



EXECUTIVE SUMMARY

Analysis of Small Business Lending in Texas

**Special Report
to**

**Finance Commission of Texas
2601 N. Lamar Boulevard
Austin, Texas 78705**

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ANALYSIS OF SMALL BUSINESS LENDING IN TEXAS

OVERVIEW

This study was undertaken on behalf of the Finance Commission of Texas to provide an in-depth view of the small business community in the State of Texas and their responses to lending and capital access issues. The study was conducted in the summer and fall of 2001 by the Institute for Policy and Economic Development at the University of Texas at El Paso (IPED) on behalf of the Finance Commission focusing on four issues related to small business lending:

1. Availability of Credit;
2. Pricing and Terms of Credit;
3. Quality of Credit; and,
4. Lending Practices and Borrower Experiences.

The study provides results of a statistically valid survey of 1567 small businesses throughout Texas designed after a series of studies by the Federal Reserve Bank over the past decade and a half.

GENERAL CONCLUSIONS

In a study of this size, it is important to consider that general conclusions are representative at the statewide level and within regions, and that exceptions to every finding no doubt exist.

Three general conclusions are derived from this study. First, access to lending opportunities is primarily through traditional banking institutions; however, many small businesses in Texas have turned to a variety of other sources to obtain loans or their equivalents. Second, access to lending is broadly available even among those small businesses that exhibit the most extreme set of conditions that

work against loan approval. Third, within sub-units of the state there exist varying patterns and conditions that lead to differences in how small business lending is conducted.

Many differences in the lending process are easily attributed to issues associated with the loan applicant's bank relationship, the credit history of the firm and its owner, the ability to support debt service in light of being a newer firm, lacking a business plan or general lack of revenues. Some differences are related to the type of loan application (land and buildings or vehicle and equipment loans) where collateral can be used to secure the debt. The access to debt lending can also change if the borrower looks to non-traditional sources such as credit card companies and is willing to accept higher rates in lieu of meeting all bank conditions of credit supply.

The preponderance of small businesses in Texas are retail and service oriented, generating revenues less than \$500,000, and are likely to have small payrolls of less than ten employees under a sole proprietorship structure. We find that the border area of Texas has more issues that are likely to work against access to debt finance. This condition, however, cannot be assessed without understanding the border more specifically. Different areas of the border each face different problems and the border region has been identified by the State of Texas as an area in need of specific policy considerations. Additional assessment of the conditions in the border region is called for as one conclusion of this study.

Women, especially minority women, are growing in the small business sector. The

data suggest problems related to availability of credit, but more closely to the way these businesses maintain records and approach the overall credit picture. Women-owned firms in the sample do not report practices by lending institutions that suggest they are treated differently than non-women owned firms. Women and minorities are also the most receptive of alternative strategies to improve their knowledge of financing and loan processes.

POLICY CONSIDERATIONS

Clearly small business lending is an area of tremendous complexity that results when a myriad of factors are brought into the business and lending process. Overall, the current economic condition at the beginning of 2002 is unclear, resulting in a period of greater risk for small businesses. Potential policy options do emerge from this study.

1. Regionally there appear to be some noticeable differences and statewide policies must take into account regional patterns.
2. The data suggests that state support of regional capital access centers, which serve as focal points for training of business owners and provide concentrated access to small businesses for lenders, can assist in tailoring to regionally-specific needs. Small businesses are interested in a variety of assistance and education opportunities that may be best designed and implemented in capital access centers.
3. Underlying many business practices are educational needs that have not been met. Programs that train and advance business knowledge, especially those related to lending and the regulations that are imposed on lenders, need to expand and new methods of outreach, such as on-line certification, should be encouraged.
4. Building on the above, "Financial Literacy" for small businesses in Texas should be a goal of civic and public economic development institutions.
5. Lending practices still involve considerable face-to-face effort by lenders and borrowers. Even in light of consolidation in the banking industry, personal contacts remain the primary method for assisting small business borrowers.
6. Minority-owned businesses are prevalent in Texas and policies must take into account the emerging majority-minority trends.
7. Minority and women-owned businesses are open to alternative strategies to assist them in pursuit of finance options and should be provided access to the greatest range of services and strategies possible.
8. Commercial banks continue dominate debt financing. Alternatives ranging from Internet banking to a variety of finance companies are emerging but are not a significant source of financing for the vast majority of small businesses in Texas. Overall, commercial banks remain the primary resource for meeting the financial needs of small businesses.
9. With the growth in alternative financing mechanisms (i.e., Internet banks, credit card lending, lease financing) regulators must examine practices to insure that protection of small businesses is extended into these new areas.
10. Loans to small businesses, in many cases, are made at a greater risk to the lending institutions. To the extent possible, lending programs that share or transfer risk for lending institutions

through guaranteed loan programs or risk sharing should be considered.

