Photograph by Cambridge Jenkins, IV Age 13

Partners
in community and economic development

Federal Reserve Bank of Atlanta
Volume 8, Number 2

Seeing Things in Black and White

by Courtney Dufries

At first glance, things frequently appear to be so clear. It's right or it's wrong. It works or it doesn't. It's bankable or it's not. But the truth is, there is a lot of gray out there. What may have been right, or would work, or was bankable in the past, may not be so in the future. Upon further review, we sometimes discover a little less black and white and a whole lot more gray.

Community Development professionals recognize that the issues we confront, whether they are social, political, or economic, are often emotionally charged and contain tremendous obstacles. Sometimes we spend so much time "putting out fires" that we lack the time and expertise to thoroughly research the issues that we confront. Fortunately, a great deal of research has now been completed to help focus our attention on the significant issues we deal with every day.

And while the results are very interesting, not everything is black and white.

For example, there is no one reason why approximately twelve million U.S. households are "unbanked," and have no transaction accounts with a mainstream financial institution. But research conducted by Jeanne M. Hogarth and Kevin H. O'Donnell, at the Federal Reserve Board, helps shed light on who is unbanked, why, and what the implications are, especially as it relates to the new focus on electronic benefit transfer payments.

Perhaps it's not surprising that many minority applicants choose to apply for loans from minority banks because they feel a sense of cultural affinity. But are they more likely to be approved or denied the loan? Federal Reserve Board Economists Raphael W. Bostic and Glenn B. Canner present some interesting results in their study, some of which is excerpted here.

Finally, when we review small business loan programs and evaluate where entrepreneurs get their money, we discover some surprising results. A tremendous amount of research conducted by Allen N. Berger at the Federal Reserve Board and Gregory F. Udell, Stern School of Business, New York University provides considerable insight to the economics of financing small business.

This newsletter presents a small sample of the extensive research projects recently undertaken by experts working with the Federal Reserve System, and we sincerely appreciate the authors allowing us to present short excerpts from the research papers. Of course, the views expressed are solely those of the authors and do not necessarily reflect those of the Board of Governors of the Federal Reserve System, or of this Reserve Bank.

And to get the whole story, to get beyond the gray, you should read the entire report. For your free copy of the papers excerpted here, write to Partners at the address shown on the back cover of this issue. ◆

In This Issue

Photograph by Tramaine Colbert Age 17

Being Accountable:
A Descriptive Study of Unbanked Households in the U.S.

by
Jeanne M. Hogarth, Senior Analyst, Consumer Policy, Federal Reserve Board and Kevin H. O'Donnell, Research Assistant, Federal Reserve Board

Nearly 13 percent of households are "unbanked;" that is they do not have transaction accounts offered by the nation's mainstream banking system. This equates to nearly 12 million U.S. households. With the passage of the Debt Collection Improvement Act of 1996, significant numbers of the unbanked will be drawn into the mainstream banking system over the next few years. However, we know little about these households—who they are and why they have no bank accounts. And, as a consequence, we know little about how to structure new types of accounts for these households and what can be done to ease their transition into being account holders.

Background

The Debt Collection Improvement Act requires that all recurring federal benefit payments be made via electronic funds transfer (e.g. Social Security, VA benefits, Government Pensions, Military Pay/Pensions). In response, the U.S. Department of the Treasury has created the Electronic Funds Transfer, 1999 program (EFT99), culminating in the establishment of an "all electronic" Treasury by January 1, 1999.

Most certainly some of the 12 million unbanked households have members who are recipients of federal benefit payments and who will be drawn into the mainstream banking system as a result of ETF99. Many of these individuals will be drawn from the ranks of the low-to-moderate income households that have relied heavily on the Alternative Financial Sector– check cashers, pawn brokers, etc.—for their banking and credit needs. These individuals will benefit from the increased access to and availability of banking and credit services and lower fee structures of the mainstream financial sector (MFS) and corresponding reduced reliance on the AFS.

The MFS will benefit from ETF99 over the next few years in terms of improved efficiency of payments delivery and reduced costs of electronic funds transfers compared to current check clearing processes. Reductions in paperwork will also reduce the administrative costs of the banks thus contributing to great cost efficiencies. Improvements in the secure delivery of funds will cut down on fraud which will result in cost savings for the industry, as a whole. Banks currently lose $70 million annually from forged Treasury checks (U.S. Treasury, 1996).

In return for these administrative cost savings, banks will need to provide accounts for recipients of federal benefit payments covered under ETF99. In 1989, the American Bankers Association estimated that more than 50 percent of commercial banks already offered some sort of basic banking or lifeline accounts (low fee, low balance requirements, limited service accounts), primarily for low-to-moderate income households. Given that substantial numbers of low-to-moderate income households are currently unbanked, it appears that there has been very little marketing of these accounts and many households remain uninformed about them.

In order to formulate a more comprehensive picture regarding the key attributes of the unbanked, the objective of this paper is to explore the demographic characteristics of unbanked households and some of the main reasons they cite as to why they do not have checking accounts. This will provide a framework for future research and studies related to the banking of unbanked households over time and the corresponding ease or difficulty with which this transition will be accomplished.

Results

Of those households without bank accounts, about half (49%) also did not use banks on a regular basis. Higher proportions of minorities (Hispanics, African Americans, and others) were among those who did not use banks. Unbanked females were more likely to not use banks than unbanked males. Unbanked households who do not use banks were slightly younger, had slightly less education, and had lower incomes than their counterparts who use banks. Unmarried, unbanked households were more likely to not use banks than their married counterparts. Unbanked, non-employed households were more likely to not

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Unbanked *Continued from previous page*

use banks than employed or retired households.

