribution of small firms, and that the problem worsened after the implementation of the LowDoc program.

Some have suggested that a focus on lending to underserved areas will dramatically increase the losses incurred by the SBA. Because they have historically been subject to private sector disinvestment supported by public policy, some lower-income communities may be more subject to changing economic conditions than more affluent markets. This is, in fact, reason to target economic development resources to these areas, where public policy can affect private lending and investment decisions and help combat historical patterns of disinvestment. This is not to suggest that double-digit loan loss rates are appropriate for the SBA program; there are many examples of successful small business financing programs that target underserved markets without suffering from large loan losses. SBA data show that, thus far, the more than 18,000 LowDoc loans made from December, 1993, through February, 1995, performed substantially better than non-LowDoc 7(a) loans made during the same period. LowDoc loans past due, delinquent, or in liquidation amounted to only 0.4

percent of approved loans, while for other 7(a) loans the figure was 1 percent. The SBA, however, should expect higher losses than nonguaranteed bank portfolios; otherwise the subsidy is only being used to increase the values of bank portfolios. The agency and policy makers must recognize that addressing historically disinvested and underserved markets will carry some costs.

Policy Recommendations

While the introduction of the LowDoc program has been duly praised as an innovation in the delivery of the SBA 7(a) guaranty, the program needs more fundamental attention if it is to achieve the goals of sound economic development policy. The following SBA policy recommendations are made with the intention of strengthening the foundations and increasing the overall public benefits of the 7(a) program, as well as improving access to credit for firms that face the greatest barriers to financing:

- 1) Policy-makers and the SBA should acknowledge the agency's role as an economic development agency and recognize the importance of small business finance to urban economic development. The agency cannot justify government subsidy or sponsorship based solely on guaranteeing more loans without regard for the development consequences of the actual lending patterns it supports. While the agency's 504 program includes some significant targeting to higher unemployment counties, the 7(a) program which is much more widely used, is essentially nontargeted geographically, and is only modestly targeted to minority-owned firms. Moreover, counties are much too large to permit effective economic development targeting.
- 2) The LowDoc program should be continued and supported by the SBA, with modifications suggested here. The program offers a significant improvement to the guaranty process, especially for smaller loans. It has increased the number of banks and other lenders active in the 7(a) program, which is good for business needing the guaranty.
- 3) The 7(a) program, and especially LowDoc, must be affirmatively marketed to minority-owned firms and to firms in modest-income metropolitan neighborhoods. Given the evidence that minority-owned businesses are poorly served by conventional financial institutions, it is not sufficient to rely upon banks to market the program. Efforts such as the prequalification programs, where businesses are prequalified by the SBA prior to approaching banks, should be expanded and should focus on both minority-owned businesses and businesses in modest-income areas. Community development corporations with business development experience should be supported to provide prequalification services.
- 4) SBA district offices should establish targets for lending to minority-owned businesses and businesses in modest-income metropolitan zip codes. These targets should at least correspond to the portion of businesses that are minority-owned and located in modest-income zip codes in each metropolitan area. This policy roughly follows the approach currently used by government sponsored enterprises in the housing secondary finance markets.
- 5) The SBA should conduct annual or biennial reviews of all banks participating in its programs. Banks that make substantially smaller portions of their loans to minority-owned firms and to firms in modest-income zip codes when compared to most other similarly situated banks should be given warnings and then, if no improvement occurs, restricted from using the program.

- 6) Incentives should also be used to encourage lending to areas in need of economic development. First, the awarding of preferred or certified lender status should depend fundamentally on the degree to which lenders serve modest-income areas and minority-owned firms. Second, lenders who sell loans on the secondary market and who perform better than the overall market in serving modest-income areas and minority-businesses might be allowed to retain a higher share of premiums made from loan sales than lenders who do not. (Currently, lenders must return one-half of any premium in excess of 10 percent to the agency.) Finally, the SBA might lower transaction fees on loans made to firms in targeted markets, especially for smaller loans where transaction costs can pose added barriers to banks' serving these markets. Any proposed increases in fees for smaller loans might be fully or partly rolled back for targeted markets.
- 7) An absolute prohibition should be imposed on the guaranteeing of loans to nonminority-owned firms relocating from modest-income neighborhoods to upper-income suburban areas.
- 8) SBA programs, including the 7(a) guaranty, should be made available to community development financial institutions. These nonbank lenders have proven that they have the ability to target financing to areas most in need of economic development while maintaining sound lending practices. CDFIs can be strong partners with the SBA in delivering many of its programs. Several CDFIs already deliver SBA 504 loans, and some even have the ability to make 7(a) guaranties. The 7(a) program can be an important tool for CDFIs in building scale and impact.
- 9) The SBA should conduct research to determine the employment impacts of the 7(a) programs. In particular, the agency should identify the location and types of borrowers that hire residents of modest-income communities and then target such firms.

The above recommendations all concern SBA policy and practice. One additional recommendation concerns the implementation of the Community Reinvestment Act, (CRA) by federal banking regulators, but has direct relevance here. No CRA credit should be given to banks based solely on the number of SBA loans made. Only SBA loans to minority-owned firms and to firms in modest-income areas should be counted. Because firms tend to have an impact on areas larger than census tracts, zip codes are likely to be a more appropriate geographic unit for this evaluation process.

Overall the SBA 7(a) guaranty has proven to be an important, and generally effective, tool for small business development throughout the country. But the support of specific small businesses without a concern for who benefits from resulting development is not an appropriate role for the federal government. Only when SBA efforts are targeted towards underserved markets and communities does the program become a justifiable economic development tool. With some significant policy redirection, the 7(a) guaranty can be such a program.

Introduction

With a portfolio of approximately \$25 billion, the U.S. Small Business Administration is the largest single financial backer of small businesses in the nation. Since its beginning in 1953, the agency has provided financial assistance totaling more than \$167 billion to more than 1.2 million businesses. The agency's primary small business financing initiative, the SBA 7(a) guaranty loan program, is the most commonly used government-enhanced small business loan product in the U.S. with more than 630,000 loans totaling more than \$70 billion over the program's life. In fiscal year 1994, the SBA guaranteed more than 36,000 loans for a total of more than \$8.1 billion.¹

Recently, the SBA has come under substantial scrutiny by Congress. Much of this scrutiny has concerned the levels of subsidy required to run the agency's various programs, the performance of its 8(a) minority contractor program, and the possibility of rising loss rates among the agency's loan programs, including some of its newer programs aimed at smaller borrowers. While these concerns may be valid, the more fundamental issue appears to have been taken off the table -- the rationale for government involvement in supporting financing or other activities of individual small businesses. Some have pushed for the SBA to occupy itself primarily in general advocacy on behalf of the entire small business community. But the rationale for such a role is weak. Even if some set of universal small business interests can be identified, the justification for federal involvement in small business advocacy is unclear. Small businesses already have ample access to numerous political action groups, including the politically powerful National Federation of Independent Business.

