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# Analysis of Small Business Lending in Texas

## Special Report
## to the
## Finance Commission of Texas

- ✓ Conducted in the summer and fall of 2001

- ✓ Focusing on 4 issues related to small business lending:

  - Availability of Credit;
  - Pricing and Terms of Credit;
  - Quality of Credit; and,
  - Lending Practices and Borrower Experiences.

- ✓ 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.

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# GENERAL CONCLUSIONS

- ✓ General conclusions are representative at the statewide level and within regions.
- ✓ Exceptions to every finding no doubt exist.

Three general conclusions are derived from this study.

1. 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.
2. Access to lending is broadly available even among those small businesses that exhibit the most extreme set of conditions that work against loan approval.
3. Within sub-units of the state there exist varying patterns and conditions that lead to differences in how small business lending is conducted.

# GENERAL CONCLUSIONS

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,
- ✓ lack of a business plan or
- ✓ general lack of revenues.

Some differences are related to the type of loan application 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.

## GENERAL CONCLUSIONS

- ✓ The preponderance of small businesses in Texas are:
  retail and service oriented,
  generating revenues less than $500,000,
  likely to have small payrolls of less than ten employees
  under a sole proprietorship structure.

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- ✓ 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 generally.
  Additional assessment of the conditions in the border is called for as one conclusion of this study.

- ✓ Women, especially minorities, are growing in the small business sector.
  The data suggest problems related to availability of credit for women-owned firms, 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.

# POLICY CONSIDERATIONS

1. Regionally there appear to be some noticeable differences and statewide policies must take into account regional patterns.

2. State support of regional capital access centers that serve as focal points for training of business owners and provide concentrated access to small businesses for lenders can assist in tailoring to regional-specific needs.

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 (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.

## POLICY CONSIDERATIONS

5. Lending practices still involve considerable face-to-face effort by lenders and borrowers. Even in light of rapid banking mergers, personal contacts may 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 conditions.

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 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 conduit 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.

## POLICY CONSIDERATIONS

10. Small businesses remain subject to greater risk in many cases and, to the extent possible, lending programs that share or can transfer risk for lending institutions through guaranteed loan programs or risk sharing should be considered among alternatives.

11. Non-bank credit providers should also be more fully explained to small business borrowers who may be faced with greater costs than traditional banking opportunities.

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 some 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 may not involve expanded higher risk small business lending. Protection of shareholder rights must be considered as part of the process of providing new opportunities to small businesses in Texas.

# METHODOLOGY

- ✓ The study followed studies by the Federal Reserve/SBA.
  - -- Mail survey was utilized to design the study and collect data
  - -- A standard randomized survey research methodology and a multi-stage research process.

- ✓ The survey instrument 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, permitting evaluation at levels of significance greater than the required 5 %.

- ✓ 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.

## METHODOLOGY

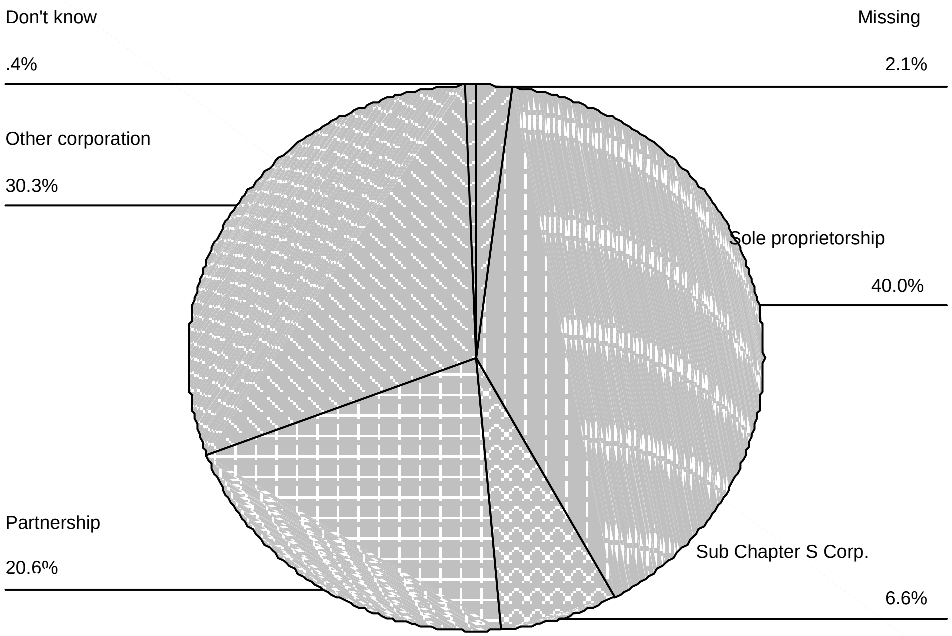
- ✓ Using the County Business Patterns database collected annually by the U.S. Census Bureau, 453,872 firms in Texas met the definition established for this study.

