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Statement of

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Mr. Chairman, I am here this morning to discuss the availability of credit to small and minority-owned businesses and to comment on the data collection proposed in H.R. 918.

Small businesses play an essential role in the health of our economy, in the creation of jobs, in the generation of new ideas, and in the competitive process which is so important to a free enterprise economy. Of the 21 million entities that filed business tax returns in 1992, all but 14,000 were small businesses -- using the Small Business Administration's guidelines that define a small business as one with fewer than 500 employees. In fact, the great majority of these enterprises had fewer than 20 employees.

Minority- and women-owned businesses are a growing share of this small business community. In 1987, the latest year for which data are available, it is estimated that there were 1.2 million minority-owned businesses and over 4 million women-owned businesses, an increase of more than 64 percent and 57 percent, respectively, from 5 years earlier.

More significant than the number of small businesses is the contribution that these firms make to economic growth and employment. The Small Business Administration estimates that small businesses account for more than half of private employment and about half of private-sector output. There is no doubt that a vibrant small business community is an essential ingredient for the economic health of our nation, both in urban centers and rural communities.

Banks and Small Businesses

Commercial banks historically have had a crucial relationship with small businesses. The Federal Reserve's 1989 National Survey of Small Business Financing revealed that local commercial banks are the primary suppliers of most financial products used by established small firms. In addition to commercial loans, banks supply other types of credit and lease financing and a wide range of deposit, brokerage and trust services. The lending relationship is especially important to small firms whose access to public capital markets is limited. Data from the 1989 survey indicated that almost half of the external debt financing of small businesses came from commercial banks. In addition, small firms rely on credit from nonbank depository institutions and finance companies, on trade credit, and on loans from family and friends.

Just a few years ago, when the banking industry was under severe stress from problems in real estate and agricultural loans, and lingering problems on loans to developing countries, there were very real concerns about the negative implications for financing small businesses. Commercial bank failures rose sharply in the last half of the 1980s and remained high during the 1990-91 recession; the cost of these failures prompted the Congress and the regulatory agencies to adopt new, more stringent regulatory standards. Many banks undertook major programs to bolster the quality of their assets, restructure their balance sheets, and reduce operating losses, with the result that new lending -- especially business loans secured by real estate -- slowed dramatically. Many long-time customers of banks were unable to renew loans or had credit lines reduced. The severity of the so-called "credit crunch" prompted questions about the longer-term direction the banking system was taking and raised concern about financing for small businesses.

Fortunately, the credit crunch had a relatively short life span. Since 1991, efforts by banks to strengthen operating efficiency and build capital positions have paid off. Over the past couple of years, banks have earned record profits; the industry's rate of return on assets in 1993 was the highest in decades and has declined only a bit this year. Both large and small banks have substantially strengthened their capital ratios; for the industry as a whole, the ratio of equity capital to assets at 7.8 percent and the total risk-based capital ratio of 13.2 percent this year are well above regulatory minimums. Only 36 commercial banks in the U.S. failed to meet the minimum capital standards in June of this year, and only 11 banks have failed in the past 9 months.

The net result is that the credit crunch is no longer the issue. Banks are in good shape to lend, and in the past year have experienced a surge in business loan growth, partly as a result of competitive solicitation. Over the first 6 months of 1994, business loans in the aggregate expanded at an annual rate of 8.5 percent, and growth was even stronger in July and August. The pickup has been apparent at thousands of smaller banks whose loans are made almost exclusively to small businesses, as well as at large domestic and foreign banks. The banks are helping to meet the increased demand for loans as the pace of economic activity accelerated. In addition, the Board's survey of senior loan officers has revealed a fairly general easing of standards and terms for commercial and industrial loans to both small and large businesses over the last year and one-half. Surveys by the National Federation of Independent Business report that credit availability has not been a concern for its members. Its most recent surveys also suggest that borrowing activity has picked up considerably. Thus, when we speak today about the availability of credit to small businesses, it is with a much different perspective -- and a much more positive one -- than two or three years ago.

