

Comptroller of the Currency
Administrator of National Banks

# Small Business Banking Issues

A National Forum
Sponsored by the
Office of the Comptroller of the Currency

Renaissance Washington Hotel
Washington, D.C.
February 5, 1998

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# Acknowledgments

The Office of the Comptroller would like to express its appreciation to the speakers at the Small Business Banking Issues Forum, whose presentations are summarized here. Appreciation is also extended to the forum attendees, listed in Appendix A of this publication, for their questions, comments, and experiences shared about small business banking.

The project was developed to enable bankers and small business owners to learn about successful programs, techniques, and strategies relevant to small business banking that could be replicated in their own communities.

OCC staff contributing to the planning and conduct of the forum included: Janice A. Booker, director, Community Development Division (CDD); Yvonne McIntire, senior attorney, Community and Consumer Law; Denise Kirk-Murray, community reinvestment and development specialist, Community and Consumer Policy Division; Alfred T. Mitchell, community development specialist, CDD; Glenda Cross, director, Minority and Urban Affairs; John Turner, national bank examiner, Credit Risk; and Jacquelyn C. Allen, community development specialist, CDD. Lillian M. Long, program coordinator, CD Investments Program, CDD, served as project leader. Administrative assistance was provided by Tawanda Hudge and Lisa Hemphill, CDD. The Communications Division, particularly Amy A. Millen, senior editor, and Rick Progar, publications liaison officer, helped to bring this publication to fruition.

The OCC welcomes your comments or questions about this publication. Please write to the Community Development Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219, or call (202) 874-4940. You are encouraged to visit the OCC Web site at <http://www.occ.treas.gov>.

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# 1. Introduction

The National Forum on Small Business Banking Issues, convened by the Office of the Comptroller of the Currency on February 5, 1998, provided a look at substantive and innovative issues affecting today's small business banking market. Forum participants shared valuable information and engaged in lively discussions about successful small business banking initiatives. The forum reflected the continuing demand and interest in small business lending and emphasized many diverse ways to ensure the realization and continuation of entrepreneurship in the new millennium. This publication summarizes the forum for the benefit of bankers, bank examiners, and others interested in small business banking opportunities.

A recent survey revealed that 87 percent of all small business owners have developed a relationship with a commercial bank. By the end of 1997, those banks were responsible for more than 60 percent of all small business credit and more than half of all loans used to finance the purchase and lease of equipment and vehicles by small firms. Commercial banks hold most small business checking accounts and perform a variety of critical financial functions — managing cash, providing accounting services, issuing letters of credit, safekeeping valuables, and conducting many other financial and fiduciary services — for small business firms.

In recent years, many large banks have targeted the small business market aggressively and developed innovative ways to serve its needs. Some banks introduced small business resource centers, which offer one-stop shopping for a wide range of products and services. Banks also created innovations in lending that have reduced paperwork and costs for both lenders and small business borrowers. For example, small business loans of nearly $1 million are offered through direct mail. Credit report data is linked directly to a computer model that establishes a maximum loan amount and interest rate. No business plan or other financial data is required.

Banks recognize that small businesses often need diverse credit types or structures, including secured and unsecured lines of credit and flexible credit terms. New or expanding small businesses, in particular, may require equity capital and technical assistance on financial management issues. An increasing trend exists among banks to establish community partnerships to make credit more available to small businesses, even though many financial institutions continue to pursue small business lending without external partners. Banks participate with government agencies, such as the Small Business Administration, community organizations, national intermediaries, and other banks to create efficiencies and to mitigate risks associated with small business lending.

***The OCC is optimistic that financial institutions will continue to make small business banking an integral part of their business strategy.***

The OCC is optimistic that financial institutions will continue to make small business banking an integral part of their business strategy. Banks know that small businesses can be excellent bank customers. Entrepreneurs place a premium on convenience and are more likely to conduct all of their banking business with their primary lender and to purchase ancillary financial products and services where they bank. Despite the relatively high small business failure rates, small business loans tend to be better collateralized than many other kinds of loans and their repayment histories compare favorably with other classes of borrowers.