11. Small business borrowers, who may be faced with substantial costs of borrowing through traditional financial channels, should be introduced to alternative sources of financing.
12. The critical nature of the issue of small business access to capital must also take into account the risk of small business ventures and the reality that most small businesses will not survive, regardless of debt leniency.
13. The development of new policies to provide greater assistance to small businesses must also take into account the rights of bank-owners and shareholders who have invested based on an expected return that challenge the feasibility of higher-risk small business lending. Protection of the safety and soundness of banking institutions must be considered as part of the process of providing new opportunities to small businesses in Texas.

BACKGROUND AND PURPOSE

Access to capital, business practices that may affect access to capital, bank responses to loan applications, and patterns in lending across sub-groups (i.e., women and minorities) among small businesses in Texas are both complicated and sensitive. In response, the State of Texas at the administrative (Finance Commission) and legislative levels is concerned about equal access to capital. This study thus becomes an important step in determining practices among both lenders and borrowers, continuing the Commission's efforts to examine alternatives to current debt financing experiences and practices, as well as to develop policy responses aimed at increasing opportunities for both businesses and the financial sector.

Economic Landscape of the Study Period

It is important to note that the period of this study did not feature high-interest rates and inflation. Instead, the period was marked by low interest rates, a decrease in profits, cautious consumer confidence, at best cautious confidence among CEOs, and a greatly diminished federal budget surplus. This period provides an interesting and important backdrop to study the financial opportunities of Texas small businesses. The period over which data was collected for this study (July to November 2001) covers an extraordinary interval in our socio-economic lives. Although the information gathered concerns financial transactions occurring up to three years ago, the survey conducted also contains attitudinal questions that apply to current state and national economic conditions.

Review of Previous Research

The issues surrounding small business access to capital are not new nor are they unique to Texas. The ability of small

businesses to obtain capital is of national, state, regional and local concern and in many ways is rooted in a concern for financial literacy that blankets the entire nation. As a result, a wide variety of studies have been conducted over the past 20 years. These research efforts provide valuable insights into the following general areas and serve in developing the approach of this study. This research examines a number of issues relevant to small business lending including:

- The utilization of financial services by small firms and the major providers of these products;
- The terms/conditions on credit received by small firms;
- Key concerns of small firms with respect to their business in general and debt financing in particular;
- The possibility of discrimination in lending to small businesses;
- The impact of banking industry consolidation upon firms' access to debt capital;
- The options/alternatives available to small businesses seeking financing;
- The importance of relationships to the availability of credit; and,
- The appropriate methodology to be employed in addressing such issues.

Clearly the most comprehensive studies of small business finance practices and issues were conducted by the Federal Reserve Bank in conjunction with the Small Business Administration in 1987, 1993, and 1998 (FED/SBA). The FED/SBA studies use a two-stage, stratified random sample procedure to develop their survey database. In reviewing the extant literature, it is the approach and methodology used in the FED/SBA studies that were adopted for this study, thus following the highest standard in this issue area.

METHODOLOGY

Following the design established by the studies of the FED/SBA, a mail survey was utilized to collect data about small business lending experiences in Texas, employing a standard randomized survey research methodology and a multi-stage research process. The survey instrument used to assess the finance and credit issues of Texas small businesses was designed to comply with the requirements of the Finance Commission relating to the four general areas of the study. The survey process generated 1567 useable responses, a number of valid responses to permit statistical evaluation of the basic research questions for this study at levels of significance greater than the required 5 percent.

