WOMEN AND MINORITY OWNED BUSINESS ENTERPRISES INVESTMENT BANKING CONFERENCE

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Access to Capital for Women- and Minority-Owned Businesses

As many of you know, the Federal Reserve's overall mission is to foster financial conditions that allow for maximum sustainable economic growth with price stability. At a macro level, we fulfill this goal through monetary policy. But, monetary policy is a blunt tool—it doesn't give us the ability to focus on improving conditions in specific regions and sectors of the United States economy. When we at the Chicago Fed want to focus on local economies, we have to turn to approaches other than monetary policy.

One approach is working to address a number of credit issues that directly affect regional communities and enterprises. Our goals here are to promote fair and equal access to credit and, more broadly, financial empowerment, so that any person can participate fully in the economy. In the past we've worked on issues such as affordable housing, predatory lending and—the issue that brings us here today—small business access to capital and credit.

Small businesses play a critical role in the national economy—more than half of the nation's jobs are in small businesses. Because of that, the Federal Reserve has an ongoing interest in small businesses' access to capital and access to credit, so they can expand and contribute to the economy's growth.

By extension, we have an ongoing interest in seeing that businesses owned by women and minorities have adequate access to capital and credit. These businesses are some of the fastest growing segments of small businesses. A recent study of Blacks, Asians, and Hispanics found that these groups tend to start their own business to a greater degree than non-minorities. According to the Kauffman foundation, Black and Hispanic men with a graduate education are more than twice as likely as white men with graduate education to start a business.

But businesses owned by women and minorities remain relatively small, undercapitalized, and underrepresented in the more capital-intensive sectors of the economy. Greater access to capital and credit are widely reported to be the number one obstacle to faster growth for these firms, with greater access to opportunities in the corporate supply chain a close second.

So today, I'd like to share some of our observations on small businesses in general and the unique needs of small businesses owned by women and minorities. And I'd like to tell you about our activities as a bank supervisor and our activities as a catalyst to assist these businesses.

In order to help us understand the nature and needs of small businesses, the Federal Reserve periodically collects detailed information on financial and other characteristics of a nationally representative sample of businesses. The most recent Survey of Small Business Finances revealed a number of interesting facts. For example:

- Small business firms rely heavily on commercial banks at every stage of growth, because they have less access to public investment markets. In fact, commercial banks are the single most important source of financing for most small business firms.

- Small businesses' relationship with their bank continues to play an important role in commercial bank lending.

- Banks rely more heavily on financial information about the owner when they make small business lending decisions.

The survey also reveals some distinctions in the access to capital for businesses owned by women and minorities:

- Firms owned by Blacks tend to have younger owners who have fewer years of experience and poorer credit histories.

- Compared to men, women rely more on personal credit cards and capital from friends and family to finance their business.

- Firms owned by minorities, particularly those owned by Blacks, are far less likely to obtain credit from financial institutions, even after considering differences in size, maturity, and invested capital.

More generally the survey suggests that businesses owned by women and minorities tend to be undercapitalized relative to other businesses, something we hear anecdotally from many sources.

Any firm with limited access to capital and credit faces limited opportunities. For example, minority-ownership tends to be concentrated in industries, such as services and retail trade, where capital expenditures for equipment are very low, and under-represented in sectors, such as manufacturing, which require greater capital investments.

Perhaps this is why minority firms are smaller—both in terms of annual revenues and the number of employees. According to the Minority Business Development Agency, the average minority-owned firm has only half the annual revenues and only ⅔ the number of employees as the average non-minority owned firm.

Of course, part of the solution to enhancing credit to underserved communities involves understanding the entire lending process. From the lenders' side, the obstacles to small business lending can be formidable.

There are a number of reasons why lending to a small business—regardless of the race or gender of the owner—is challenging for banks. Small businesses are very susceptible to swings in the economy and have a much higher failure rate than larger operations. The extreme diversity of small businesses and the diversity of their uses of borrowed funds make it hard for banks to develop general standards for assessing small business loans. In addition, small businesses have less extensive, and sometimes less reliable, financial information for banks to base their lending decisions. And even after a loan has been made, small business loans require more active monitoring than loans to larger firms. But in spite of these obstacles, many banks conduct small business lending safely and profitably. Also, recent trends—such as the use of credit scoring and increased non-bank competition for small business loans—should favorably affect the cost and supply of credit to small businesses.

As a bank supervisor responsible for the safety and soundness of banks, the Federal Reserve wants banks to get their credit decisions right. We'd like them to have appropriate credit standards—not too loose and not too tight. We don't want banks to fund businesses that are not sound—that could lead to loan losses that might undermine bank earnings and capital, as well as potentially lead to losses for depositors. We also don't want banks to deny credit to sound businesses—that way, banks could lose potentially profitable opportunities, and the economy as a whole could suffer.