- ✓ Based on County Business Patterns, the state's small business community is classified in two basic ways:
  1) geographic location 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; 3) non-urban/non-border.

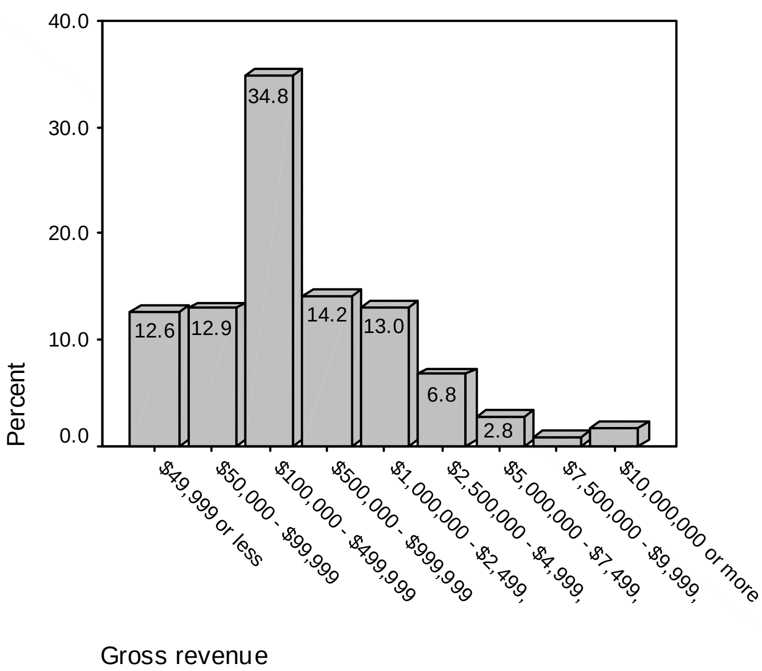
- ✓ The responses were placed into five industrial classifications of:
  1) retail and services; 2) construction;
  3) wholesale; 4) manufacturing; and,
  5) other.

- ✓ Responses to the survey are in a pattern statistically equivalent to the distribution of small firms in the state.