The target population for this study was defined by the Finance Commission as non-agricultural, non-depository, for-profit small businesses operating in Texas with 100 or fewer employees. Using the County Business Patterns database collected annually by the U.S. Census Bureau, 443,872 firms in Texas met the definition established for this study. Between 1993 and 1999, this sector of Texas businesses grew at an average annual rate of 1.7 percent, ahead of the national average rate of 1.47 percent over this same period. Given the size and growth of this business sector, there is little disagreement that the continued economic health of the state depends on the ability of small businesses to grow and prosper.

Based on County Business Patterns, the state's small business community is classified in two basic ways:

- 1) geographic location and,
- 2) industrial classification.

The geographic distribution of small businesses can be considered in a variety of ways, but for the purposes of this study were sub-divided into three regions:

- 1) urban/non-border;
- 2) border; and,
- 3) non-urban/non-border.

The responses were also placed into five industrial classifications of:

- 1) retail and services;
- 2) construction;
- 3) wholesale;
- 4) manufacturing; and,
- 5) other.

Overall, firms responded to the survey in a pattern statistically equivalent to the distribution of small firms in the state.

FINDINGS

Firm Profiles

Profiles of the responding firms suggest a picture of small businesses in Texas that allows us to better understand issues associated with financial services and access to capital. These profiles indicate that Texas small businesses are comparable to the national profile as established by the U.S. Census Bureau's *Statistical Abstract of the United States: 2001*.

- ✓ 40 percent of the businesses are sole proprietorships indicative of our traditional view of small business organizations.
- ✓ Approximately 35 percent stated that their business is some form of corporate structure (30.3 percent) or a sub-chapter S corporation (6.6 percent), with 20.6 percent arranged as a partnership.
- ✓ Firms with annual sales of \$100,000 to \$499,999 accounted for 34.8 percent of the survey respondents.
- ✓ Over 60 percent (60.4 percent) report annual sales below \$500,000, while 25.4 percent report revenues exceeding \$1 million.
- ✓ Over three-quarters (76.7 percent) have fewer than 10 employees.

The length of time that the responding firm has operated under the current ownership structure is, to some extent, a measure of business stability and, therefore, important in the acquisition of credit.

- ✓ 35.9 percent of the sample had operated under the same structure for 15 years or more.
- ✓ Over half of the sample (52.42 percent) indicated that their firms have been in business under the same ownership for more than 10 years, suggesting that there is a

well-established small business sector in the state.

- ✓ Only 3.2 percent of the sample had been operating for less than one year.
- ✓ Approximately one-quarter (23.5 percent) of the sample are self-identified as minority-owned, reflecting the ethnic diversity that exists in Texas.
- ✓ Among minority owners, 43.4 percent are Hispanic and 9.9 percent African American, with over one-third representing a mix of other ethnic groups.
- ✓ 80.8 percent of the sample reported that a single individual has majority ownership.
- ✓ Approximately two-fifths (38 percent) of the sample are reported to be women-owned businesses.

Financial Services Uses and Processing

As a beginning step in assessing financial services usage and overall satisfaction, some basic criteria deemed necessary for meeting lending requirements are considered by the survey that address business practices. Underscoring these conditions and practices is the degree to which the small business community can respond to demand and supply conditions of lenders, conditions that, to a large extent, determine the conditions under which they may obtain financing.

- ✓ Effective demand is based on a business's legitimate needs for funds consistent with its business plan and operating strategy within its industry.
- ✓ Effective supply addresses providers of both traditional and alternative lenders, and the requirements, which may vary by institution, that borrowers *must* meet as a result of the regulatory environment.

Critical to obtaining any form of credit financing from a financial institution is the requirement that the firm maintain adequate financial records. These accounting systems may range from rudimentary tax records to professionally audited financial statements.

- ✓ A clear majority (56.2 percent) maintain an accounting system “that provides monthly, quarterly, and year-end financial statements and tax information,” representing the highest level of financial reporting sophistication.
- ✓ Over 20 percent (21.7 percent) of responding firms utilize an accounting system that generates only a year-end tax return.
- ✓ Lack of adequate record keeping may create problems when requesting credit because of the regulatory requirements that must be followed.
- ✓ Slightly less than 15 percent (14.4 percent) of small businesses generate only year-end financial statements, a level of reporting which may be insufficient to meet the application requirements for certain types of credit.

The study also posed questions concerning the responding firm’s level of outstanding liabilities. The existing debt load and ability to service that debt may be a critical factor in a lending decision.