It now appears that the SBA will continue to play an important role in providing credit enhancements for individual small businesses across the country. The agency will most likely remain the single largest provider of such enhancements. Given this continued role, it is important to recognize that the only defensible justification for federal government involvement in the financing of individual small businesses is an economic development rationale. If policies and programs support the creation and or retention of economic activity and jobs in places and among communities where such activity is lacking, then they can be justified.

In recent years, however, some have questioned the degree to which to the SBA serves those segments of the market which have been most neglected by private financial institutions: minority-owned businesses and firms in low- and moderate-income communities. The available evidence shows that minority-owned firms, particularly African American-owned firms, have more difficulty obtaining bank loans than nonminority-owned firms, even after controlling for the education and age of the owner, as well as other business characteristics. Using data from the U.S. Census Bureau's Characteristics of Business Ownership database, Timothy Bates finds that small, young, African American-owned firms are able to leverage only approximately \$.89 of debt for every dollar of equity, while small, young, white-owned firms are able to obtain \$1.79 of debt per dollar of equity, even after controlling for age and management experience. In addition to the decreased

¹ The SBA guaranty loan program provides 75-90 percent guaranties of loans to small U.S. businesses for a wide variety of purposes, including financing real estate, equipment, and working capital. Eligible financing sources include banks, savings and loans, and finance companies. Currently, the SBA will guarantee up to \$500,000 in financing, down from an earlier ceiling of \$750,000. Data on aggregate lending totals comes from *Community Dividend*, Federal Reserve Bank of Minneapolis, Fourth Quarter, 1994.

access of African American-owned businesses, Bates finds that establishments located in minority neighborhoods have more difficulty obtaining credit than those located in nonminority neighborhoods.²

Applying Principles of Sound Economic Development to the SBA

SBA loans, of whatever form, involve the use of government subsidy of some kind to benefit private businesses. The public purpose of such subsidy should be clear. Merely subsidizing small businesses, without regard to public purpose is not good public policy. Even when SBA efforts create economic activity where it would not have occurred otherwise, it may also result in eliminating economic activity in different areas of the national economy.

For example, if a firm obtains an SBA guaranty that allows it to produce its product at a lower price, the firm's principal competitor may be hurt. Jobs created at the first company may be largely shifted from the competitor firm. If the business receiving the subsidy is located in a relatively affluent area and the competitor is located in a high unemployment area, the guaranty may have enabled jobs to be shifted from a job-poor area to a job-rich one, an inefficient, inequitable, and probably unintended outcome.

Similarly, if barriers to financing are greater for minority entrepreneurs than for nonminority-owned businesses, as the evidence suggests, it makes little sense to aggravate this inefficient and unfair bias by merely letting the private market determine where the subsidy should go. This will, in effect, aggravate the bias problem, and the inefficiencies.

From a federal policy perspective, more is required to justify business subsidies than merely pointing to activity at specific firms that would not have occurred otherwise. It is important to look at the results of policies and programs and at which communities are served by these results.

One goal of sound economic development policy should be the promotion of *efficient* metropolitan economies. Federal economic development programs, including the SBA 7(a) guaranty, are efficient at the metropolitan level if they, in general, further at least one of two outcomes:

- 1) They result in improved business development and employment opportunities for those who are arbitrarily denied access to economic opportunity, including minorities who may face barriers to financing or business relationships. The existence of bias in private markets is inefficient and counterproductive to the welfare of the entire region.
- 2) They result in increased economic activity in locations where there is a greater need for such activity and where other policies have discouraged investment. This means encouraging the development of jobs, stores and service providers in areas that have borne the brunt of suburban sprawl and disinvestment, such as minority and modest-income metropolitan neighborhoods. Creating jobs in places and for communities that need them, for example, actually fosters a more efficient regional economy.

² Timothy Bates, *Banking on Black Business*, Joint Center for Political and Economic Studies, Washington, DC, 1993.

A second and often compatible goal that sound economic development aims toward is social *equity*. Julia Parzen and Michael Kieschnick point out that equitable economic development involves an increase in economic activity that results in a *wider distribution* of jobs, goods, or services among families and households, and not simply an overall increase in activity.³ And many argue that good public policy should prioritize equity above efficiency.

SBA programs must be evaluated based on the degree to which they foster efficient and equitable economic development, i.e., the economic development of communities and geographic areas that have relatively greater needs for economic activity, including modest-income neighborhoods and minority-owned businesses. Programs that primarily foster the inefficient expansion or relocation of nonminority-owned businesses into distant, more affluent suburban or exurban areas, where jobs, goods and services are already in abundant supply, may actually be counterproductive in serving efficient and equitable metropolitan economies. They certainly do not meet Parzen and Kieschnick's definition of economic development, but they also fail to meet the simple efficiency goal outlined above.

Recent cost-cutting proposals and actions by the SBA and Congress must also be examined in this framework. Increasing up-front fees, lowering maximum loan amounts, and decreasing the portion of loans guaranteed may be appropriate policy changes. But these policies should be evaluated, in large part, on the degree to which they support or hinder financing of minority-owned businesses and businesses in modest-income areas, and not simply on their impact on overall lending. Additional policy changes may also be in order to make the program address the needs of underserved markets. Overall the agency must concern itself less with the minutiae of subsidy rates that have negligible fiscal effects on the U.S. budget and instead focus more on redirecting its programs to the communities that should be the beneficiaries of federal involvement in this arena.

The Evidence on SBA Lending and Underserved Markets

In January, 1994, the California Reinvestment Committee, (CRC) a statewide advocacy group, issued a report finding that the SBA had done little lending to minority-owned businesses, amounting to less than 10 percent of all loans. CRC also found that the agency tended to make relatively large loans, with less than 15 percent of loans being for less than \$50,000 and more than 30 percent being for amounts over \$250,000.⁴

Soon after the CRC study was issued, the SBA acknowledged that it was doing a poor job of serving the credit needs of minority- and women-owned businesses. Under former Administrator Erskine Bowles, the agency had asked each of its district directors across the country to sign an agreement committing their districts to more lending to minorities and women. While agency staff may argue that they can not affect the flow of loans to minorities because they merely approve

³ Julia Ann Parzen and Michael Hall Kieschnick, *Credit Where Its Due: Development Banking for Communities*, Temple University Press, 1992.

⁴ See Alan Fisher, Chan U. Lee, and Patrick Zak, *No Credit for Those Who Need It: Uncle Sam Ignores Small and Minority Business*, California Reinvestment Committee, San Francisco, January, 1994.

guaranties brought to them by banks, it appears that some districts do a better job at serving minority-owned firms than others.

In addition to considering how well SBA served minority-owned businesses, the CRC study also showed that lower-income California counties received only about 39 percent of SBA loans despite having 42 percent of the state's businesses. So regardless of business ownership, firms located in job- and business-hungry areas were less likely to benefit from SBA products.