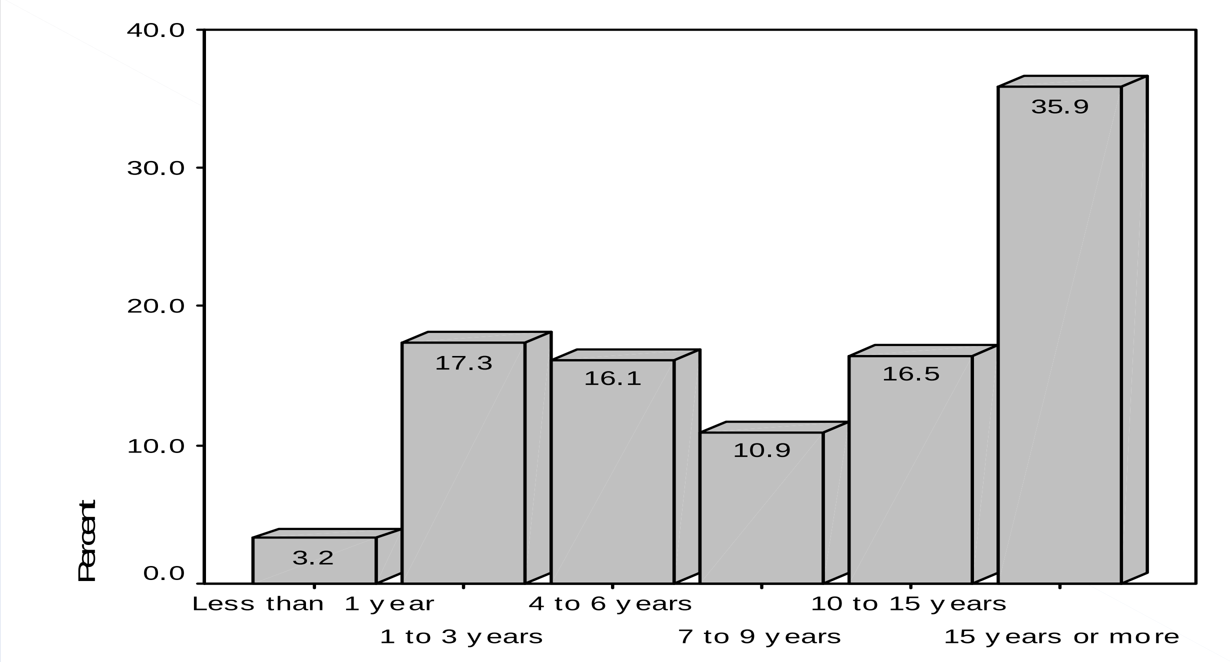

40% are sole proprietors

60% report sales less than $500,000 annually



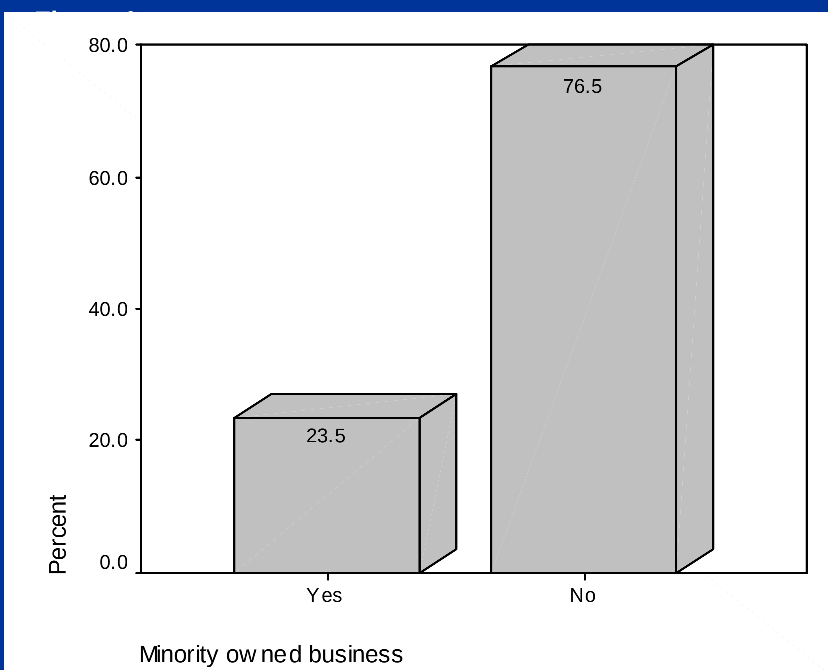

# Firm Profiles

## Firm Profiles

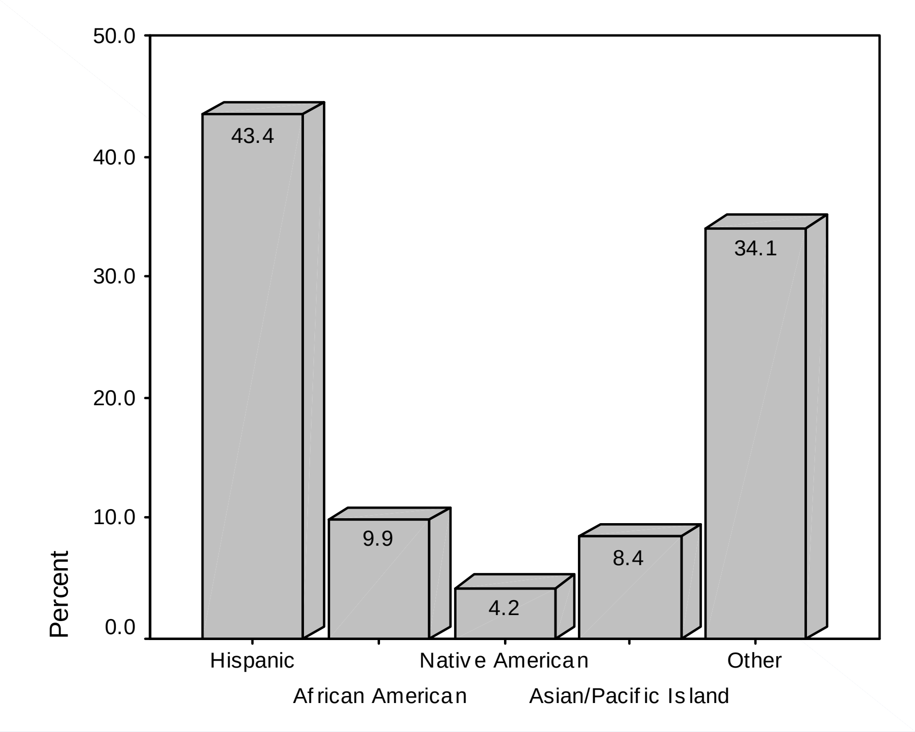



35.9% have operated for 15 years or more

23.5% are minority-owned



43.4% of minorities are Hispanic

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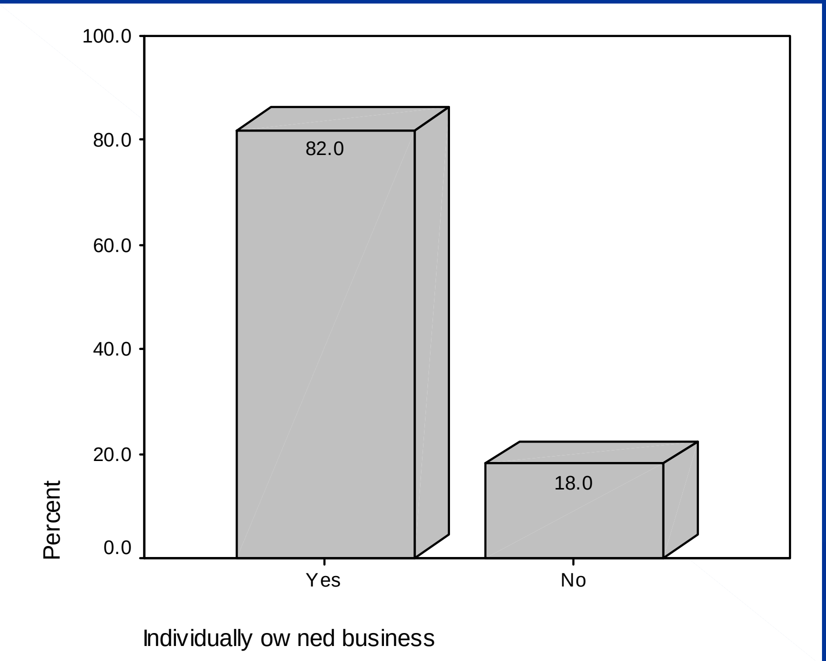
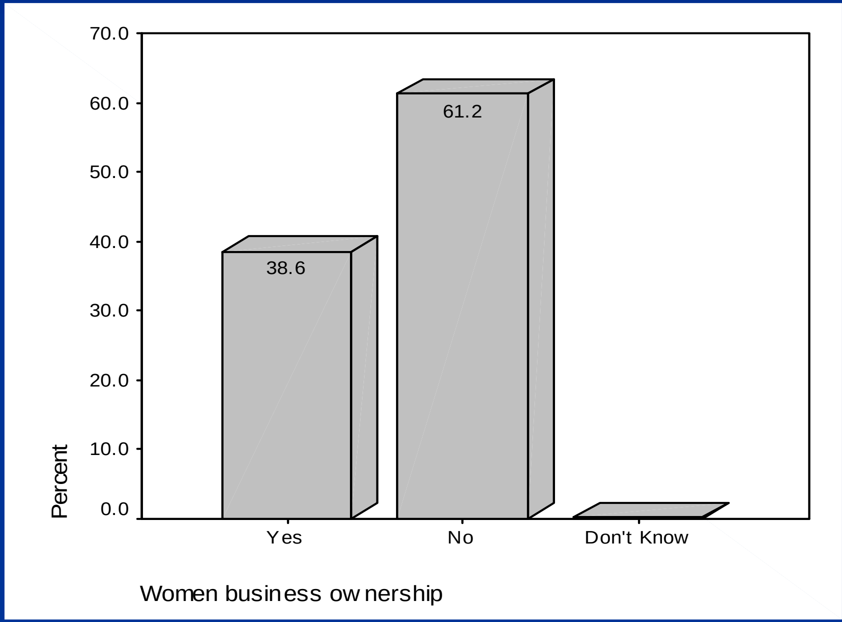



82% are individually Owned firms

Woman Ownership

Firm Profiles




38 percent report women-ownership, above the national average

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# Financial Services Uses and Loan Processing

- ✓*Accounting System*
- ✓*Liabilities*
- ✓*Delinquencies and Credit Issues*
- ✓*Banking Relationship*

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# Accounting System

- ✓ 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 year-end tax compilations.
- ✓ 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 a year-end tax and financial statement, a level of reporting which may be insufficient to meet the application requirements for certain types of credit.