*The Community Development Division develops policies and procedures for national banks' economic and community development activities and approves bank investments in community development corporations, projects, and financial institutions. The division also works with national community and economic development groups and monitors banks' innovative community development lending and investing activities.*

We put most of the emphasis on local community development loan funds, community development banks, and similar organizations carrying out the program. Those organizations originate and underwrite loans and advance funds to borrowers. They can act as subservices, but they do not have the money to act as credit supporters or to provide liquidity in the marketplace. Essentially, they find the borrowers, package the loans, make the loans in accordance with agreed upon underwriting standards, and fund the loans.

My favorite part of this partnership is loan securitization. We have asked a couple of cities to create a "secondary market" organization, using existing loan assets. This corporation essentially buys loans from the originators, packages them into securities, and resells the senior piece of the securities to the banks.

***With respect to CRA, they can meet the investment test or the lending test, whichever test they wish to meet.***

Securitization transactions involve putting the loans in a pool or in a trust and dividing them into two pieces. You have $10 million in loans. You divide the loans into two pieces, a senior piece and a junior piece. The senior piece has a priority on the cash flows of a pool of loans, and the junior piece has subordinate interest. We want the banks to invest in the senior piece, and the conduit or someone else to hold the subordinate interest. The result is a system that places the banks in three roles with which they may be comfortable: originating loans, funding loans, and investing in senior securities. With respect to CRA, they can meet the investment test or the lending test, whichever test they wish to meet.

In Miami and Atlanta, we are looking at existing community development block grant loans to capitalize the secondary market vehicle. The cities admit that some loans have not been well-managed. We are trying to improve their management, and we are going to sell those loans. The city will place the money in the special purpose corporation. It is "found" money for them. Once again, it will use the capital to purchase loans from the originating community development bank. The special purpose corporation or conduit will package those loans into securities and sell them to local banks.

As long as the pricing of loans is appropriate and the losses are not too severe, this program can replenish continually the amount of lending in that community. We call it our perpetual credit machine, because you replenish continually the amount of capital flowing through the system. There is plenty of liquidity in the system. The bankers I know do not have problems with funding loans. They have excess liquidity. They are looking for earning assets. That is their big problem. Investors come to us all the time since the Resolution Trust Corporation closed. There is a huge appetite for new types of assets and no one to supply them. There is a huge amount of money looking for deals.

The partnership that seems to work has a structure that places the city or government in the credit support role, assigning the origination responsibility to competent organizations that exist in profusion in cities to originate and service loans, and putting the banks in the position of investor that funds credit lines to the originator. We have tested this in conceptual form, given banks in a few cities term sheets, and said, "Will you do this?" So far, we have had a good response.

*Paul Pryde, Jr., is president of Capital Access Group, a limited liability company, a financial advisory and consulting firm, specializing in financial innovation for lenders in underserved markets. He has more than 25 years of economic development and finance experience. He is the author of several publications, including "Black Entrepreneurs in America." He also is a consultant to and a board member of several national policy development organizations. Most recently, Mr. Pryde has focused his energies on small business loan securitization.*

**Q and A Summary**

Mike James provided additional detail on capital access programs, which exist in 20 states. The program in Michigan was begun

# 2. Opening Session

The National Forum on Small Business Banking opened with a discussion of the state of small business today and the role of the lending community in ensuring its continued success. Eugene A. Ludwig, former Comptroller of the Currency, discussed federal government initiatives of the past five years to foster small business lending. Those initiatives were: revisions to the Community Reinvestment Act (CRA) regulations; innovative programs to encourage financial institutions to lend to small businesses; research into problems that interfere with small business lending; and steps to strengthen the national banking system and the banks' ability to lend. Ludwig also discussed the OCC's Banking on Minority Business Program. The program encourages improved communication among bankers and potential small business borrowers; counseling and education for entrepreneurs; increased use of established programs, such as the Low Doc Program; innovations in lending, such as the second- and third-look programs; and the importance of partnerships among lenders and small business people. Richard C. Hartnack, vice chairman, Union Bank of California, defined small business market characteristics and how they are viewed by lending institutions. He explained that market awareness is critical to retaining and improving market share in an increasingly competitive landscape.

**Keynote Address, Eugene A. Ludwig, former Comptroller of the Currency, OCC, 1993-1998**
It is a genuine pleasure to welcome you to our meeting on small business banking — a subject that is crucial to our nation's continued economic vitality and opportunity.