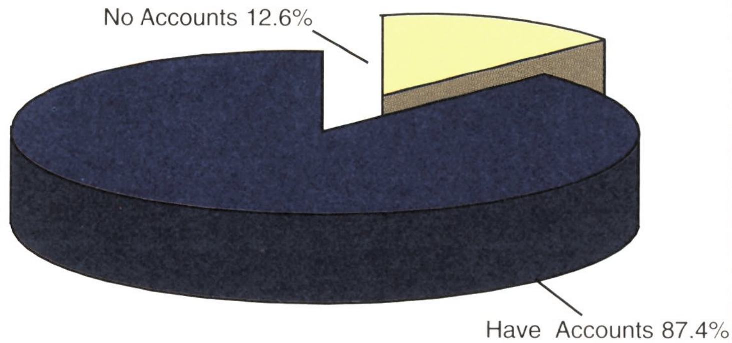
To better understand these "hard core" unbanked households (households with neither a checking nor savings accounts and who do not use banks on a regular basis), we explored the reasons they gave for not having a checking account. The three main reasons cited for not having a checking account were: 1) don't write enough checks (21%), 2) don't like dealing with banks (21%), and 3) don't have enough money (32%). It is interesting to note that a larger proportion of persons who do use banks (versus those who do not use banks) say that the reason they don't have an account is that they don't like dealing with banks.

Relative to the overall proportions of households citing a given reason, Hispanic households were more likely to cite economic reasons while African American households cited a combination of not having enough money and not writing enough checks. Whites and others were more likely to cite "don't have enough money" and "don't like dealing with banks." Women were more likely to give economic reasons (not enough money) for not having an account while men were more likely to say they don't like dealing with banks. Married households were more likely to say they don't like dealing with banks while unmarried households were more likely to say they don't have enough money. Older persons, persons with lower educations, and persons with lower incomes were more likely to say they don't have enough money or they don't write enough checks.

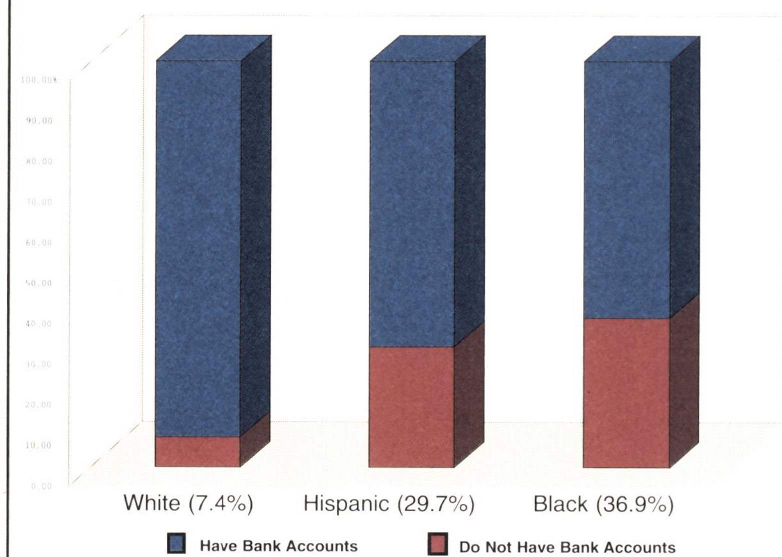
Discussion

The profile of households without bank accounts that emerges from these data is that they are minority, female, young, low income, less educated, unmarried, non-employed with a slightly higher probability of living in the South or South-Central regions. Furthermore, households without accounts who also do not use banks are even more likely to be

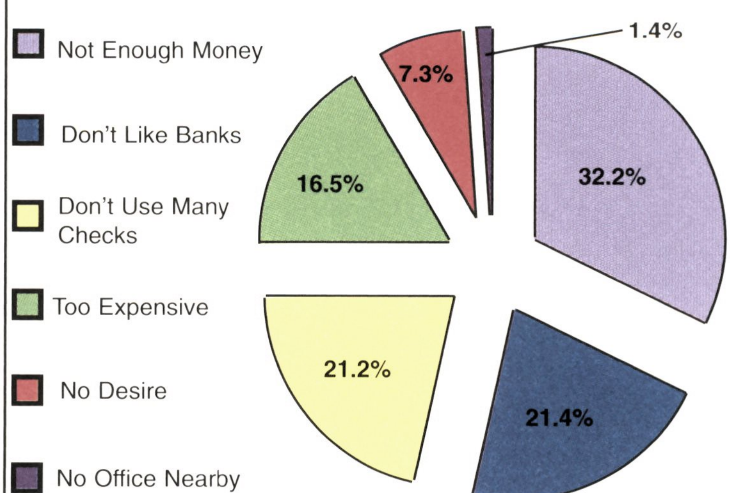
1997 Profile of Bank Account Ownership



Households Who Have No Bank Accounts



Most Common Reasons Cited by Households Without Bank Accounts



Source: Survey of Consumer Finances, 1995

Unbanked *Continued on next page*

Unbanked *Continued from page 3*

minority, female, young, low income, less educated, unmarried, non-employed, and living in the South.