Credit for Minority-owned Small Businesses

The specific focus of this hearing is on the availability of credit to minority-owned businesses. The committee is responding to reports that creditworthy, minority-owned firms have difficulty obtaining credit and to concerns that lending discrimination is one of the obstacles. The Subcommittee is interested in exploring the extent to which H.R. 918 and other proposals may provide a productive means for addressing these issues.

H.R. 918 would amend the FDICIA to require insured depository institutions to submit annually information on small business and small farm lending in "call reports" provided to the federal banking agencies. The bill would require institutions to provide the total number and dollar amount of loans made, and the total number and dollar amount of applications received for small business loans. Institutions would have to report separately data for five different size classifications of businesses; for example, data would be reported for businesses with annual sales of less than $100,000. Institutions would separately report the total number and dollar amount of loans made, and the total number and dollar amount of applications for commercial loans and commercial real estate loans to start-up businesses, to businesses in operation for less than one year, and to minority-owned businesses.

We can all agree about the importance of ensuring that race and other protected characteristics play no role in the credit process for small businesses. That objective is a sound one. Discrimination in credit decisions has no place in our financial system. Discrimination would directly limit the ability of its victims to own homes, build businesses, create job opportunities, or accumulate wealth. We have taken steps to deal decisively with this problem and to ensure our ability to detect noncompliance. For example, we have been aggressive in communicating our expectations on equal credit opportunity to senior management of financial institutions, have augmented our examination procedures, and have strengthened examiner training. But the effort is not over, and we will continue to search for ways to ensure that markets operate fairly for all.

We are also reviewing what steps can be taken in ensuring that discrimination does not occur in business credit decisions. At the outset, we have to recognize that the "small business" sector is an amorphous concept. The community of small businesses comprises diverse enterprises, with very different financing needs, management skills, and economic prospects. Most small businesses are sole proprietorships, and more than half of those operate in the retail or service industries. Roughly 15 million are self-employed persons, working full-time or part-time, and they include carpenters, doctors, writers, independent taxi drivers, and so on. Only about 6 million businesses have paid employees, most of them employing small numbers of workers. The construction industry accounts for a large share of small businesses outside of the service sector, while manufacturing firms count for only about 10 percent of small businesses.

Given this wide array, the differences among small businesses are likely to be much greater than their similarities. It is important to understand these differences, but unfortunately, there are few existing sources that provide comprehensive data on financial and other characteristics of small firms.

Survey of Small Business Finances

Recognition of the need for more information prompted the Federal Reserve, with support from the Small Business Administration, to undertake this year its second major survey of small business financing. The survey is designed to provide extensive information on characteristics of small business firms and their owners, on their income flows and balance sheets, and on their recent borrowing experiences, including credit sources, recent loan applications, credit history, and the owner's view of credit conditions. By selecting a large sample of 6,000 businesses, we sought to obtain adequate coverage for comparisons of firms in urban and rural areas, in different geographical areas, in different size groups, and among ownership classes. In addition, we are oversampling in order to ensure coverage of minority categories; 1,200 minority-owned businesses will be surveyed.

We expect to obtain a great deal of information about credit needs and about the experiences of small businesses from the survey data. The information will cover not only bank financing, but the substantial portion of small business credit extended by other sources as well. A number of questions on the survey will elicit information about recent credit experiences of businesses, including loan approvals and turndowns, the terms associated with the credit extended or reasons given for denials, and the firm's own assessment of its experience. While a survey of businesses cannot be used to assess an individual bank's lending policies, the data may very well shed light on key factors that enter lending relationships and on similarities and differences among small businesses that seek credit. It may also help us understand better any special needs for, or impediments to, financing of minority businesses.

Regulations Under the Community Reinvestment Act

The Committee also should take note of the interagency proposal published just last week. As you know, the Federal Reserve Board has joined with the other banking agencies in publishing a proposal to amend the regulations implementing the Community Reinvestment Act (CRA). That proposal would require banks and savings associations with assets of $250 million or more (or that are subsidiaries of a holding company with total banking and thrift assets of $250 million or more) to report certain information about small business and small farm loans.