Progress in One Area: Serving Smaller Borrowers

Those involved in economic development financing and commercial lending in urban areas generally agree that smaller businesses seeking smaller loans, particularly in amounts under \$100,000, are less well served by conventional credit markets than relatively larger businesses seeking larger loans. These larger firms -- although still small relative to middle-market or corporate borrowers -- often have more collateral to offer, tend to be older and more established, and typically have clear and well documented financial statements. Many very small firms (e.g., those with sales under \$2 or 3 million) looking for small loans have less collateral to offer, are often younger, and may have less well documented financial statements. As a result, when banks apply the same lending approach to these smaller customers that they apply to their larger customers, they may find serving these borrowers less profitable and undesirable. Perhaps just as importantly, the net revenue derived from a smaller loan will be substantially less than that derived from larger loans, so the incentive to make small loans, especially loans that require some creativity or special structuring, can be minimal. In general, it may be difficult to get banks that are used to serving relatively large firms to begin serving smaller ones.

One way to encourage banks to serve smaller businesses needing smaller loans is to reduce the perceived risk banks face when attempting to lend to these firms. This perceived risk consists of two types of risk. The first is the real risk derived from the repayment, collateral and interest rate risks to which smaller, younger firms may sometimes be more susceptible. The second type of perceived risk is the greater uncertainty a bank may face in its dealing with less rigorously formulated financial statements or some other feature (e.g., line of business) of the business that distinguishes it from most of a bank's existing small business customers. While the bank's uncertainty may not be related to the actual risks faced by a business, it poses a real risk to a bank's own performance if not addressed.

A loan guaranty, such as the 7(a), is one tool that can be used to mitigate both categories of risk. With access to a substantial guaranty, a bank can assume greater repayment risk, such as often encountered with a newer firm, or can take on greater collateral risk, as may often be the case with small service or retail businesses. At the same time, it may be unreasonable to expect a very small company to incur the costs of fully audited financial statements, but tax returns or compiled statements alone may be insufficient to provide a bank with sufficient comfort on the performance of the company. Thus a bank may be more willing to work with companies even in the face of significant uncertainty, if it has access to a loan guaranty.

At the same time, the SBA 7(a) has been historically criticized for being overly bureaucratic, requiring excessive paperwork and being unfriendly to small businesses and banks. In effect, the

program has been accused of adding to the transaction cost of making small business loans, thereby making it even harder to serve many small businesses seeking small loan amounts.

One key structural problem with the SBA program that the agency has attempted to address in recent years has been its poor attention to smaller loans, especially those under \$50,000, where many argue guaranties are more often needed to make loans bankable. Perhaps the single largest initiative of the agency since late 1993 has been the low-documentation or LowDoc program, initiated by former Administrator Bowles. While the program ostensibly involved reducing the number of forms required for 7(a) loans of less than \$100,000, it was also accompanied by the political will of agency leadership to do more small loans.

Judged solely on the number of 7(a) guaranties for smaller loans being made, the LowDoc program appears to have been successful. In fiscal year 1994, the number of SBA 7(a) loans increased nationally by 36 percent over 1993, with LowDoc loans accounting for more than 16 percent of the loans, even though the program was not introduced in most areas until late in the year.⁵ Average 7(a) loan size dropped from more than \$245,000 in the first six months of fiscal 1994 to less than \$164,000 in the second six months, after LowDoc had been widely introduced. In the first six months of fiscal 1995, more than 55 percent of 7(a) loans were LowDoc loans, and so were for amounts under \$100,000.⁶ Average loan size is expected to decline further due to the agency dropping its maximum 7(a) guaranty size from \$750,000 to \$500,000.

While the LowDoc program appears to be meeting the agency's goal of increasing the number of loans to smaller borrowers, the question remains as to whether the 7(a) program is serving minority-owned businesses adequately, and whether businesses located in low- and moderate-income neighborhoods are being well served. Former Administrator Bowles had been quoted as characterizing the LowDoc program as a tool to address such needs.⁷ Before looking at recent data on 7(a) trends, there is some cause for concern here however.

Because the 7(a) program is one in which banks rather than businesses apply directly to the SBA for the guaranties, the program may, without targeting its marketing or policies, tend to follow or even compound the inequities in the conventional small business lending markets. The available evidence clearly shows that minority-owned firms, particularly African American-owned firms, have more difficulty obtaining credit than nonminority-owned firms, even after controlling for the education and age of the owner, as well as other business characteristics. Moreover, establishments located in minority neighborhoods have more difficulty obtaining credit than those located in nonminority neighborhoods.⁸

Lowering the costs and improving access to SBA products is likely to result in more loans for both nonminority and minority-owned firms, and for firms in all neighborhoods. Yet, making more loans does not necessarily result in improved economic development practice. Data from San

⁵ *Community Dividend*, Federal Reserve Bank of Minneapolis, Fourth Quarter, 1994.

⁶ "SBA LowDoc Program Riding High," *American Banker*, April 25, 1995, p.6.

⁷ "SBA Vows More Lending for Minorities and Women," *Wall Street Journal*, July, 11, 1994.

⁸ See Timothy Bates, *Banking on Black Business*, Joint Center for Political and Economic Studies, Washington, DC. 1993.

Antonio, the pilot city for the program, show that the LowDoc program has actually resulted in substantially larger benefits for nonminority-owned businesses and businesses in more affluent, nonminority neighborhoods than for minority-owned businesses and firms in modest-income and minority neighborhoods.

SBA 7(a) Lending to Minority-Owned Businesses in San Antonio

In order to examine whether the SBA is serving minority-owned businesses relatively well, and whether the LowDoc program is improving service to these markets, SBA 7(a) loan origination data for the San Antonio metropolitan statistical area (Bexar County) were examined. The San Antonio district of the SBA, which contains an area extending far beyond Bexar County, was the first district to introduce the LowDoc program, as a pilot beginning in late 1993.

It should first be noted that the minority business development environment in San Antonio is not representative of most other U.S. metropolitan areas. In fact, data from of the U.S. Census Bureau show that the San Antonio area's minority business ownership rate of 26 percent far exceeds the national rate of 9 percent as well as the rate of most urban counties.⁹ It should also be noted that Mexican-Americans make up the predominant minority business group in San Antonio. While access to credit may be a problem for this segment of the business community, the available evidence speaks more strongly to the credit access problems of African American-owned businesses. Thus, evidence from San Antonio may understate any problems of minority access and may overstate progress in this arena.¹⁰ Notwithstanding the distinct nature of the minority business development market in San Antonio, SBA loans to minority-owned firms can be compared to the number and sales of minority-owned businesses in the area to evaluate the agency's performance in serving these markets.

In order to examine SBA 7(a) lending to minority-owned businesses in an urban context, and particularly the effect of the LowDoc program, data from the SBA were obtained for 7(a) loans during a two year period, beginning one year before the introduction of the LowDoc program in November, 1993, and running until one year later. Only data on guaranties approved, not applications, were obtained.