The majority of respondents in the 1995 Survey of Consumer Finances who do not have accounts and do not use banks cited "don't have enough money" or "don't write enough checks" as the main reasons for not having a checking account as opposed to "don't like dealing with banks." Thus, it may not be difficult to draw these individuals into the mainstream banking system with the establishment of basic banking accounts. Given that these households currently are unbanked despite the fact that many banks already offer such accounts, educational efforts are needed to inform unbanked recipients of federal benefit payments about the need to open up bank accounts and the availability of these lower cost types of bank accounts.

Furthermore, these new account holders will need to be educated on how to manage their new accounts. Opportunities for public/private partnerships between community organizations and financial institutions (e.g. trained volunteers to help new account holders balance their accounts at the end of the month) are apparent. This educational effort will require cooperation and the joint sharing of information on the part of federal agencies, state governments, consumer advocacy groups, community based organizations, and mainstream financial institutions.

Conclusion

The advent of ETF99 has implications for financial educators, counselors, and researchers. Financial planning educators will have their work cut out for them as federal benefits recipients begin to set up their EFT99 accounts. As with any new product, consumers may need some help and guidance in learning about account features and which account best suits their needs. Helping households sort through the features and fee structures of these accounts will be key educational objectives for financial educators in the next year.

Equally important will be information on using and managing these accounts. Some accounts may only be accessible through ATM and/or point of sale terminals. Consumers will need to learn not only how to use the technology, but also how to track their withdrawals and about their rights – and liabilities - under the Electronic Funds Transfer Act.

Counselors need to be prepared to help new account holders manage these accounts. Sessions on how to balance your account (whether with or without a checkbook), how to track your spending, or what to do when you're overdrawn are likely to be needed. Some agencies and organizations may want to work with financial institutions in their communities to train volunteers who can be available to ETF99 participants to help them during their first few months of learning how to use their accounts.

Given what we know about the audience (low-income, low education levels, young, female, with a large proportion for whom English is a second language), outreach efforts and education materials need to be specially targeted to these households. This may mean working in conjunction with community groups, parent organizations, churches, and established programs such as WIC and Cooperative Extension's Expanded Food and Nutrition Education Program to reach and teach these clients.

Researchers will need to monitor the progress of EFT99 and help policy makers and financial institutions fine-tune the process and the products associated with the transition. EFT99 will not affect all unbanked households, so there will be a continuing need to update the profiles we've presented in this paper.

This descriptive exploration of the unbanked has shed some light on these households. Those who will be drawn into the banking system due to EFT99 are only a portion of all unbanked households, however. Additional analysis is needed to identify other unbanked households and to understand and address the barriers to banking for these families. ◆

March 8-9, 1999

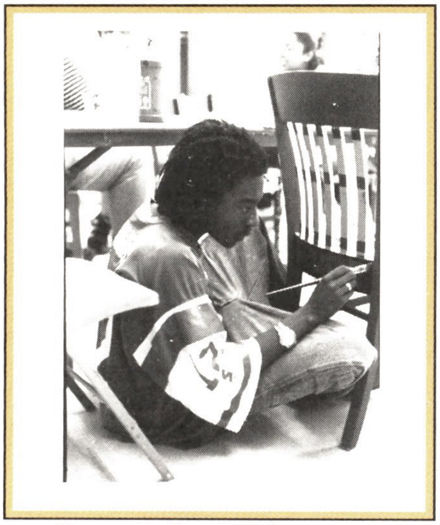
Federal Reserve System

Conference on Business Access to Capital and Credit

Conference Date: March 8-9, 1999
Conference Location: Sheraton National Hotel
(just minutes from downtown Washington, DC)

March 8-9, 1999

The Community Affairs Officers of the Federal Reserve System are jointly sponsoring a conference on topics about various aspects of businesses' access to capital and credit. The academic conference is intended to bring together interested parties from academia, financial institutions, nonprofit organizations, foundations, government, and various regulatory agencies to learn about recent research and to exchange views on directions for future research. The conference will include both panels and individual research papers, with presentations intended for a broad audience. Mark your calendars!



Photograph by Tramaine Colbert Age 17

The Economics of Small Business Finance:

Roles of Private Equity and Debt Markets in the Financial Growth Cycle

by

Allen N. Berger, Board of Governors of the Federal Reserve System and Wharton Financial Institutions Center, and Gregory F. Udell, Kelley School of Business, Indiana University.

This article is an excerpt from a paper that will appear in its entirety in the Journal of Banking and Finance, *Volume 22, 1998, pages 613-73.*

The role of the entrepreneurial enterprise as an engine of economic growth has garnered considerable public attention in the 1990s. Much of this focus stems from the belief that innovation - particularly in the high tech, information, and biotechnology areas – is vitally dependent on a flourishing entrepreneurial sector. The spectacular success stories of Microsoft, Genentech, and Federal Express embody the sense that new venture creation is the key to future productivity gains.

Other recent phenomena have further focused public concern and awareness on small business, including the central role of entrepreneurship to the emergence of Eastern Europe, financial crises that have threatened credit availability to small business in Asia and elsewhere, and the growing use of the entrepreneurial alternative for those who have been displaced by corporate restructuring in the U.S.

Accompanying this heightened popular interest in the general area of small business has been increased interest by policy makers, regulators, and academics in the nature and behavior of the financing growing companies need and receive at various stages of their growth, the nature of the private equity and debt contracts associated with this financing, and the connections and substitutability among these alternative sources of finance.