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# Liabilities

- ✓ 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 may not seem excessive, however, servicing this debt can be problematic for small businesses, especially those who may be operating with small margins.

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# Delinquencies and Credit Issues

- ✓ 12.6 % of the small businesses self-report having a credit discrepancy.
- ✓ Less than 10 % report having filed a report to correct the credit error.
- ✓ 10% report that resolution of the credit error was very easy.
- ✓ Almost one-half 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.
- ✓ 75% report they had been delinquent in the past to creditors.

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# Banking Relationship

- ✓ Loans were made to new customers with no previous relationship with the lender approximately 25% of the time.
- ✓ Loans to customers who had previously had a loan with the lending institution occurred over 50 % of the time.
- ✓ Two-thirds of the time the applicant makes the loan request in person.
- ✓ In less than one-quarter of the cases the loan request is made by telephone.
- ✓ In well over 60 % there is only one application made.
- ✓ 20% reported 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.
- ✓ The primary sources of information about borrowing are from local bankers (47.4%), through business relationships (40.3%), followed by friends or business acquaintances (14.6%).

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# Documentation and Evaluation

❖ At one extreme, 27% reported not needing to provide documentation.

❖ 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 %.

❖ In 49.1% of the cases, personal financial records were requested indicating a link between personal financial capabilities of the owner with the firm.

❖ Surprisingly, 43.3 % had no knowledge of how their credit was evaluated.

❖ An overwhelming 84.6 % agreed that the evaluation process was fair.

# Institution of Application

- Over two-thirds of the credit requests were made at "local" TEXAS financial institutions with multi-state banks being the second most approached institutions (26.3%).
- Small businesses also report the use of credit card companies in 15.9 % 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.