To gauge the level of lending to minority versus nonminority firms, loan data was compared to counts of minority- and nonminority-owned businesses in the San Antonio area from the Census Bureau's 1987 Survey of Minority Business Enterprises (SMOBE), which includes data on both minority-owned and nonminority-owned businesses.¹¹ The 1987 SMOBE shows that 26 percent of very small firms with employees in San Antonio were minority-owned, with the vast majority of

⁹ Based on the U.S. Census Bureau's 1987 Survey of Minority Owned Business Enterprises.

¹⁰ The Woodstock Institute is in the process of conducting additional analysis of the SBA 7(a) program for another metropolitan area, in which African Americans constitute a large segment of the minority business population.

¹¹ The universe for the Survey of Minority Owned Business Enterprises includes all firms that filed Internal Revenue Service Schedule C (Sole Proprietorship/Self Employed); Form 1065 (Partnership); or Form 1120 S (subchapter S Corporation). Regular corporations are not included. Therefore, this survey covers generally very small firms (most with sales under \$1 million). Small businesses incorporated as regular corporations are also eligible for SBA programs.

these being Latino-owned. Table 1 indicates the rate of SBA 7(a) lending per SMOBE business in the year prior to the introduction of the LowDoc program.

Table 1 and Figures 1 and 2 indicate that, while minority-owned businesses accounted for approximately 25 percent of SMOBE businesses with employees in the San Antonio area, minority-owned small businesses obtained 32 percent of all SBA 7(a) loans prior to the introduction of the LowDoc program.¹² When comparing dollars loaned compared to total business receipts, minority firms did even better. While minority-owned firms only accounted for nine percent of receipts of SMOBE businesses with employees, minority-owned businesses obtained 35.6 percent of all SBA 7(a) loan dollars.

Table 1
SBA 7(a) Loan Distribution vs. Business Distribution
for Minority vs. Nonminority Firms in San Antonio Area
Year Before LowDoc

	<u>White-Owned Businesses</u>	<u>Minority-Owned Businesses</u>
Number of SBA 7(a) Loans	138	65
Percent of Loans	68.0%	32.0%
SMOBE Survey		
Number of Businesses w/Employees	12,192	4,139
Percent of Businesses	74.4%	25.6%
SBA 7(a) Loan Dollars		
Percent of Loan Dollars	64.5%	35.5%
SMOBE Sales/Receipts		
Percent of Receipts	91.4%	8.6%

¹² It should be noted that the San Antonio area is rich in Mexican-American-owned businesses, offering the SBA fertile ground for minority lending. The Census Bureau's 1987 Survey of Minority Business Enterprises shows that minority business ownership rates vary significantly across urban counties. Typical medium-sized and larger urban counties (those large central cities) have minority business ownership rates below 15 percent, when looking at small firms with employees. Examples include Wayne County, Michigan (Detroit) at 11.1 percent; San Diego County at 11.3 percent; Cook County, Illinois (Chicago) at 11.2 percent. Dade County, Florida (Miami) is an example of another county with a minority business ownership rate (31.7 percent) similar to that of San Antonio.

Figure 1
All SBA 7(a) Loans in San Antonio
Number of Loans

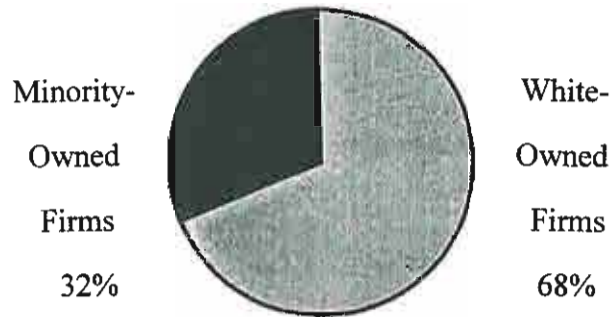
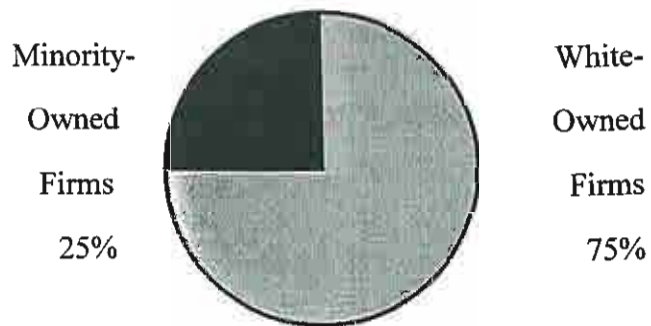