Under the CRA proposal, information would be collected for business loans with an original loan amount of $1 million or less -- and farms loans of $500,000 or less. Institutions would report for each loan made that has a balance outstanding at year-end. Information would be provided on the location of the business or farm (including the MSA, state, county, and census tract) and whether the business' gross annual revenues are $1 million or less.

The agencies have also proposed for comment a provision that would require lenders to ask (in connection with written applications, and for all loans made) about the race and gender of the ownership of small businesses and small farms. Based on this information, institutions would report the number and dollar amount of loans made to small businesses or small farms owned by minorities or women.

Mr. Chairman, the Federal Reserve is absolutely committed to eliminating discrimination, but I must tell you that some Board members have concerns about requiring lenders to ask for and maintain information on the race of business customers. They believe the CRA proposal risks introducing non-economic factors into the credit granting process. Indeed, creditors currently are prohibited from asking for or collecting this type of information. Regulation B (which implements the Equal Credit Opportunity Act) restricts a creditor's ability to inquire about the race, color, religion, national origin, sex, or marital status of an applicant, and has done so since 1976. In essence, the regulation encourages a color-blind, gender-neutral approach in credit transactions by restricting the collection of information that is unrelated to evaluating creditworthiness. The one exception relates to home mortgages, where lenders are required to collect race or national origin for loans to purchase one-to-four family dwellings. The regulation also permits lenders to obtain the information to comply with other statutory requirements, such as HMDA or other federal or state requirements. Nonetheless, the CRA provision for collecting race and gender is part of the package that we have published for comment, and we shall be very interested in the comments that we receive from the public.

Under the proposed regulation, institutions required to collect these data under CRA would make the following information available to the public: (1) the number and amount of the institution's small business and small farm loans located in low-, moderate-, middle-, and upper-income census tracts; (2) the number and amount of the institution's small business and small farm loans located inside and outside the bank's service area; (3) the number and amount of such loans made to minority- and women-owned businesses; (4) the number and amount of such loans to small businesses and small farms with annual revenues $1 million or less; and (5) a list of the census tracts where the bank had outstanding at least one small business or small farm loan. Those statistics appear quite similar to the reporting requirements in H.R. 918. Indeed, the bill's requirements likely would be redundant and confusing if imposed in addition to the CRA requirements.

The outcome of the CRA proposal will not be decided until the agencies have a chance to review and react to the comments received in the next 45 days, but I will touch on some of the pros and cons involved in collecting such statistics this morning. If the data collection proposed in the CRA goes forward, the micro loan data presumably could be aggregated to produce summary numbers for small and minority-owned business loans.

It is not completely clear, however, how such statistics could further the enforcement of fair lending practices. In particular, the number and dollar volume of loans and denial rates provide no information on borrower characteristics and risks of the loans that were made as compared to loans that were not made. (The data also would not provide information about a particular lender's evaluation standards.) If there is a common thread connecting small businesses in the credit process, it is that lending to them is information-intensive. That is, suppliers of credit need to gather an extensive amount of information to evaluate accurately the potential risks and returns on a loan. In addition to a borrower's financial statements, if such exist, a lender needs to understand the markets in which the business operates; to assess the value of assets that may provide collateral; and to make judgments about the financial creditability of the management.

The CRA data could prove useful to the regulatory agencies in evaluating a lender's small business lending--to help determine if the lender is serving the entire community. The data also could be beneficial to institutions by enabling them to measure how successful their small business lending is, particularly if they have set up special programs to better serve women- or minority-owned businesses. Such data could provide a red flag to the agencies suggesting closer scrutiny of an institution's efforts to comply with the Equal Credit Opportunity Act (ECOA).

It is highly unlikely, however, that these data could be used to establish discrimination. Just as the data collected under the Home Mortgage Disclosure Act alone cannot be used to determine if an institution is treating all applicants fairly, the same would be true of data for small businesses. Inevitably, the fairness of a bank's lending decision must be addressed on a loan-by-loan basis and in light of information in the loan files and the bank's lending policies. This is where our compliance examinations come in.