- ✓ Nearly one-half of the sample (48.2 percent) have outstanding liabilities to financial institutions less than \$10,000.
- ✓ Overall, approximately 70 percent (68.3 percent) of the respondents maintain outstanding obligations to financial institutions of less than \$50,000.
- ✓ Total liabilities to all creditors, in addition to those owed to financial institutions, are less than \$10,000 for 38.4 percent of the sample.

- ✓ Total liabilities, in addition to those to financial institutions, were less than \$50,000 for approximately 60 percent of the respondents.

The overall picture is of a debt structure that is not excessive by some measures. However, servicing this debt can be problematic for small businesses, especially those who may be operating with small margins.

Loan Application Experience

The loan application experience also has an effect on future borrowing tendencies among business owners and how they view their potential to work with a financial institution. It is, therefore, a two-way experience. The degree to which the borrower can feel he or she is part of a business relationship and the way in which that relationship plays itself out during a debt request is important to both the lender and borrower. In addition, small businesses also are likely to look for consistencies in requests made by their financial institutions, in order to have or prepare the appropriate documentation. When inconsistencies arise, the borrower may see the process as problematic. The survey assessed the motive for the loan, the institution approached for the loan, the source of information about the loan, whether the loan application was approved or denied, and, if denied, the stated reason for the denial.

- ✓ There is a near even distribution among those who applied for a loan (48.4 percent) and those who did not apply for a loan (51.6 percent) in the previous three years.
- ✓ Nine times out of ten (88.7 percent) the loan was with a Texas-based institution. Thus, Texas small businesses for the most part are linked to the state’s lending bodies and use them as their primary

lending sources over out-of-state sources.

An examination of the most recent loan applications showed that:

- ✓ 46.9 percent were for a line of credit, followed by working capital loans for 14.2 percent of the respondents.
- ✓ Equipment loans (9.9 percent) and vehicle loans (9 percent) were the third and fourth most common types of loan applications.

Survey respondents also indicated the institutions from which their firms made loan requests. The type of institution and the relationship with an institution are possible factors in the type of loan that may be obtained.

- ✓ Over two-thirds (67.3 percent) of the credit requests were made at "local" financial institutions with multi-state banks being the second most approached institutions for business loans (26.3 percent).
- ✓ Texas small businesses approach local depository institutions in general proximity to their businesses more frequently than other types of institutions.
- ✓ Small businesses also report the use of credit card companies in 15.9 percent of the responses. Credit cards have grown in use among small businesses in the last decade and undoubtedly have become more frequently used for short term financing.
- ✓ Application to guaranteed government loan programs is relatively low among small businesses in Texas.
- ✓ When considered, the Small Business Administration (SBA) is the most often utilized government sponsored program by small businesses in Texas.

The relationship that a business owner has with his or her bank and the approach used is a factor in how a loan application is treated and processed.

- ✓ Loans were made to new customers with no previous relationship with the lender approximately one-quarter of the time (23.9 percent).
- ✓ Loans to customers who had previously had a loan with the lending institution occurred over 50 percent of the time (56.5 percent).
- ✓ Two-thirds of the time (66.4 percent) the applicant made the loan request in person and in slightly less than one-quarter of the cases (22.4 percent) did so by telephone.
- ✓ In well over 60 percent of the cases (65.1 percent) there was only one application made, while in approximately one-fifth of the reported applications (18 percent) two applications were submitted.
- ✓ The report of only one application in the majority of cases suggests many businesses are, more than likely, aware that they will qualify for their loan request.

Borrowing opportunities are assisted by a variety of means that make the borrower aware of the market.

- ✓ The primary sources are local bankers (47.4 percent), through business relationships (40.3), followed by friends or business acquaintances (14.6).

The process of obtaining a loan includes a number of factors that determine the terms of the credit contract.

- ✓ At one extreme, 27 percent reported not needing to provide additional documentation beyond the loan application.

- ✓ Only one-half provided the previous year's financial records.
- ✓ In one-third of the cases, three years of financial records were required to complete the loan application.
- ✓ Audited financial statements were necessary in one-fifth of the cases (19.4 percent) and a business plan in 15.8 percent.
- ✓ In 49.1 percent of the cases, personal financial records of the business owner were requested indicating a link between personal financial capabilities of the owner with the firm.
- ✓ Surprisingly, 43.3 percent had no knowledge of how their credit was evaluated.
- ✓ An overwhelming 84.6 percent agreed that the evaluation process was fair.