Figure 2
Small Firms (SMOBE)
in San Antonio Area



SBA 7(a) Lending to Minority-Owned Firms After the Introduction of LowDoc

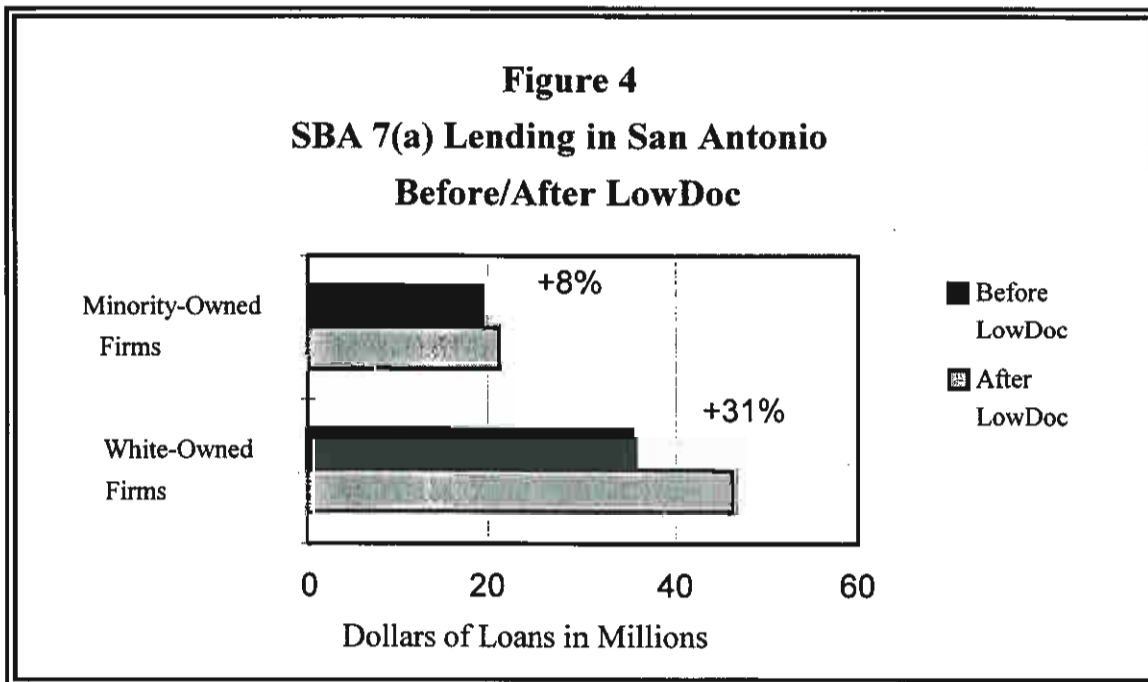
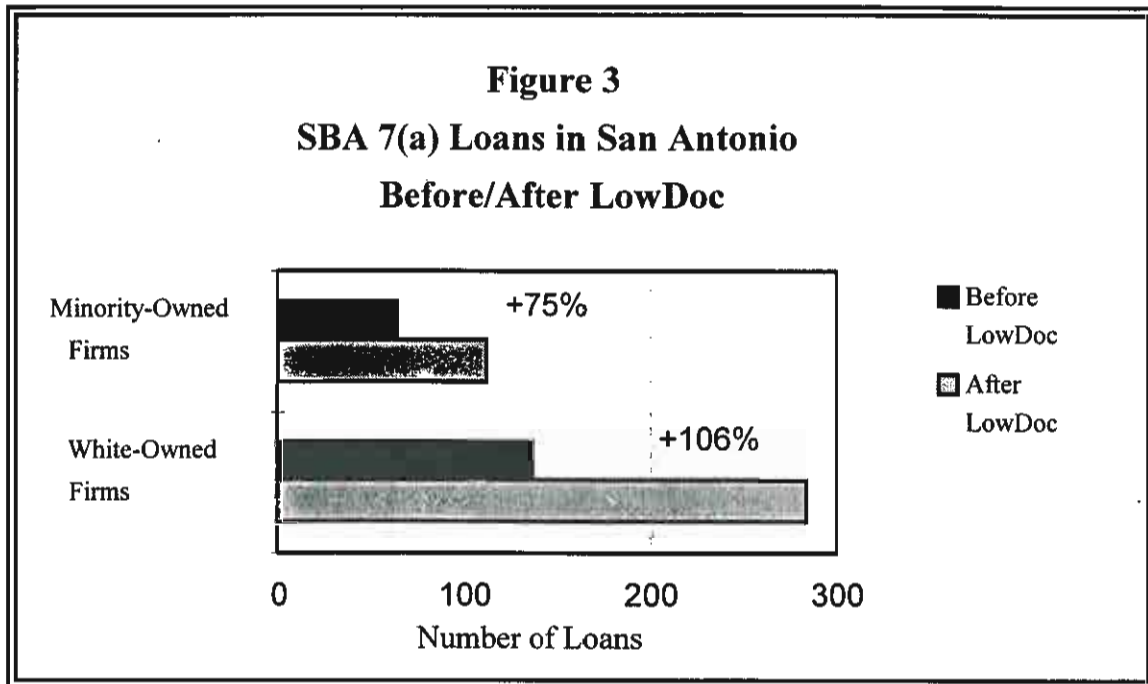
Despite the fact that San Antonio may not be representative of many larger U.S. cities with respect to the climate for minority business development, we can still look at whether the LowDoc program is effective, by itself, in improving access to credit for minority-owned firms. This requires examining 7(a) lending rates for the year following the introduction of the program compared to lending patterns before LowDoc began. Table 2 shows the extent to which minority-owned businesses received SBA loans in the 12 months following LowDoc's introduction.

As was the case before the program was introduced, minority-owned businesses obtained a larger share of SBA loans after LowDoc began than their representation in the local economy would suggest. But, rather than gaining in their access to SBA loans, minority-owned firms obtained smaller shares of SBA loans and total dollars than in the year preceding the program. While minority firms obtained 32 percent of all 7(a) loans before LowDoc, they obtained only 29 percent after the program's introduction. Figures 3 and 4 illustrate the relatively faster growth in 7(a) lending to nonminority-owned firms when compared with minority-owned firms both by number and dollar amount of loans.

While minority access to SBA 7(a) loans appears to have been strong in San Antonio prior to the LowDoc program, the portion of loans and dollars to minority-owned firms declined after the introduction of the program. There may be real virtue in LowDoc, especially in reaching down to smaller borrowers for whom the traditional 7(a) product was often too expensive, but it appears that the LowDoc program has not been targeted particularly effectively to minority-owned businesses, despite the stated intentions of former Administrator Bowles.

Table 2
SBA 7(a) Loan Distribution vs. Business Distribution
to Minority vs. Nonminority Firms in San Antonio Area
Year After LowDoc

	White-Owned <u>Businesses</u>	Minority-Owned <u>Businesses</u>
Number of SBA 7(a) Loans	284	114
Percent of Loans	71.4%	28.6%
SMOBE Survey		
Number of Businesses w/Employees	12,192	4,139
Percent of Businesses	74.7%	25.6%
SBA 7(a) Loan Dollars		
Percent of Loans	\$46.3 MM 68.8%	\$21 MM 31.2%
SMOBE Sales/Receipts		
Percent of Receipts	\$6.06 B 91.4%	\$566 MM 8.6%



SBA 7(a) Lending to Minority and Modest-Income Neighborhoods in San Antonio Prior to the LowDoc Program

In order to examine geographic patterns of SBA lending before and after the LowDoc program, loans and lending dollars to nonmanufacturing businesses were compared to the number and sales volume of retail and service establishments for zip codes in the San Antonio area (Bexar County).¹³ Comparing loan flows across zip codes requires accounting for potential loan demand, including both number and economic activity (e.g., sales) of firms.¹⁴

To account for the possibility that businesses located in middle- and upper-income, nonminority zip codes might tend to be larger and have a greater capacity for debt, it is useful to examine another set of ratios. Examining the share of metropolitan retail and service receipts compared to the dollar amount of loans is a reasonable check for this concern.

In the case of nonmanufacturing businesses, minority zip codes received somewhat fewer SBA loans than would be suggested by their corresponding shares of these sorts of establishments. Table 3 and Figures 5 and 6 show that while minority neighborhoods contain 39 percent of the nonmanufacturing businesses in the areas and 39 percent of the related sales and receipts, they received only 32 percent of the 7(a) loans and only 36 percent of the loan dollars.

Table 4 and Figures 7 and 8 show that the problem is even worse when comparing zip codes by income. While zip codes with median incomes below the county-wide median account for 55 percent of retail and service establishments and 54 percent of retail and service receipts, they received only 39 percent of SBA loans to nonmanufacturing businesses and 43 percent of loan dollars.