# Types of Loans

An examination of the most recent loan applications showed that:

- 46.9 % were for a line of credit, followed by working capital loans for 14.2 % of the respondents.

- Equipment loans (9.9 %) and vehicle loans (9 %) were the third and fourth most common types of loan applications.

## Of those who applied for a loan:

- ✓ Small businesses are generally very successful in obtaining financing.
- ✓ 82 % report they were approved and funded.
- ✓ The approximately one-fifth who were denied credit discontinued credit solicitation 59 % of the time and sought another lender one-quarter of the time (25.3%).

For those denied credit:

- ✓ The major reason given for the denial was poor credit history (31%).
- ✓ Insufficient capital and earnings were cited in 21.9 % and 22.3 % of the cases, respectively.
- ✓ Too much debt also was associated with denial in 22.8 % of the cases.
- ✓ The lack of collateral was reported for 26 % of the respondents.

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# Terms of Credit

- Over 60 % of the loans required some form of collateral.

- Inventory and accounts receivables accounted for 44.2 % of the collateral, followed by vehicles and equipment (43.1 %).

- Business real estate was contributed as collateral in 22.9 % of the responses.

- Other collateral included: personal assets of cash and securities (19.7%), personal real estate (10.3 %) or other personal assets (7.2 %).

- A personal financial statement from the owner was required 49.1 % of the time.

- Additional written agreements were required 21 % of the time as a supplement.

- 44.5 % of the time additional protection (i.e., co-signer or insurance) was required.

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# Loan Terms

•The majority of loan requests were for less than $100,000 (62.4%), with loans between $100,000 and $250,000 making up 19.3 % of the requests.

•A majority of loans are scheduled for repayment in 5 years or less (74.4 %), while 41.6 % are paid off in 1 to 2 years and 32.8 % between 2 and 5 years.

•

•Loan payments are predominantly set for monthly terms (82.9%).

•Fixed interest rates dominate in 58.6 % of the loans obtained with 34.8% reporting variable rates.

- Nearly 7% were unaware of the rate they pay.

•The majority of the loans reported are at an interest rate below 12%, however, a few borrowers reported rates in excess of 12%, high in light of interest rates of the past 3 years, but must be considered with regards to the lending source and individual credit record.

•Over one-third reported they also incurred additional fees.

- Over 10% report no knowledge of fees.

•Almost one-third of the loan recipients, were unaware that loan fees incre the true cost of borrowing.

# Information Sources

- Borrowers find marketing information easy to read (44%)
  *but*
  did not receive any in 30.5% of the cases.

- Disclosures were found to be understandable for a majority of loan recipients.

- For both marketing information (10.6%) and disclosures (14.4%), some respondents did not find the material easy to understand.

# Overall Satisfaction

- Three-quarters of the respondents were either very satisfied (40.2%) or satisfied (36.6%) with the credit they obtained.

- 5% were dissatisfied or very dissatisfied, and approximately one-fifth were neutral about their satisfaction level.

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# Financial Services

- ✓ 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 rely on a host of financial services, many of which require the personal financial statement of the business owner.
- ✓ A business checking account is the most utilized service (93.3%), followed by personal credit cards (68%), and personal checking accounts (52.8%).
- ✓ 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 being employed.
- ✓ The use of new financial services technologies indicates:
  The most common use is for automatic funds transfers (36.5%) and automatic payment services (24.1%).

# Barriers to Obtaining Financing

*Respondents were asked to rank issues and barriers.*

Rigorous lending requirements were assessed as the greatest barrier to borrowing, followed by the cost of obtaining financing, and the feeling that only conventional and SBA loans are available versus alternative financing options.

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.*

Income and property taxes were perceived as significant issues by respondents.

Government regulations and two labor issues -- the quality and costs of labor were also seen as issues among small businesses.