Of those who applied for a loan:

- ✓ Small businesses are generally very successful in obtaining financing.
- ✓ 82 percent report they were approved, leaving 15.3 percent denied and 2.7 percent pending approval at the time of the study.
- ✓ The approximately one-fifth who were denied credit discontinued credit solicitation 59 percent of the time and sought another lender one-quarter of the time (25.3 percent).

For those denied credit:

- ✓ The major reason given for the denial was poor credit history (31 percent).
- ✓ Insufficient capital and earnings were cited in 21.9 percent and 22.3 percent of the cases, respectively.
- ✓ Too much debt also was associated with denial in 22.8 percent of the cases.

- ✓ The lack of collateral was reported for 26 percent of the respondents.

The processing time of a loan application was found to also vary.

- ✓ Loans were processed in less than 7 days 50.5 percent of the time and less than two weeks 67.5 percent of the time.
- ✓ Lengthier periods were evidenced in one-third of the responses, undoubtedly a function of type of loan, additional requests for information, or because of attempts to clarify credit-related issues.

Terms of Credit

Overall, the terms of credit to small businesses are important to insure they are treated fairly and can benefit from their borrowing.

- ✓ Over 60 percent (62.1 percent) of the loans required some form of collateral.
- ✓ Inventory and accounts receivables accounted for 44.2 percent of the collateral, followed by vehicles and equipment (43.1 percent).
- ✓ Business real estate was contributed as collateral in 22.9 percent of the responses.
- ✓ Collateral was required and used in a variety of ways, including personal assets of cash and securities (19.7 percent), personal real estate (10.3 percent) or other personal assets (7.2 percent).
- ✓ A personal financial statement from the business owner was required 49.1 percent of the time.
- ✓ Additional written agreements were required 21 percent of the time to supplement the loan.
- ✓ 44.5 percent of the time additional protection, such as a co-signer, guarantees of the majority shareholder or business owner, or insurance was required.

The amount of a loan is a function of need and ability to pay-off the loan by the applicant.

- ✓ The majority of loan requests were for less than \$100,000 (62.4 percent).
- ✓ Loans between \$100,000 and \$250,000 make up 19.3 percent of the requests.

The length of scheduled payoff for a loan, the interest rate and add-on fees also play a role in developing the loan package and credit terms.

- ✓ A majority of loans are scheduled for repayment in five years or less (74.4 percent), with 41.6 percent scheduled for two years or less.
- ✓ 32.8 percent of loans are repaid between two and five years.
- ✓ Loan payments are predominantly set for monthly terms in 82.9 percent of the responses.
- ✓ Fixed interest rates dominate in 58.6 percent of the loans obtained, while 34.8 percent report a variable rate. Nearly 7 percent (6.6 percent) were unaware of the rate they pay.
- ✓ The majority of the loans reported are at an interest rate below 12 percent.
- ✓ Less than a 6 percent rate was available in 5.2 percent of the cases, while 44 percent obtained a rate between 6 and 8.9, and another 35.9 percent between 9 and 11.9.
- ✓ A few borrowers reported rates in excess of 12 percent, relatively high in light of the lower interest rates of the past three years.
- ✓ Refinancing resulted in a lower rate for 44.6 percent.
- ✓ Over 10 percent (10.7 percent) reported a higher rate after refinancing.
- ✓ Over one-third (38.3 percent) reported they also incurred additional fees in order to obtain

their loan, such as processing fees, points, etc.

- ✓ The most common fees are loan processing fees (44.4 percent), administrative fees (43.1 percent), document preparation fees (38.6 percent) and filing fees (36 percent).
- ✓ Fees under \$100 are reported 20.9 percent of the time and between \$100 and \$200 for 25.8 percent of the respondents.
- ✓ Over one-quarter of the respondents report fees in excess of \$1000, no doubt linked to loan administration and preparation expenses, as well as costs of larger lines of credit and real estate loans.
- ✓ Over 10 percent (13.2 percent) report no knowledge of the fees and throughout the fee questions, low knowledge levels about the fees are consistently near 10 percent.
- ✓ 31.7 percent, almost one-third of the loan recipients, were unaware that loan fees increase the true cost of borrowing.