Examinations

Our compliance examiners from the Reserve Banks check for discrimination in small business lending by first reviewing policy documents, loan manuals, and board minutes, and by interviewing bank employees to learn about the bank's lending policies and procedures. Examiners then review forms, applications, and financial statements in the loan files to determine the actual criteria the bank uses to decide who is approved or turned down for credit. In reviewing the data from loan files, they look at both accepted and rejected applicants, and make comparisons among different classes of applicants (for example, based on gender or surname) to see if lending criteria are applied on a consistent basis to all applicants or if certain individuals are treated differently on a prohibited basis. In addition, our examiners often geocode the location of small businesses to determine any geographic patterns to the bank's lending that might assist in determining compliance with fair lending laws.

The necessity of going to the loan files to make any determinations about fairness and compliance with the law is confirmed by our experience with the HMDA data. Our fair lending reviews indicate that observed differences in denial rates, as reflected in HMDA data, frequently are explained by differences in underlying economic circumstances of the borrower or loan contract.

I certainly do not wish to imply that the HMDA data have served no useful purpose. Analysis of these statistics has stimulated lenders and regulators to take a closer look at existing policies and practices and to seek ways to ensure that the administration of lending programs not lead to unintentional discrimination. In many cases, institutions have taken actions that likely increased credit availability to lower income and minority borrowers. For example, many banks have revised underwriting guidelines and created new loan products; they have instituted second review programs; and they have expanded home buyer education programs and credit counseling programs. Indeed HMDA data reveal a marked increase in relative lending to minorities, although differences in denial rates still persist. For example, from 1992 to 1993, home loans to blacks rose 36 percent, to Hispanics 25 percent, and to whites 18 percent. Increases were even larger for low-income minorities. In some cases, efforts to expand lending to minorities, while increasing the volume of such loans, have also boosted denial rates as less qualified persons are drawn into the applicant pool. In this respect, denial rates can be a misleading indicator of a bank's lending efforts.

The overall positive HMDA experience, however, may not be entirely relevant. The process of obtaining a small business loan differs in key respects from that involved in obtaining a mortgage loan. For example, a business may not file a loan application at all or not until several meetings between the loan officer and the small business have established that a loan will be approved. Thus, evaluation of loan denials based on written applications may be misleading.

In addition, evaluating the risk and expected return of a small business loan is far more subjective than for mortgage lending. In the case of mortgages, there are well established and widely followed underwriting guidelines for reviewing creditworthiness, often dictated by a very active and important secondary market. Lenders nearly always require written applications with fully documented financial and employment information. These files provide the basis for assessing differences in treatment. In contrast, the factors considered in credit assessments of small business loans vary widely and involve judgment regarding the future cash flow potential of the enterprise and the skill of management. The credit history of the firm and integrity of its owner frequently play an important role. Collateral also can take any number of forms with a small business loan, most being much harder to value than the land or structures securing a residential mortgage. This makes detecting illegal credit discrimination in small business lending far more difficult than for mortgage credit.

In light of this, I question whether aggregate data about business loans by size and race characteristics of borrower will take us very far in efforts to ensure that fair lending practices are being pursued. And, we must be extremely circumspect about collecting data without a good use for it. The reports that lenders must file are already very burdensome and ultimately increased burden will raise the cost of lending to all borrowers.

Complaints

Our experience in the investigation of complaints in business lending may be helpful to the Committee. The Federal Reserve receives and investigates, through the regional Reserve Banks, complaints from individuals about all types of banking practices and issues that involve a state member bank. This includes complaints alleging illegal discrimination in business or agricultural lending. We have established special procedures for analyzing and investigating all complaints alleging illegal discrimination, to make sure that they receive proper attention. Reserve Bank staff contact the complainant by telephone to clarify the issues raised and to aid in structuring a thorough investigation of the allegations. Often the Reserve Bank makes an on-site investigation, which may be carried out separately or in conjunction with a regularly scheduled examination. The Reserve Bank decides whether an on-site examination is needed in consultation with Board staff, and after reviewing a state member bank's response to the complaint and all relevant information.