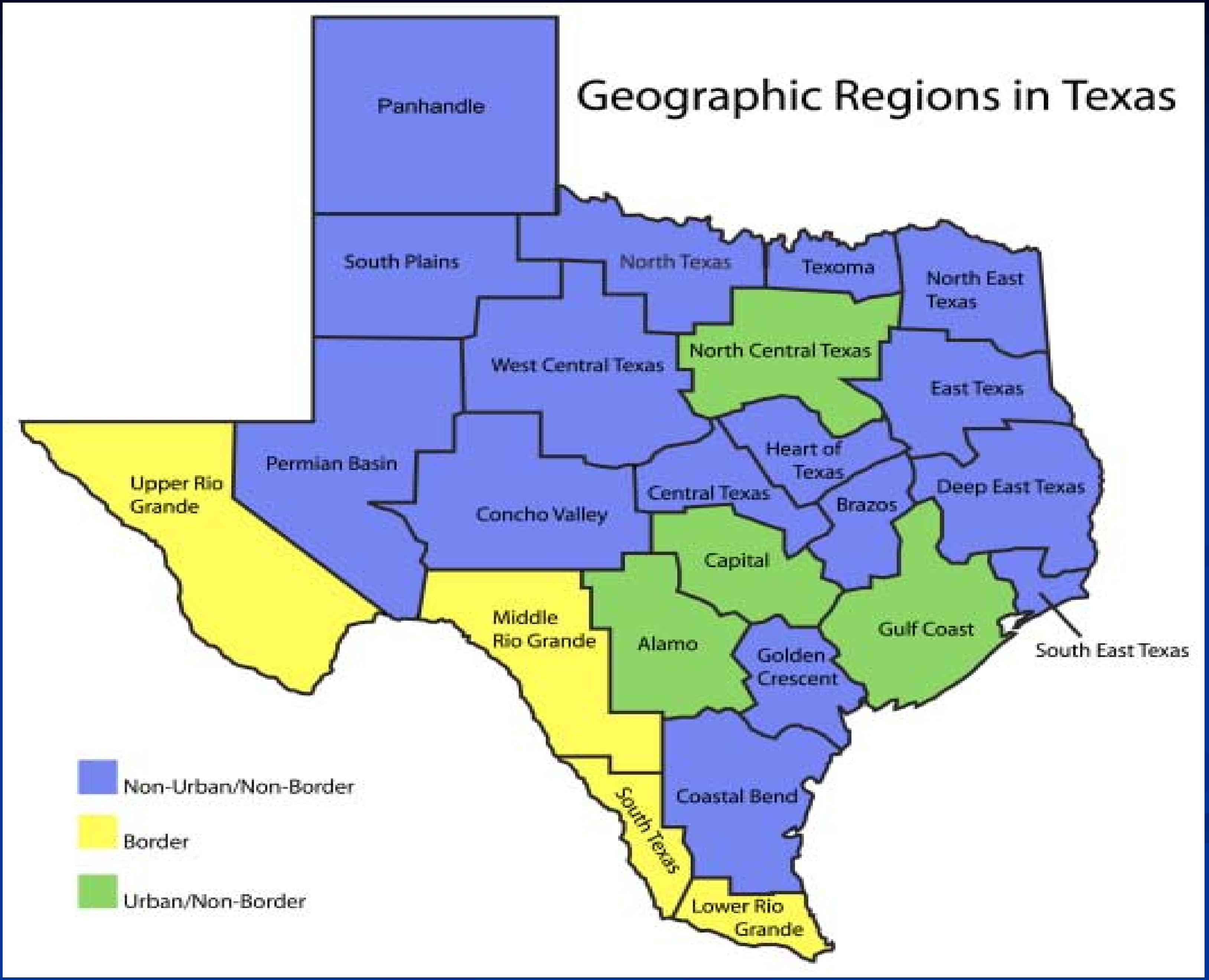
Declining sales and competition from larger firms also draw attention businesses.

Inflation and interest rates are lower in salience relative to other issues.