Information Sources and Financial Services

One common myth is that the language used in credit applications and loan agreements can be difficult to understand. The survey instrument included two questions addressing this issue.

- ✓ The results suggest borrowers find marketing information easy to read (44 percent) but did not receive any in 30.5 percent of the cases.
- ✓ Disclosures were found to be understandable for a majority of loan recipients.
- ✓ For both marketing information (10.6 percent) and disclosures (14.4 percent), some respondents did not find the material easy to

understand, potentially putting these borrowers at a disadvantage.

Survey participants who requested and received business loans were asked their overall satisfaction with the terms and conditions of the agreement.

- ✓ Three-quarters of the respondents were either very satisfied (40.2 percent) or satisfied (36.6 percent) with the credit they obtained.
- ✓ 5 percent were dissatisfied or very dissatisfied, and approximately one-fifth were neutral about their satisfaction level.

Another concern is the degree to which loan applicants use business support services. For those small businesses that may not have the “in-house” capabilities that allow them to meet all loan requirements, the use of outside accounting, legal and other support services can become quite important.

- ✓ Two-thirds of small businesses have not relied on accounting firms in developing loan applications in the last three years under consideration.
- ✓ Legal firms record the second level of usage followed by less than ten percent use among other options.

Small businesses also utilize a variety of financial services.

- ✓ A business checking account is the most utilized service (93.3 percent), followed by personal credit cards (68.0 percent), and personal checking accounts (52.8 percent).
- ✓ The latter two uses further the concept that the small business owner routinely co-mingles personal and business funds, also supported by over one-quarter

reporting personal loans (26.5 percent) being employed to finance business activities.

The use of new financial services technologies indicates:

- ✓ The most common use is for automatic funds transfers (36.5 percent) and automatic payment services (24.1 percent).

Credit Issues

Credit reporting is critical to loan decisions. A series of questions concerning credit issues were included in the survey.

- ✓ 12.6 percent of the small businesses self-report having a discrepancy in their credit record.
- ✓ Less than 10 percent (8.3 percent) report having filed a report to correct the credit error with the same number reporting that resolution of the credit error was very easy.
- ✓ Almost one-half (47.7 percent) report that resolving the issue was difficult or very difficult.
- ✓ Among those who have dealt with credit discrepancies, over one-half (52.3 percent) report that resolving credit issues did not occur in a timely fashion, with disputes still pending in 11.8 percent of the cases reported.

Another credit issue relates to delinquencies.

- ✓ Three-quarters of the respondents report they had been delinquent in the past to creditors. A history of delinquencies can be a major obstacle in obtaining incremental credit.

- ✓ The most common experience reported was a reminder notice in three-quarters of the cases (75.6 percent).
- ✓ Phone call inquiries were noted for over one-half of those having been delinquent in the past (57.8 percent).
- ✓ Visits by creditors or their representatives occurred in 8.1 percent of the cases, with legal action and repossession occurring in 8.6 and 5.6 percent of the reported cases, respectively.

Barriers to Obtaining Financing

Obtaining credit involves a variety of issues that are both borrower-based and due to requirements placed on lenders by state and federal agencies. While a variety of strategies can be employed to work through these issues and barriers, how small businesses address them and respond can determine their potential to obtain credit and financing. Respondents were asked to rank issues and barriers.

- ✓ Rigorous lending requirements were assessed as the greatest barrier to borrowing by the respondents, followed by the cost of obtaining financing, and the feeling that only conventional and SBA loans are available versus alternative financing options (i.e., leasing, factoring receivables, floor plans).
- ✓ Issues relating to financial literacy, namely, lack of information and lack of knowledge about loans are also perceived as barriers among small businesses.

Questions also addressed a number of issues that small businesses must face in the current economy.

- ✓ Income and property taxes were perceived as significant issues confronting the respondents.

- ✓ Government regulations and two labor issues -- the quality of the labor pool and costs of labor -- also were seen as issues among small businesses.
- ✓ Declining sales concerns and competition from larger firms also draw the attention of small businesses.
- ✓ Inflation and interest rates are lower in salience relative to other issues facing small businesses.