The private markets that finance small businesses are different from the public markets that fund large businesses. The private equity and debt markets offer highly structured, complex contracts to small businesses that are often acutely informationally opaque. (Informational opacity refers to the limited reports, details, statistics, and news available on small businesses.)

Data on Small Business Finance

Small businesses are generally not publicly traded and, therefore, are not required to release financial information on 10K forms, and their data are not collected on CSRP tapes or other data sets typically employed in corporate finance research. Some data are collected on lending by regulated financial institutions like commercial banks and thrifts, but these data traditionally were not broken down by the size of the borrower. The lack of detailed micro data is one of the reasons that small business finance has been one of the most underresearched areas in finance. However, several data sets have recently become available, including the National Survey of Small Business Finance, the National Federation of Independent Business survey, the Survey of Consumer Finances, the Survey of Terms of Bank Lending, the bank Call Report, and Community Reinvestment Act data sets that all have useful information on small business finance.

The Financial Growth Cycle

Small businesses may be thought of as having a financial growth cycle in which financial needs and options change as the businesses grows, gains experience, and becomes less informationally opaque. As outlined in the chart on page 6, smaller, more opaque firms must rely on initial insider finance, trade credit, and/or angel finance. As firms grow, they gain access to intermediated finance on the equity and debt side and, eventually, they may gain access to public equity and debt markets.

Angel Finance

Angel finance is private investment from high net worth individuals. It differs markedly from most other categories of external finance in that the angel market is not intermediated. Instead, it is an informal market for direct finance where individuals invest directly in the small companies through an equity contract, typically common stock.

Because angels by definition and SEC regulation are high net worth individuals, the increment of funds that an angel wishes to invest in a small firm is often consistent with the amount that the firm needs – typically in a range of about $50,000 to $1,000,000, below that of a typical venture capital investment.

Angels do not always act alone, however. They sometimes work as a small investment group where they coordinate their investment activity. Sometimes this is done in conjunction with a "gatekeeper" such

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as a lawyer or accountant who brings deal flow to the group and helps structure contracts. The angel market tends to be local, where investor proximity may be important in addressing information problems.

Angels sometimes act as active investors, taking on the consulting role of venture capitalists. Frequently, however, angel deals involve a close group of co-investors led by a successful entrepreneur who is familiar with the venture's technology, products, and markets. The advice and counsel they provide to entrepreneurs can be quite important.

Angels often invest in multiple rounds at different stages as the companies they are investing in move through the early stages of financial growth. In comparison to venture capitalists, they demand less control and, on average, bring less financial expertise to the table.

Some attempts have been made to formalize the market, perhaps to reduce the search and information costs that are perceived to be significant impediments to the efficiency of the angel market. One thrust has been to create private angel networks in which entrepreneurs can solicit equity investments by angels who are members of the network.

Typically, the network is operated by a nonprofit, such as a university, sometimes referred to as the "switch". The entrepreneurs solicit private equity by displaying summary information about their firm and their financial needs in the form of term sheets on the network. Angels who have been qualified by the switch can then search the term sheets and identify companies of interest. The angel is then put in touch with the entrepreneur to discuss the investment opportunity. Recently, the Small Business Administration has linked a number of angel capital networks together to form a system called ACE-net. This system permits angels to search term sheets from entrepreneurs across the U.S.

The value of angel networks in general, and ACE-Net in particular is an unresolved issue. The networks are typically subsidized and are predicated on the assumption that there is some degree of market failure in the angel market. However, the informal nature of the angel market may be the optimal solution to the acute information problems associated with early stage new venture financing. The role played by gatekeepers, for instance, may be quite important in reducing information-driven contracting costs. For example, an accountant may have both an entrepreneur and an angel as clients. In connecting the two, the accountant has reputational capital at stake and thus provides some of the services associated with classic intermediation. Whether a more formal market for angel finance can provide an economically significant substitute or addition to the current informal angel market remains to be seen.

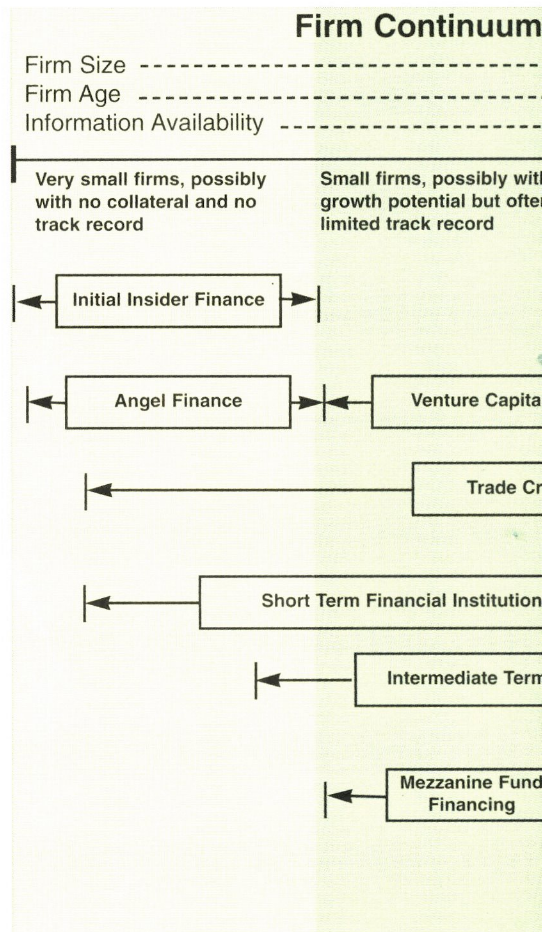
Venture Capital

Unlike the angel market, the venture capital market is intermediated. Venture capitalists perform the quintessential functions of financial intermediaries, taking funds from one group of investors and redeploying those funds by investing in informationally opaque issuers. In addition to screening, contracting, and monitoring, venture capitalists also determine the time and form of investment exit. They are active investors, often participating in strategic planning and occasionally in operational decision making.