One thing that can distort credit decisions is discrimination. The Federal Reserve is responsible for promoting fair and equal access to credit. We keep a watchful eye out for evidence of non-financial factors that lead to persistently different credit access for businesses owned by women and minorities. Any discrimination by lenders to small businesses, in addition to being inequitable, would restrict the flow of capital, leave viable economic activity under-funded, and reduce the performance and efficiency of the markets in which they operate. We at the Federal Reserve will continue to examine banks to ensure that they are complying with fair lending laws and that they are operating in a safe and sound manner.

Beyond our supervisory role, we conduct research related to the availability and constraints on credit for small businesses. For example, we researched small businesses in two minority neighborhoods—a Black neighborhood and a Hispanic neighborhood—to see how they financed their businesses and how they used trade credit. We found that these small businesses use informal networks to finance and grow their businesses. We also found that they make little use of trade credit.

We are also actively involved in a number of efforts to help expand the supply of credit available to women and minorities, including the CDFI network and the federal government's New Markets Tax Credit program. CDFIs, or community development financial institutions, are directly relevant to today's discussion. A CDFI is a private organization whose primary mission is to provide loans to or invest in underserved communities and markets.

In order to sustain their role in the economy and lessen their need for subsidies, CDFIs are expected to earn profits. However, they are not profit maximizing. CDFIs take big risks, have flexible underwriting policies, provide additional technical assistance, and sometimes offer below-market terms, so their returns are not as high as traditional financial institutions'. Rather than pursuing high returns, the CDFIs' most important goal is to serve consumers and businesses once considered 'high-risk' or 'unconventional' and help them move into the financial mainstream. We at the Federal Reserve fully support this goal. There are 37 CDFIs certified in Illinois, many of which offer small business loan products and support services. In 2003 alone, seven of the CDFIs in Illinois made nearly 200 business loans totaling $6 million, and their portfolios at the end of year included 345 business loans.

Our staff has also been working to promote the federal government's New Markets Tax Credit program, which supports small businesses in low-income communities. In the last two years, over $1.9 billion in equity has been invested in low-income communities through the program. Nearly half the investment has come from regulated financial institutions, the rest from investment bankers and corporate investors. At the Chicago Fed, we've helped stimulate local involvement in both of these programs by hosting workshops, publishing articles, and contributing to other activities related to the programs.

We are also involved in efforts to expand the business opportunities available to women and minorities. The Federal Reserve Banks of Chicago and Boston have partnered with the Business Roundtable and others to address minority supplier development issues in a comprehensive manner. Minority-owned companies in America's urban centers present opportunities for corporations to strengthen their supplier networks. These emerging markets also offer corporations one of the last, untapped growth opportunities in domestic markets. As many of you know, the Business Roundtable is an association of CEOs from the nation's leading corporations, so they are a valuable partner to have in this effort. Our other partners include the Minority Business Roundtable, National Urban League, National Economic Council, Urban Entrepreneur Partnership, Ewing Marion Kauffman Foundation and the BusinessLINC Coalition.

Over the next three years, we are co-sponsoring the Promoting Economic Growth and Corporate Leadership series. This year, at an event on June 9 and 10 at Northwestern University, we will focus on the role of corporate executives and board members in minority supplier development strategies. In 2006 and 2007, we will co-sponsor other events on this important topic.

Finally, as I mentioned earlier, good credit and strong personal finances are often factors in determining a small business's access to capital. We're actively involved in promoting personal financial education to anyone who is interested—not just small business owners. One of our biggest efforts is Money Smart week, which devotes one week each year to highlight financial education programs offered by financial institutions, schools, non-profits, and government. This year's Money Smart Week in Chicago is May 23 to 28; and we also have a Money Smart Week in Detroit from April 17 to 26.

If you want to learn more about the various programs and vehicles that are available to small businesses, I encourage you to read the Federal Reserve Bank of Chicago's publication, "Profitwise News & Views." Copies are available at this conference, and you can find archives and subscription information on our website, chicagofed.org. In fact, you can find information about all of our programs—including the series we are co-sponsoring with the Business Roundtable—on our website under the heading of community development.

In closing, demographic and economic trends at both the national and local levels argue for continued vigilance and supportive intervention in assuring full credit opportunities for small businesses owned by women and minorities. Our nation's economic progress has long been shaped by our entrepreneurial spirit. By ensuring that every small business owner has equal access to credit and business opportunities, we will promote continued and wide-spread prosperity within our local and national economies.