In response to these barriers and issues, a series of strategies were proposed to assist small businesses in earlier studies. These strategies are aimed at making the small business owner better prepared in developing loan requests and to better understand the lending process.

- ✓ Access to more information obtained the highest response.
- ✓ In general, support for all strategies is low, except access to more information.
- ✓ 20 percent or more do think each of the strategies would be helpful, indicating a variety of opportunities for financial services providers.

SOURCES OF VARIATION

One major objective of this research is to determine whether the state's financial services institutions meet the needs of the Texas small business community. Specifically, are all subsets of the business community served?

Each subset represents potential groups with varying concerns and issues within the small business environment. Because of its size, Texas has a wide range of businesses linked to geographic regions. There also are a variety of businesses in Texas ranging from manufacturing and construction to retail and service. The extent to which small business financial services may vary by industry may be important to our understanding of the issues they face. Texas also has a large minority population including Hispanics in the border area and a diverse mix in the major urban areas. Minority concerns about lending, along with how women increasingly play a larger role in businesses, also require full consideration.

Highlights of Cross Tabulations

The following summarize the findings from cross tabulations. To achieve this objective, the small business community of the state was subdivided by four basic characteristics:

- 1) geographic area;
- 2) industrial classification;
- 3) ownership ethnicity; and,
- 4) gender of majority owner.

Geographic Area

- ✓ Minority ownership issues are prominent in the border region, consistent with the ethnic mix in that area;
- ✓ The legal structure of the firm suggests sole proprietorships are more likely to occur outside the major urban areas of east Texas;

- ✓ Two-thirds of all loans are applied for in urban areas, consistent with their distribution among firms in the state;
- ✓ Urban respondents are more likely to be new customers and have a limited previous banking relationship while border and non-urban/non-border businesses have histories of longer relationships with banks;
- ✓ Lines of credit requests are higher in urban areas, as is use of credit unions and multi-state institutions;
- ✓ Form of initial contact is related to the manner in which business is conducted in the various regions, such that personal meetings with lenders are more likely in the border over other regions and non-urban/non-border over urban;
- ✓ The number of institutions contacted is higher in the border and non-urban/non-border regions;
- ✓ Non-urban/non-border applicants are more likely to need to provide collateral, while the border requires additional protection at a higher rate;
- ✓ Interest rates paid appear higher in the border region and lower in the major urban areas;
- ✓ Supplemental fees are added to loans more often in the border;
- ✓ Co-mingling of a firm's finances with personal banking services is higher outside the urban areas.

Industry Classification

- ✓ Small firms were more likely to be sole proprietorships in the retail or service sectors;
- ✓ Gross revenue was likely to be lowest in retail and service sector;
- ✓ Minority ownership is slightly higher in retail and service sector;
- ✓ Number of employees per firm were lowest among retail and service firms;

- ✓ One individual with majority control is more dominant among retail and service businesses;
- ✓ Size of most recent loan is likely to be under \$100,000 and more likely to be in the retail and service classification;
- ✓ Gender ownership shows women are more likely to be in retail and service businesses;
- ✓ Sophistication of accounting systems suggest the weakest systems are in retail and service businesses;
- ✓ Type of credit requested is primarily a line of credit for all industry classifications;
- ✓ Applications for credit are more likely to be among the retail and service classification of small businesses, a response consistent with their frequency;
- ✓ In the retail and service sector comingling of funds between the business and the owner is higher;
- ✓ Delinquency on a credit agreement is more prone to occur in the retail and service classification;
- ✓ Additional protection is more likely to be required for a loan applicant from the retail and service businesses;
- ✓ Fixed rate loans clearly dominate regardless of industry type;
- ✓ Amount of liabilities are lowest in retail and service sector.

Minority-Owned Businesses

- ✓ Minority-owned firms generate lower gross revenue than their non-minority-owned counterparts;
- ✓ Minority-owned small businesses appear to be newer;
- ✓ Women-owned minority firms are more prevalent than male-owned;
- ✓ Accounting systems for minority-owned firms are less sophisticated than for non-minority firms, but at rates lower than reported in earlier studies;

- ✓ Applications for credit financing occur at a higher rate among minority-owned firms;
- ✓ Minority-owned firms also take greater advantage of guaranteed loan programs;
- ✓ The credit evaluation process is longer for minority firm credit applications than for non-minority firms;
- ✓ Minority firms question the fairness of the loan evaluation process at a much higher rate than do non-minority firms, although the evaluation process appears to be the same;
- ✓ Minority-owned firms are denied credit at a higher rate;
- ✓ Minority-owned firms are more likely to pay higher interest rates;
- ✓ Credit discrepancies are more frequent with minority firms;
- ✓ Minority-owned small businesses are not required to provide additional credit enhancements at a higher rate than non-minority firms.