About 80% of all venture capital in the U.S. flows through independent limited partnerships, with most of the remaining 20% provided by subsidiaries of financial institutions. In the partnerships, the general partners usually consist of senior managers of venture capital management firms and the limited partners are institutional investors.

The biggest categories of institutional investors are public pension funds (26%), corporate pension funds (22%), commercial banks and life insurance companies (18%), and endowments and foundations (12%). The limited partners typically put up 98% or more of the funds and receive 80% of the partnership's profits. The general partners receive 20% of the partnership's profits plus a fee for managing the fund.

The typical venture capital fund has a 10 year life span. Contract features that characterize venture capital investing include the staging of investments, the control and choice of equity/debt instrument, entrepreneur compensation, restrictive covenants, board representation, and the allocation of voting rights. Venture capitalists often tend to specialize in particular industries where they develop expertise.



The Role of Private Debt Markets in Small Business Finance

As discussed above, the capital structure decision between equity and debt is different for small firms than for large firms in part because small businesses are usually more informationally opaque than large firms. In addition, since small busi-

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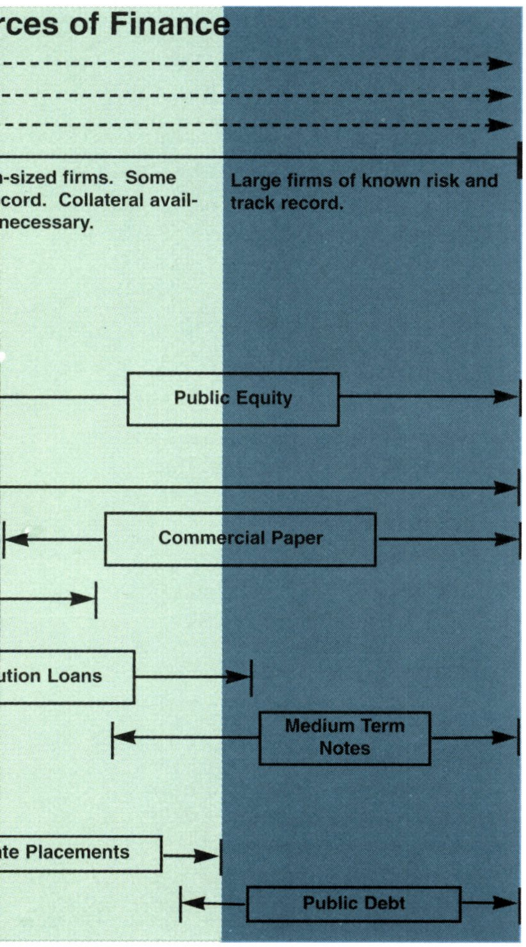
nesses are usually owner-managed, the owner/managers often have strong incentives to issue external debt rather than external equity in order to keep ownership and control of their firms.

Financial institutions account for 26.66% of the total funding of small businesses, or slightly more than half of the total debt funding of 50.37%, with commercial banks providing the lion's share at 18.75%. Nonfinancial business/government debt provides 19.26% of small business funding (mostly trade credit),



and debt owed to individuals accounts for only 5.78% of small business funding.

Trade Credit

A sizable 15.78% of total small business assets are funded by trade credit, as measured by accounts payable at the end of the prior year. Clearly, trade credit is extremely important to small business finance, but has received much less research interest than commercial bank lending, which provides only slightly more credit to small business. Although relatively expensive, a small amount of trade credit may be optimal from the viewpoint of transactions costs, liquidity, and cash management and may help give the borrowing firm and supplier information that helps predict cash flows.

It is not necessarily clear, however, whether working capital finance is best provided by suppliers versus by a financial institution through a line of credit. In some cases, suppliers have advantages over financial institutions because they may have better private information about the small business' industry and production process, or may be able to use leverage in terms of withholding future supplies to solve incentive problems more effectively. Suppliers may also be better positioned to repossess and resell the supplied goods.

Trade credit may also provide a cushion during credit crunches, monetary policy contractions, or other shocks that leave financial institutions less willing or less able to provide small business finance. During these times, large businesses may temporarily raise funds in public markets, such as commercial paper, and lend these additional funds to small businesses through trade credit.

Trade credit that extends beyond a few days of liquidity, however, is often quite expensive. A typical trade credit arrangement makes payment due in full in 30 days, but gives a 2% discount if payment is made within the first 10 days. The implicit interest rate of 2% for 20 days (although it is not always strictly enforced) is much higher than rates on most loans from financial institutions, and so would likely only be taken in cases in which credit limits at financial institutions are exhausted. Since only about half of small businesses have loans from financial institutions, it may be that very expensive trade credit may often be the best or only available source of external funding for working capital.

In the U.S., as a small business ages and its relationships with financial institutions mature – and it presumably becomes more informationally transparent – it tends to pay off its accounts payable sooner and become less dependent on trade credit. Recent evidence from Russia suggests that in developing economies, trade credit provides a signal that leads to more bank credit. This suggests that in economic environments with weak informational infrastructure and less developed banking systems, trade credit may play an even more important role because of its strength in addressing information problems.