¹³ Between the 1987 Zip Code Economic Census and the 1990 Census of Population (STF3B), 89 zip codes were identified in the San Antonio metropolitan statistical area. Of these, five were nonresidential. All analyses were performed on the remaining 84 zip codes. Manufacturing businesses and loans were excluded from the geographical analysis, because no information on sales of manufacturers was available by zip code, and because manufacturers are much more hard-asset based and less comparable to service and retail firms in credit capacity. Loans to nonmanufacturers accounted for 78.3 percent of loans and 81.6 percent of loan dollars in the year before the LowDoc introduction, and accounted for 98.5 percent of loans and 98.9 percent of loan dollars in the year following introduction. Firm counts are actually establishment counts; it is unlikely that relative firm densities would vary much from relative establishment densities.

¹⁴ It should first be noted that, at the zip code level at least, the San Antonio study area is less racially and ethnically segregated than many other U.S. metropolitan areas, especially many of those in the Midwest and Northeast. Of the 84 San Antonio area zip codes studied, only three had a minority population of more than 50 percent in 1990, with 28 zip codes being between 25 and 50 percent minority. In terms of income, the area appears to be more segregated. Six zip codes had 1990 incomes below 50 percent of the county median of approximately \$27,000 and 14 had incomes below 80 percent of median. Another 17 had incomes between 80 and 100 percent of area median.

Table 3
SBA 7(a) Loan Distribution vs. Business Distribution
in Minority vs. Nonminority Zip Codes
for Nonmanufacturing Businesses in San Antonio Area
Year Before LowDoc

	0-25 Percent Minority <u>Zip Codes</u>	25+ Percent Minority <u>Zip Codes</u>
Number of SBA 7(a) Loans	106	50
Percent of Loans	68.0%	32.0%
Zip Code Economic Census Number of Retail/Service Establishments	9,806	6,120
Percent of Establishments	61.6%	39.4%
SBA 7(a) Loan Dollars	\$28.3 MM	\$15.6 MM
Percent of Loan Dollars	64.4%	35.6%
Zip Code Economic Census Retail/Service Receipts	\$6.7 B	\$4.2 B
Percent of Receipts	61.1%	38.9%

Figure 5
SBA 7(a) Loans to Non Manufacturing
Firms in San Antonio Before Low Doc

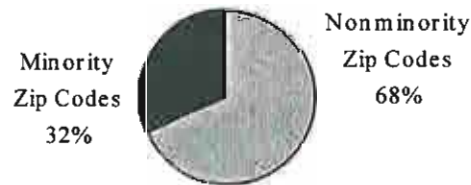


Figure 6
Nonmanufacturing Establishments in
San Antonio, 1987



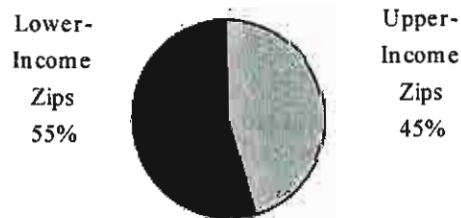
Table 4
SBA 7(a) Loan Distribution vs. Business Distribution
in Modest-Income vs. Middle/Upper-Income Zip Codes
for Nonmanufacturing Businesses in San Antonio Area
Year Before LowDoc

	<u>Zip Codes</u> Above Area <u>Median Income</u>	<u>Zip Codes</u> Below Area <u>Median Income</u>
Number of SBA 7(a) Loans	96	60
Percent of Loans	61.5%	38.5%
Zip Code Economic Census		
Number of Retail/Service Establishments	7,196	8,730
Percent of Establishments	45.2%	54.8%
SBA 7(a) Loan Dollars		
Percent of Loan Dollars	\$25.2 MM 57.4%	\$18.7 MM 42.6%
Zip Code Economic Census		
Retail/Service Receipts	\$5.04 B	\$5.84 B
Percent of Establishments	46.3%	53.7%

Figure 7
SBA 7(a) Loans to Nonmanufacturing
Firms in San Antonio Before Low Doc



Figure 8
Nonmanufacturing Establishments in
San Antonio, 1987



Impact of the LowDoc Program on 7(a) Lending to Modest-Income and Minority Neighborhoods

Unfortunately, the advent of the LowDoc program appears to have exacerbated the SBA's tendency to underserve minority and modest-income neighborhoods in San Antonio. When comparing neighborhoods across either income or race, lower-income and minority zip codes were even less well served by SBA loans after the LowDoc program than before it was started. Table 5 gives the number and dollar amount of 7(a) loans made to nonmanufacturing establishments in minority vs. nonminority neighborhoods after LowDoc was introduced. An even greater percentage of loans (73 percent of loans, 74 percent of dollars) went to nonminority neighborhoods after the program was introduced than before it began.

Similarly, Table 6 shows that the situation also deteriorated when comparing loans made to businesses in lower versus upper income areas. Even though lower-income zip codes accounted for almost 55 percent of retail and service establishments, these areas received only 34 percent of 7(a) loans after LowDoc was introduced.

If we compare the changes in 7(a) loans to all firms, including manufacturers, in minority versus nonminority zip codes, we see that the bulk of the increase in 7(a) lending occurred in nonminority zip codes. Lending increased by only 34 loans, or 52 percent, in minority areas and by 145, or 110 percent, in nonminority areas. This means that approximately 80 percent of the increase in loans went to nonminority areas. Figure 9 illustrates these trends.

These trends are similar when zip codes are grouped by income level instead of race. Figure 10 shows that 7(a) lending increased in lower-income zip codes by only 38 loans, or 44 percent, while increasing by 131 loans, or 110 percent, in upper income zip codes. Again, more than 75 percent of the increase in loans accrued to upper-income areas.