Women-Owned Businesses

- ✓ Women-owned firms are likely to be newer businesses;
- ✓ Women-owned firms are smaller in terms of gross revenues but not in number of employees;
- ✓ Women-owned firms are likely to be structured as sole proprietorships;
- ✓ Women-owned firms are more likely to utilize a less sophisticated accounting system;
- ✓ Women-owned businesses report having fewer outstanding liabilities;
- ✓ Women-owned businesses also borrow smaller amounts, on average, than non-women-owned businesses;
- ✓ Women-owned firms apply for government-guaranteed loans at a higher rate than the remainder of the small business community;

- ✓ Women-owned businesses are no more likely to be required to provide additional written agreements as part of lending requirement;
- ✓ Women-owners, however, report no substantial differences in the terms or requirements of credit.

ASSESSING SMALL BUSINESS LENDING USING MULTIPLE CRITERIA

A scale of conditions that link the issues of availability of credit, terms of credit and the quality of a loan was developed based on three criteria. The index reflects three key issues discovered throughout the previous analysis. The sophistication level of accounting systems links directly to bank underwriting requirements, while delinquency rates were in evidence in all areas, all businesses, and regardless of ownership, although at varying rates. The customer relationship has also been identified as an important criterion. These criteria are combined into one measure that can be used to summarize the potential range of loan conditions. At one extreme, a sophisticated accounting system, a previous banking relationship and no previous delinquencies combine for a hypothetical "best case." At the other extreme, an unsophisticated accounting system, no previous banking relationship and a history of delinquencies would combine for the "worst case." As a combined measure the index shows us that:

- ✓ 25 percent would appear to have the worst set of conditions confronting them in the loan process, while approximately one-third would conceivably be in the best position.
- ✓ Approximately one-sixth (15.4 percent) who report the characteristics that determine the worst case scenario were still able to obtain financing.
- ✓ Those who had the higher scores, and subsequently, we would assume, the best chance of obtaining financing, were funded in over ninety-eight percent of the cases.
- ✓ Even with a mixed record across the three conditions, funding is likely to occur six out of seven times.

- ✓ Overall, the findings suggest that potential borrowers in the small business arena have a good chance of obtaining funding and can overcome potential obstacles related to their past experiences and practices.

MULTIVARIATE ANALYSIS

The Binary Logistic Regression (BLR) technique was used to estimate a total of 17 equations evaluating the predictors noted above. These findings place the variables into a statewide context and provide a macro level assessment of interaction of a variety of variables considered by the survey. Key findings were as follows:

- ✓ Three financial predictors: previous relationship with lender, delinquency record, and accounting system play a significant role in determining the probability of loan application approval.
- ✓ The status of minority ownership when examined at a statewide level does not impact the probability of loan approval.
- ✓ The gender of a firm's majority owner has no statistically significant impact upon loan acceptance/denial rates.
- ✓ The nature of a firm's business (retail or service, wholesale, construction or manufacturing) has no significant effect upon approval or denial odds.
- ✓ The legal form of the firm plays no role in determining loan approval rates.
- ✓ The age of the firm is not a significant predictor of loan approval or denial rates.
- ✓ Larger firms gain an advantage with respect to obtaining credit based on revenues. This may reflect the fact that a firm's size and a more sophisticated accounting system are highly correlated.
- ✓ There is evidence that border-based firms are faced with lower loan approval rates after allowing for the role of financial variables and firm size. Focused research

into narrowly defined areas should be undertaken.

The BLR analysis presented in this report assesses the impact, individually and collectively, of a considerable number of factors which are potentially important in determining success in obtaining debt financing. The estimated equations, however, are not intended to be interpreted as credit scoring decision models but provide an overview of the research that needs to be done and areas where policy concerns might be focused in the future.

**For a copy of the complete report visit
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iped.utep.edu/reports

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