*In response to these barriers and issues, a series of strategies were proposed.*

Access to more information obtained the highest response.

In general, support for all strategies except access to more information is low.


Geographic Regions in Texas
Panhandle
South Plains
North Texas
Texoma
North East Texas
North Central Texas
West Central Texas
East Texas
Upper Rio Grande
Permian Basin
Heart of Texas
Central Texas
Brazos
Deep East Texas
Concho Valley
Capital
Middle Rio Grande
Alamo
Golden Crescent
Gulf Coast
South East Texas
Coastal Bend
South Texas
Lower Rio Grande
Non-Urban/Non-Border
Border
Urban/Non-Border

# SOURCES OF VARIATION

## Geographic Area

- Minority ownership issues are prominent in the border region;
- Sole proprietorships are more likely outside major urban areas of east Texas;
- Two-thirds of all loans are applied for in urban areas;
- Urban respondents are more likely to be new customers 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;
- 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 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 is higher outside the urban areas.

# SOURCES OF VARIATION

## 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/majority control is more dominant among retail and service businesses;
- The recent loan is likely to be under $100,000 and 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;
- Applications for credit are more likely to be among the retail and service classification;
- In the retail and service, co-mingling of funds between the business and owner is higher;
- Delinquency on a credit agreement is more prone to occur in retail and service;
- Additional protection is more likely for a loan applicant from retail and service businesses;
- Fixed rate loans clearly dominate regardless of industry classification;
- Amount of liabilities are lowest in retail and service sector.

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# SOURCES OF VARIATION
## Minority-Owned Businesses

- Minority-owned firms generate lower gross revenue;
- Minority-owned small businesses appear to be newer;
- Women-owned minority firms are more prevalent;
- 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 occur at a higher rate among minority-owned firms;
- Minority-owned firms take greater advantage of guaranteed loan programs;
- The credit evaluation process is longer for minority applications;
- Minority firms question the fairness of the loan evaluation process at a much higher rate than do non-minority firms,
- 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 firms are not required to provide additional credit enhancements at a higher rate than non-minority small businesses.

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## SOURCES OF VARIATION
## 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;

▪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**
**Scale of Multiple Loan Criteria**

<u>Best Conditions ---------------------------------------------------------------------------Worst Conditions</u>
Monthly Accounting------Quarterly Accounting--------------Year-End Financial----------Year- End
Statement and Taxes Taxes Only

No Delinquencies---------------------------------------------------------------------------------- Delinquencies

Present Customer with ---------------------------- Present Customer --------------------- New Customer
Previous Credit Relationship No Credit Relationship No Credit Relationship

- ✓ 25 percent would appear to have the worst set of conditions confronting them.
- ✓ Approximately one-third would conceivably be in the best position.
- ✓ Approximately one-sixth report the worst case, but did obtain financing.
- ✓ Those who had the highest scores were funded except in less than 2% of the cases.
- ✓ Even with a mixed record across the 3 conditions, funding is likely to occur 6 out of 7 times.
- ✓ The findings suggest that potential borrowers have a chance of obtaining funding and can overcome obstacles related to their past experiences and practices.

# MULTIVARIATE ANALYSIS

Binary Logistic Regression (BLR) was used to estimate a total of 17 equations evaluating the variables of the study in 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:

- ✓ 3 financial predictors play a significant role in determining the probability of loan application approval :
  1. previous relationship with lender;
  2. delinquency record; and,
  3. accounting system

- ✓ Minority ownership at a statewide level does not impact the loan approval.

- ✓ Gender of a firm's owner has no significance upon loan approval/denial rates.

- ✓ The nature of a firm's industrial classification has no significant effect upon approval or denial odds.

- ✓ Legal form of the firm plays no role in determining loan approval rates.

- ✓ Age of the firm is not a significant predictor of loan approval or denial rates.

- ✓ Larger firms gain an advantage with respect to credit obtainment based on revenues.

- ✓ 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.

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