Other Funding Sources

Small business debt held by individuals accounts for just 5.71% of small business finance. Most of this (4.10%) represents debt funding from the principal owner in addition to his or her equity interest in the firm. In some cases, these personal loans may be just a convenient way of providing short term finance to the firm, while in other cases, these loans may create tax benefits by substituting interest for dividends.

The amount of funding raised through credit card financing – which has received much press attention as a potential alternative to conventional bank loans – appears to be quite small, just 0.14% of total small business finance. However, this figure may be understated because it includes only the amount of debt carried after the monthly payment is made, neglecting short-term float between the purchase date and the monthly payment. Finally, 1.47% of small business funding is provided by loans from other individuals, most of which is likely from family and friends or other insiders.

Financial Institution Debt

Only a little over half of small businesses, 54.23%, have any loans or leases from financial institutions. Small firms tend to also specialize their borrowing at a single financial institution – only about one third of the borrowing firms have loans from two or more institutions. In 86.95% of the cases, small businesses identify commercial

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banks as their "primary" financial institution, since banks dominate other institutions in providing transactions/deposit services, and also provide most of the loans to the small businesses that receive financial institution credit.

Small businesses tend to stay with their financial institutions. On average, small firms have been with their current financial institutions for 6.64 years, and 9.01 years for their primary institution.

Most of the funds, 52.03%, are drawn under lines of credit. Such loan commitments are promises by the financial institution to provide future credit, and may be used to reduce transaction costs, provide insurance against credit rationing, and other purposes described below. Mortgage loans, the next largest category at 13.89%, may be secured by either commercial property or personal property of the owner. For most equipment loans, motor vehicle loans, and capital leases, the proceeds of the loan or lease are used to purchase the assets pledged as collateral. Secured debt represents 91.94% of all small business debt to financial institutions. This very high percentage implies the vast majority of virtually all types of financial institution loans and leases to small businesses – including loans drawn under lines of credit – are backed by collateral.

In addition, 51.63% of financial institution debt is guaranteed, usually by the owners of the firm. The data suggest that financial institutions use a number of contracting methods like collateral and guarantees, lines of credit, and relationships extensively to deal with the information and incentive problems of small businesses.

Collateral and Guarantees

Collateral and guarantees are powerful tools that allow financial institutions to offer credit on favorable terms to small businesses whose informational opacity might otherwise result in either credit rationing or the extension of credit only on relatively unfavorable terms. These contract features address adverse selection problems at loan origination and moral hazard problems that arise after credit has been granted. Collateral and guarantees may also reduce the cost of intermediation because a financial institution may be able to assess the value of pledged or guaranteed assets at a lower cost than it can assess the value of the business as a going concern.

Guarantees give the lender general recourse against the assets of principal owner or other party issuing the guarantee for deficiencies by the firm in repaying the loan. A guarantee is similar to a pledge of outside personal collateral, but differs in two important ways. First, a guarantee is a broader claim than a pledge of collateral, since the liability of the guarantor is not limited to any specific assets. Second, a guarantee is a weaker claim than a pledge of collateral against any given set of assets, since a guarantee does not involve specific liens that prevent these assets from being sold or consumed.

Both guarantees and outside personal collateral may provide powerful incentives for the entrepreneur to behave in a way that benefits the beneficiary creditor (often to the detriment of other creditors) when the business is in distress. This incentive depends more on the importance to the entrepreneur of losing the assets than on the value of the assets to the lender in the event of default. Therefore, a guarantee or pledge of personal collateral from an entrepreneur with only a modest amount of personal wealth may still provide a strong incentive that benefits the lender, even if recourse against these personal assets represents only a small fraction of the value of the loan. Personal outside collateral and guarantees, while commonly used by small businesses, are rare for large firms. An owner of a large corporation rarely has enough wealth to back the debt of the firm or owns a large enough share of the firm to want to back the debt personally.

Many small businesses pledge accounts receivable and/or inventory as inside collateral to secure lines of credit in which the amount of credit granted fluctuates with the value of qualifying receivables/inventory. This may be especially useful to the lender when the borrower is an informationally opaque firm because the lending institution's risk exposure is not as closely tied to the uncertain future cash flows of the firm as in other types of lending. The monitoring of receivables and inventory may also produce valuable information about future firm performance as well as information about the value of the collateral and, therefore, be used as part of an overall relationship that may lead to more favorable credit terms in the future.

Outside personal collateral and guarantees are also important to the financing of small firms that have few pledgeable business assets. About 40% of small business loans and close to 60% of loan dollars are guaranteed and/or secured by personal assets. Personal guarantees and pledges of personal assets may be seen as substitutes for an injection of additional equity by the owners. Under most circumstances, financial institutions would offer better terms if the same amount of equity were added to the firm, which would save the costs of pursuing recourse against personal assets in the event of financial losses. However, these extra costs may be offset by some benefits for the owner of personal collateral and guarantees, such as better convenience, lower transactions costs, or better diversification, rather than liquidating personal assets and investing the proceeds in the business.

Loan Commitments/Lines of Credit

Most small business debt held by financial institutions is under lines of credit, which is a form of loan commitment. The financial institution is obliged to provide the credit unless the borrower's condition has suffered "material adverse change," or if the borrower has violated a covenant in the contract. Lines of credit are generally pure revolving facilities that allow the firm to borrow as much of the line as needed at any given time during the specified term.