Over the past four years, the Federal Reserve investigated approximately 2574 complaints involving credit transactions -- most of which involved issues other than credit discrimination. A very small number involved business or agricultural loans. During this 4-year period, we have received 42 complaints alleging illegal discrimination in business or agricultural lending. Of the 42, 20 involved state member banks and were investigated by our Reserve Banks; four of these investigations are still in process. The remainder of the complaints involved other lenders and were referred to the appropriate enforcement agencies.

One Reserve Bank found a violation of the Board's regulation, in that the state member bank had not given proper notice to the applicant about the credit decision. Of the other 15 cases, the investigation by the Reserve Bank established that the evidence did not support the allegation of unlawful discrimination. The findings indicated, for example, that the actions complained about (the denial of a loan or the closing a line of credit) had been taken for legitimate nondiscriminatory reasons: lack of capital; weak management; inadequate cash flow to support the loan; insufficient tangible net worth; poor credit record, including recorded judgments; concerns about a change of staff and management continuity; declaration of bankruptcy; the fact that the business owner was overextended; etc. It is, of course, difficult to know why we have received so few complaints. But these low numbers do suggest some caution in setting up new data collection schemes.

Promotion of Business Lending

Given the difficulty of detecting unlawful discrimination, other measures that we can take to ensure the availability of credit to small and minority-owned firms assume added importance. In the case of the Federal Reserve, these measures have included a strong focus on working to promote small business lending. Through our Community Affairs program, the Federal Reserve has worked for many years to encourage state member banks and other financial institutions to help finance small and minority business development. Through outreach activities, each Reserve Bank's Community Affairs program works with representatives of small and minority businesses, state and local economic development officials, and federal small- and minority-business development agencies in its district. In some Reserve Banks, Community Affairs staff prepare and publish community profiles that focus on the credit needs and program resources of a given city or metropolitan area. The Reserve Banks' Community Affairs staff also regularly sponsor educational programs and develop publications to assist bankers, community representatives, and owners of small businesses in dealing with issues related to credit needs.

There is also a need to provide information to potential entrepreneurs about how to gain access to credit. To help meet this need the Federal Reserve Bank of New York recently published The Credit Process: A Guide for Small Business Owners. This guide provides extensive suggestions about how to apply for a business loan, and the type of financial and other information banks consider in evaluating a request for such credit. Knowing what lenders look for prior to applying may make a significant difference in the ability to obtain a small business loan. With your permission, Mr. Chairman, I would like to submit this separately for the record.

Conclusion and Comments on Proposed Legislation

What does this all mean for the need for additional legislation to spur data collection, such as proposed in H.R. 918 or in the CRA review process? What information is needed to accomplish our task? What data are feasible to collect?

There is no general agreement on the answers to these questions. As discussed in my testimony, there is much uncertainty about the adequacy, and concerns about the appropriateness, of collecting data on the race of business borrowers. Aggregate data on small business and minority loans may not prove particularly useful in efforts to uncover discriminatory practices because such measures provide no insights into the fundamentals that underlie the loan decision. Such measures may be useful in assessing the community involvement of lending institutions or other indicators, though how they will be used is not clearly defined. The comments that we receive on the CRA proposal may raise other questions or may provide insights into alternative means of gathering useful information. We will weigh such comments carefully.

In the meantime, I would note that the proposed data collection in the CRA seems to closely approximate the general requirements in H.R. 918--albeit details on size breakdowns are somewhat different. Individual loans reported for CRA could be aggregated to produce the type of measures anticipated in the bill. To the extent that definitions of loans and size categories are different in the legislation, it likely would impose an unnecessary and confusing additional burden on banks. In sum, at a minimum we would suggest that the Congress defer consideration of additional data collection pending the outcome of the CRA review.