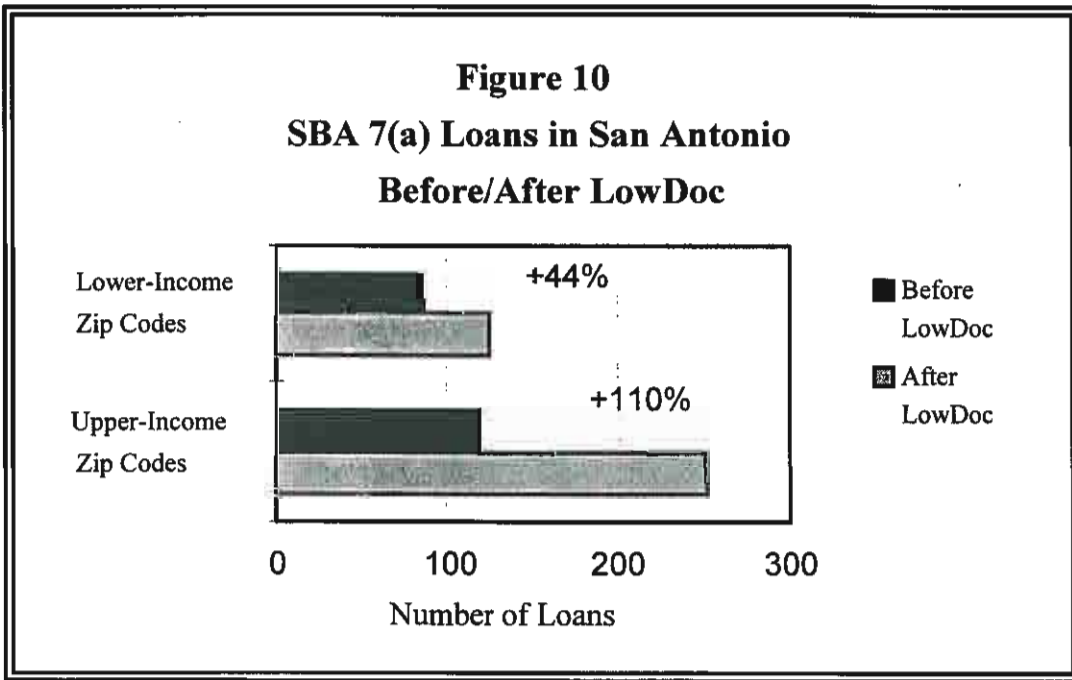
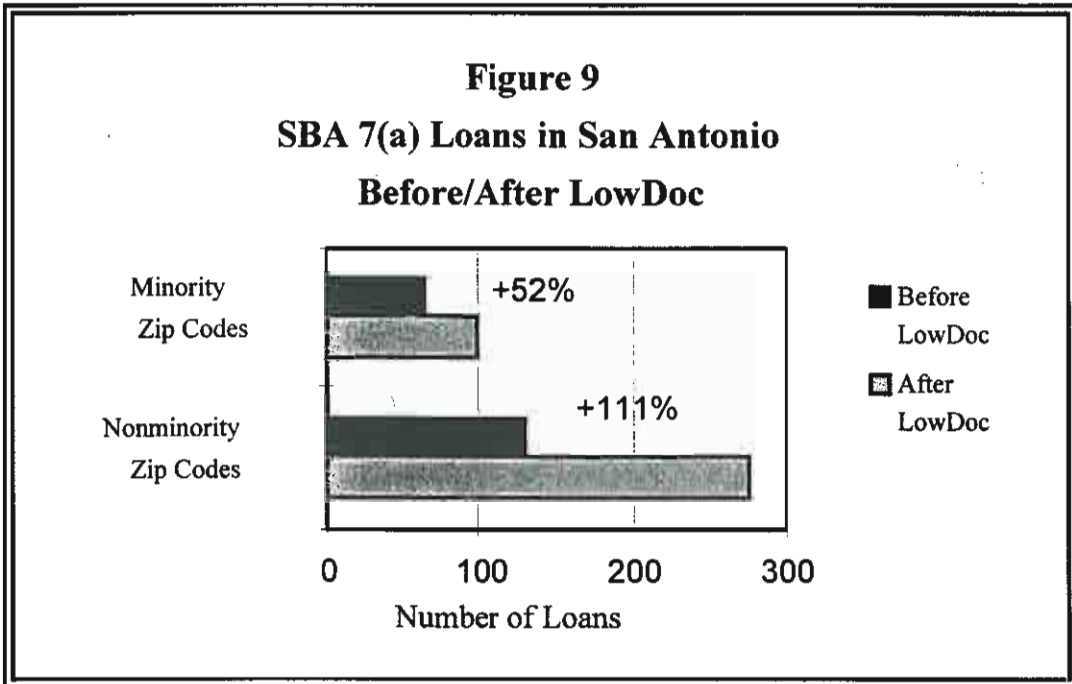
Increasing the number of loans the agency guarantees may be desirable, but the 7(a) program must ultimately be evaluated on its impact on economic development patterns. If the program disproportionately benefits nonminority-owned firms in upper income areas, then it may actually be an impediment to sound urban economic development practice.

Table 5
SBA 7(a) Loan Distribution vs. Business Distribution in
Minority vs. Nonminority Zip Codes for Nonmanufacturing Businesses in San Antonio
Year After LowDoc

	<u>0-25% Minority</u> <u>Zip Codes</u>	<u>25+% Minority</u> <u>Zip Codes</u>
Number of SBA 7(a) Loans	271	99
Percent of Loans	73.2%	26.8%
Zip Code Economic Census		
Number of Retail/Service Establishments	9,806	6,120
Percent of Establishments	61.6%	39.4%
SBA 7(a) Loan Dollars		
Percent of Loan Dollars	\$45.4 MM	\$15.9 MM
Zip Code Economic Census		
Retail/Service Receipts	\$6.7 B	\$4.2 B
Percent of Receipts	61.1%	38.9%

Table 6
SBA 7(a) Loan Distribution vs. Business Distribution in Modest-Income vs.
Middle/Upper-Income Zip Codes for Nonmanufacturing Businesses in San Antonio
Year After LowDoc

	<u>Zip Codes</u> <u>Above Area</u> <u>Median Income</u>	<u>Zip Codes</u> <u>Below Area</u> <u>Median Income</u>
Number of SBA 7(a) Loans	246	124
Percent of Loans	66.5%	33.5%
Zip Code Economic Census		
Number of Retail/Service Establishments	7,196	8,730
Percent of Establishments	45.2%	54.8%
SBA 7(a) Loan Dollars		
Percent of Loan Dollars	\$40.9 MM	\$20.4 MM
1987 Zip Code Economic Census		
Retail/Service Receipts	\$5.04 B	\$5.84 B
Percent of Establishments	46.3%	53.7%



Moving the SBA Towards Sound Economic Development Practice

Despite the rhetoric often surrounding the future of the SBA, the agency's activities, like those of any government agency, must ultimately be evaluated based on how they affect communities and individuals, not merely on how they affect private businesses. Merely increasing the number of loans it guarantees to small businesses is not a sufficient measure of success. In fact, if a program subsidizes the inefficient migration of economic activity out of central cities, or out of minority communities, the program is counterproductive. There already exist a large number of overt and subtle policies that encourage the movement of economic activity out of central cities; federal small business development programs should not further subsidize these patterns. Sound economic development policies require the SBA to encourage lending to communities that are poorly served by private markets.

Private financial markets, in particular, have demonstrated patterns of bias against lending to minorities and to firms located in minority and modest-income areas. While evidence from San Antonio suggests that the SBA has countered this bias in the case of lending to minorities prior to the LowDoc program, data from the year following the program's introduction suggest that the agency may be losing its commitment to minority business development. In terms of geographic lending patterns, the San Antonio data suggest that the agency has underserved modest-income and minority neighborhoods, even after accounting for the distribution of small firms. Since the introduction of LowDoc, the problem has only worsened.