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Flexible and convenient for the borrower, lines of credit are usually used to provide working capital, rather than to fund specific large investments.

Loan commitments provide protection for the borrower against having their credit withdrawn in instances of credit rationing or credit crunches that are based on general market conditions, rather than specific, identifiable, legally defensible deteriorations in the individual borrower's condition.

Debt Covenants and Maturity

Restrictive covenants and choice of maturity dates are other tools financial institutions use to solve the informational opacity problems of small businesses. In part, covenants are designed to give the financial institution more control by requiring the borrower to return to the institution to renegotiate covenants when strategic opportunities arise or when the financial condition of the firm changes. The strictest covenants are usually placed on firms with the greatest credit risk and greatest moral hazard incentives.

A borrower can request a waiver when a covenant prevents the firm from engaging in a new activity. Renegotiation around the waiver allows the lender considerable control over whether the new activity will be undertaken and under what terms. This control can be an effective monitoring and stabilizing tool, although it can put the financial institution in a position of negotiating for higher rates or other concessions. The market limits the control by the financial institution, however, because most commercial bank loans can be prepaid without penalty, so borrowers have the option of obtaining more accommodating finance elsewhere. In addition, a financial institution has an incentive and ability as a repeat player to maintain a reputation for fairness in renegotiation.

Covenants are common in commercial bank loans and are generally stricter than those in private placements and much stricter than those in public bonds. In part, this reflects the comparative advantages of financial institutions in renegotiating and selectively relaxing these covenants. The covenants in bank loans and private placements are usually set sufficiently tightly that renegotiation is likely. One study found that 57% of private placements required renegotiation one or more times over the maturity of the contract. While no hard data is available on the frequency of renegotiation for bank loans, anecdotal evidence suggests that bank loans with covenants are renegotiated even more frequently.

While the use of covenants on small business loans is a very under-researched field, the evidence of the use of covenants in bank lending to larger firms confirms the positive role of covenants in bank loan agreements in making external funding available at reasonably low cost. Bank loans and commitments to mid-sized and large firms that were syndicated most broadly tend to carry the most covenants, suggesting that covenants play a positive role in assuring other syndicate members that sufficient controls on firm behavior are in place, or that members will be informed of changes in borrower condition when covenant waivers are negotiated.

The choice of debt maturity is similarly used by financial institutions as a contract feature to address control and information problems. The longer the agreement, the greater the opportunity for the borrower to alter its risk profile and/or suffer financial distress; hence, maturity can be viewed as a particularly strong type of covenant. With a sequence of short-maturity credits, a lender can force renegotiation frequently. By contrast, with covenants renegotiation can only be triggered by those covenants outlined in the loan agreement. One reason that smaller firms typically have less access to longer maturity debt is that they tend to be more informationally opaque and risky than large firms. In addition, because small firms do not have audited statements, it is difficult to impose ratio-related financial covenants that typically accompany intermediate and long term bank debt.

Relationship Lending

A final tool used by financial institutions to address the information problems of small business is relationship lending. Information is gathered through continuous contact with the firm and entrepreneur, often through the provision of multiple financial services. The information gathered in conjunction with a series of loans may include a repayment history, periodic submissions of financial statements, renegotiations and other visits with management. Deposit accounts provide information in the form of balance information, transactions activity, payroll data, etc. Information about the quality of the entrepreneur can also be culled from the provision of personal loans, credit cards, deposit accounts, trust accounts, investment services, etc., and from other business dealings or personal contact outside the firm. Knowledge of the local community gained over time may also allow the bank to judge the market in which the business operates, to obtain references and feedback on borrower performance, and to evaluate the quality of the firm's receivables. This information is then used to help make decisions over time about contract terms and monitoring strategies. Relationship lending can have a number of benefits to small business, including lower cost or greater availability of credit due to efficient gathering of information, protection against credit crunches, or the provision of implicit interest rate or credit risk insurance.

Summary

While research has begun on the topic of small business finance, more remains to be done. Our analysis of the financial growth cycle and the interconnectedness of small firm finance suggests that some of the most exciting areas for future research may involve investigating how sources of small firm finance may change over the business cycle, in reaction to changes in government policy, during times of distress in private or public markets, and as information processing technology continue to improve.

Photograph by Adria Wiggins Age 16

Do Minority-Owned Banks Treat Minorities Better?

An Empirical Test of the Cultural Affinity Hypothesis

by

Raphael W. Bostic, Economist, and Glenn B. Canner, Senior Advisor, Board of Governors of the Federal Reserve System

National data on the disposition of applications for home mortgages reveal wide disparities in rejection rates among racial and ethnic groups. One theory offered to explain these disparities is the "Cultural affinity hypothesis," developed by Calomiris, Kahn, and Longhofer (1994). This hypothesis posits that lenders find it easier, and therefore less costly, to evaluate applicants "like them" than applicants with different backgrounds. Regarding mortgage rejection differentials, then, the cultural affinity hypothesis suggests that lenders at white-owned banks reject minority applicants more often because they have more difficulty precisely estimating the credit risks they represent.

Recently, Black, Collins, and Cyree (1997) found that black-owned banks are more likely to reject black applicants than white-owned banks with similar characteristics. On its face, these results appear inconsistent with the cultural affinity hypothesis. However, these findings do not necessarily refute the notion of cultural affinity. Rather than occurring only on the part of lenders, cultural affinity might play out among applicants as well.