Some have suggested that a focus on lending to underserved areas will increase the losses incurred by the SBA. Because they have historically been subject to private sector disinvestment supported by public policy, some lower-income communities may be more subject to undulating economic forces than more affluent markets. This is, in fact, reason to target economic development resources to these areas, where public policy can affect private lending and investment decisions and help combat historical patterns of disinvestment. This is not to suggest that double-digit loan loss rates are appropriate for the SBA program. There are many examples of successful small business financing programs that target underserved markets without suffering from large loan losses.¹⁵ Rather, it merely acknowledges that disinvestment and perverse policies may carry some costs. In general, regardless of location or type of borrower, total SBA loan losses should be expected to be higher than conventional bank rates; otherwise the purpose of the program is unclear. Overly liberal lending practices should be controlled by methods such as reducing the portion of loans guaranteed by the SBA, not by directing lending away from where it is most appropriate.

¹⁵ The Woodstock Institute will be publishing a report profiling a number of examples of such programs in the Fall of 1995.

Policy Recommendations

While the introduction of the LowDoc program has been duly praised as an innovation in the delivery of the SBA 7(a) guaranty, the program needs more fundamental attention if it is to meet the criteria for sound economic development policy. Merely increasing the lending activity of the program is not sufficient to justify the program's support and sponsorship by the federal government. The program can only be justified if it works to correct inefficiencies in the small business finance markets and if it supports lending to those markets which are underserved. The following policy recommendations are made with the intention of strengthening the foundations and increasing the overall public benefits of the 7(a) program, as well as improving access to credit for firms that face the greatest barriers to financing:

- 1) The SBA should recognize its role as an economic development agency and the importance of small business finance to urban economic development. The agency cannot justify government subsidy or sponsorship based solely on the notion of increasing access to small business finance without regard for the consequences of the actual lending patterns it supports. While the agency's 504 program includes some significant targeting to higher unemployment counties, the 7(a) program, which is much more widely used, is essentially nontargeted geographically, and is only modestly targeted to minority-owned firms. Moreover, counties are much too large of a geographic area to permit sound economic development targeting.
- 2) The LowDoc program should be continued and supported by the SBA, with modifications suggested here. The program offers a significant improvement to the guaranty process, especially for smaller loans. It has increased the number of banks and other lenders active in the 7(a) program, which is good for businesses needing the guaranty. The agency should continue to monitor individual banks for overly liberal lending practices, but thus far, the evidence fails to corroborate fears of widespread problems. SBA data show that, thus far, the more than 18,000 LowDoc loans made from December, 1991, through February, 1995, performed substantially better than non-LowDoc 7(a) loans made during the same period. LowDoc loans past due, delinquent, or in liquidation amounted to only 0.4 percent of approved loans, while for the other 7(a) loans the figure was 1 percent. SBA staff in San Antonio suggested that this is due to the fact that borrowers of smaller amounts can more easily cover debt payments with secondary sources of repayment when they encounter business slowdowns.¹⁶
- 3) The 7(a) program, and especially LowDoc, must be affirmatively marketed to minority-owned firms and to firms in modest-income neighborhoods. Given the evidence showing that minority-owned businesses are poorly served by conventional financial institutions, it is not sufficient to rely upon banks to market the program. Efforts such as the prequalification programs, where businesses are prequalified by the SBA prior to approaching banks, should be expanded and should focus on both minority-owned businesses and businesses in modest-income areas. Community development corporations with business development experience should be supported to provide prequalification services.

¹⁶ Interview with Laura Agüero, Chief of LowDoc, San Antonio District, U.S. Small Business Administration. June 5, 1995. Data supplied by U.S. SBA.

- 4) SBA district offices should establish targets for lending to minority-owned businesses and businesses in modest-income zip codes within metropolitan areas. These targets should at least correspond to the portion of businesses that are minority-owned and located in modest-income zip codes in each metropolitan area. This roughly follows the approach currently used by government sponsored enterprises in the housing secondary finance markets (e.g., Fannie Mae). The agency should seek public comment on appropriate methods for determining targets.
- 5) The SBA should conduct annual or biennial reviews of all banks participating in its programs. Banks that make substantially smaller portions of their loans to minority-owned firms and to firms in modest-income zip codes when compared to most other similarly situated banks should be given warnings and then, if no improvement occurs, restricted from using the program. Again, other federal sources of banking support, such as the Federal Home Loan Bank, look at the community reinvestment practices of participating financial institutions.
- 6) Incentives should also be used to encourage lending to areas in need of economic development. First, the awarding of preferred or certified lender status should depend fundamentally on the degree to which lenders serve modest-income areas and minority-owned firms. Second, lenders who sell loans on the secondary market and who perform better than the overall market in serving modest-income areas and minority-business might be allowed to retain a higher share of premiums made from loan sales than lenders who do not. Currently, lenders must return one-half of any premium in excess of 10 percent to the agency. Lenders serving unserved markets might be required to return only one-quarter of the premium over 10 percent, for example. Finally, the SBA might lower transaction fees on loans made to firms in targeted markets, especially for smaller loans where transaction costs can pose added barriers to banks' serving these markets. Any proposed increases in fees for smaller loans might be fully or partly rolled back for targeted markets.
- 7) An absolute prohibition should be imposed on the guaranteeing of loans to nonminority-owned firms relocating from modest-income central-city neighborhoods to upper-income suburban areas.
- 8) SBA programs, including the 7(a) guaranty, should be made available to community development financial institutions. These nonbank lenders have proven that they have the ability to target financing to areas most in need of economic development while maintaining sound lending practices. CDFIs can be strong partners with the SBA in delivering many of its programs. Several CDFIs already deliver SBA 504 loans, and some even have the ability to make 7(a) guaranties. The 7(a) program can be an important tool for CDFIs in building scale and impact.
- 9) The SBA should conduct research to determine the employment impacts of the 7(a) programs. In particular, the agency should identify the location and types of borrowers that hire residents of modest-income communities and then target such firms.

The above recommendations all concern SBA policy and practice. One additional recommendation concerns the implementation of the Community Reinvestment Act, (CRA) by federal banking regulators, but has direct relevance here. No CRA credit should be given to banks solely based solely on the number of SBA loans made. Only SBA loans to minority-owned firms and to firms in modest-income areas should be counted. Because firms tend to have an impact on areas larger than census tracts, zip codes are likely to be a more appropriate geographic unit for this evaluation process.

Overall the SBA 7(a) guaranty has proven to be an important, and generally effective, tool for small business development throughout the country. But the support of specific small businesses without a concern for who benefits from resulting development is not an appropriate role for the federal government. Only when SBA efforts are targeted towards underserved markets and communities does the program become a justifiable economic development program. With some significant policy redirection, the 7(a) program can be such a program.

The Woodstock Institute

The Woodstock Institute is a not-for-profit organization based in Chicago. For the past 22 years, the Institute has carried out applied research and developed and implemented programs which increase private sector investment in modest-income and minority communities for the benefit of those who live there. It designs programs which bridge the gap between the needs of communities and the resources of banks, savings and loan associations, foundations and others.

The Institute provides a variety of services to community-based organizations, financial institutions, foundations and government agencies, including applied research, policy analysis, program design, and evaluation.

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