Minority applicants may feel more comfortable applying for mortgages at minority-owned banks, which could result in a relatively large volume of marginally qualified minority applicants at minority-owned banks. In such a case, minority-owned banks could have higher rejection rates of minority applicants than white-owned banks, even if only minority lenders exhibit cultural affinity or if lenders of both races applied the same underwriting standards.

This paper provides empirical tests which identify and separate the potential effects of applicant-driven and lender driven cultural affinity. Applicant-driven cultural affinity is tested by searching for differences in the applicant pools of minority-owned and white-owned peer banks.

Our methodology for studying lender-based cultural affinity is similar to that used in Black, Collins, and Cyree (1997), but it differs from theirs in important ways. First, we use a sample selection methodology which avoids the potential confounding of the two cultural affinity effects which might arise if applicants across banks differ systemically in their general characteristics. This approach thus permits a more direct test of the existence of lender-based cultural affinity.

Second, we test for whether the theory applies differently across races by conducting the analysis for both blacks and Asians. Lender-based cultural affinity among Hispanics could not be evaluated due to a small number of Hispanic-owned banks.

We find strong evidence suggesting that cultural affinity operates through applicants as, after controlling for non-ownership bank characteristics, black-owned and Asian-owned banks are significantly more likely to receive applicants from blacks and Asians, respectively. Interestingly, the data suggest no affinity between Hispanics and bank owners at either black-owned or Asian-owned banks.

The evidence also suggests that affinities are individual-based rather than geography-based, as no relationship is observed between application rates and the percentage of the local population that is minority. In contrast to the result for applicant-based cultural affinity, we find no evidence that lender-based cultural affinity exists. After accounting for differences in the applicants' pools, whites, blacks, and Asians all largely face the same likelihood of rejection at black-owned, Asian-owned, or white-owned peer banks.

Conclusion

The cultural affinity hypothesis has been offered as one explanation for observed racial disparities in mortgage lending. According to this theory, lenders are better able to assess the riskiness of applicants with similar backgrounds, which results in these applicants facing more favorable underwriting conditions relative to members of other ethnic groups and backgrounds.

Additionally, although the cultural affinity hypothesis was introduced in the context of lender behavior, it

Continued on next page

Minority Banks

Continued from previous page

may also be more relevant for applicants. In particular, applicants may be more likely to apply to banks owned or operated by members of their ethnic group, for comfort reasons or because they believe their chances for acceptance are enhanced at such institutions.

In this paper, these arguments are evaluated by comparing the characteristics of applicant pools and application approval rate patterns for minority-owned banks and white-owned peer banks. The evidence is consistent with the view that cultural affinity occurs among mortgage applicants, as minorities are significantly more likely to file applications at minority-owned banks than at white-owned peer banks. This affinity appears to be quite specific among minorities, as only Asians are more likely to apply to Asian-owned banks and only blacks are more likely to submit applications at black-owned banks.

No"across-race" affinity is observed. Also, we find no evidence of "neighborhood-based" applicant-driven cultural affinity. Application distributions at minority-owned and peer banks do not vary significantly with the minority composition of the neighborhood. Regarding lender-driven cultural affinity, however, the evidence is not supportive of the theory.

Like Black, Collins, and Cyree (1997) we find no evidence that black-owned banks treat black applicants better than their white-owned peer banks do or that Asian-owned banks treat Asian applicants better than their white-owned peer banks do. Unlike those authors, however, we find no evidence that they systemically treat minorities any worse either. Consistent lender-driven cultural affinity does not appear to exist.

Overall, our results differ from those of Hunter and Walker (1996), who find evidence consistent with the existence of lender-based cultural affinity. However, their approach differs from ours in that they do not attempt to control for differences in the applicant distributions or in lender characteristics, both of which we do using matching procedures. As we have shown, these differences can have an important effect on observed outcomes. In particular, they tend to attenuate observed behavioral differences.

An important *ex ante* assumption underlying our interpretation of the results is that underwriting standards for institutions operating in the same market do not vary with the race of the bank's owners. The evidence offers general support for this assumption. Within a given market, applicants with similar characteristics received the same treatment on average, regardless of the characteristics of a bank's ownership. This is consistent with the notion that bank underwriting standards are based on objective measures of risk and that more subjective factors which might come into play, such as cultural affinity, do not significantly influence underwriting decisions.◆

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As Seen By Teens **is a summer photography program sponsored by Nexus Contemporary Art Center which teaches young people the skills of photojournalism while enhancing their talent and imagination through creative exercises. The program, among the many supported by the Coca-Cola Foundation, enrolls fifteen students from Fulton County, Georgia to teach photography and journalism skills while creating an awareness of both self and community. We are pleased to present some of that remarkable work in this newsletter.**

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CALENDAR

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SEPTEMBER

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Sept. 10-12 San Diego, CA: Economic Development Finance. Sponsor: National Council for Urban Economic Development.
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Sept. 15 Richmond, VA: Accessing Capital: Start to Finish. Sponsor: Federal Reserve Bank of Richmond. Note: This conference will be repeated September 22 in Charlotte, NC; September 28 in Washington, DC; October 5 in Charleston, SC; October 27 in Baltimore, MD; and October 28 in Charleston, WV.
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OCTOBER

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Oct. 8-9 Denver, CO: Equity for Rural America: From Wall Street to Main Street. Sponsor: Federal Reserve Bank of Kansas City.
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