To understand *how* crucial, one must look at the facts and figures. By Small Business Administration (SBA) standards, more than 99 percent of our nation's businesses qualify as "small." The vast majority are very small — two-thirds of them employ fewer than five people. But they make an outsized contribution to our nation's well-being. Small businesses employ more than half of the private nonfarm work force and, combined, generate 51 percent of our private gross domestic product. Today they produce almost two-thirds of all new jobs.

The small business community is largely the reason why we have enjoyed an unparalleled economic expansion of the past five years — an expansion driven mainly by small business people like yourselves, especially in the service and technology areas.

Small business men and women are the vehicles for the nation's initiative and creative imagination. We count on all of you here to support that initiative and imagination and to put it to work — as you always have. Small firms produce twice as many product innovations per employee as do larger firms. From small businesses have come innovations as complex as the artificial heart valve and the optical scanner and as prosaic as the zipper. From small businesses will come undoubtedly the product breakthroughs of the future that will enhance the American standard of living and ensure the nation's continued economic success.

Notwithstanding the strength and ingenuity of the small business sector, we live in turbulent times. The financial turmoil that today besets so many of the nations of Asia — nations that not many months ago were hailed for their economic successes — reminds us that the future is essentially unknowable. And yet, I believe that we have much reason for optimism. The reason is sitting right in this room. Our forum today shows that we are not resting on our laurels. We came here today because we recognize that there remains a rich mother lode of ideas and enterprise in our people — ideas and enterprise — waiting to be recognized and financed. We came here today because, despite all that many of our financial institutions have done already, lack of credit or capital is still an obstacle that may prevent tomorrow's small business success stories from being written. And we are here — all of us together — because we understand that through partnerships between financial providers and small entrepreneurs, all things are possible for ourselves and for our people.

I believe we have proved that over the past five years. Five years ago, we were in the midst of a credit crunch. Many in the small business community were unable to get the loans they needed and deserved. Some firms undoubtedly failed as a result. Yet, as painful as it was for many, the credit crunch experience reminded us of something terribly important: that financial institutions and small business need one another — and so does the national economy.

***Through partnerships between financial providers and small entrepreneurs, all things are possible for ourselves and for our people.***

That lesson was on everyone's mind when I became Comptroller of the Currency, and it led us immediately to develop and implement a four-point plan to restore the flow of credit into the small business community. First, we went over our regulatory rule book with a fine-toothed comb, weeding out or modifying those rules that seemed to complicate unduly fair access to small business credit. Second, we developed innovative new programs to encourage financial institutions to make those loans. Third, we conducted research into the systemic problems that interfere with the whole process of small business lending. Finally — and the one that made all the other possible — we sought to stabilize and strengthen the national banking system, so that banks were once again in a position to lend.

Let me give you some specific examples.

- We liberalized the rules requiring a small business owner to obtain a real estate appraisal from a licensed appraiser whenever personal real estate was used as collateral for a business loan — a change whose benefits, for those who qualify, can be measured, not only in the savings of dollars, but also in the savings of time — weeks sometimes, critical weeks when loans can be delayed awaiting the completion of an appraisal.
- We adopted a low documentation loan program to allow highly rated and well-capitalized banks to make a portion of their loans to small and medium-sized businesses — loans that examiners would review solely on the basis of performance and not on the basis of the documentation in the file. These are loans made because of character that may not necessarily meet standard requirements for collateral or detailed performance plans.

But nothing has done more to highlight and promote that constructive partnership between small business and financial institutions than our revisions to the Community Reinvestment Act (CRA). Much has been said, and rightly so, about the new CRA's emphasis on performance as opposed to paperwork. As important, in my mind, is that the new CRA takes a far broader, more holistic view of what really constitutes community development. It recognizes that small business lending can be an important component of financial institutions' commitment to the communities they serve.

Stimulated by CRA and their own good business sense, financial institutions have demonstrated lately a renewed commitment to small business lending. One of the most auspicious developments in recent years has been the growth of small business finance intermediaries for institutions that lack the expertise or the resources to establish special small business lending programs of their own. Their variety is truly impressive —and encouraging. Lending consortia, loan pools, bank-owned or affiliated community development corporations, small business investment companies, community-based micro-enterprise loan funds — all of those institutional devices are helping to fill the gaps in the small business lending market.

Thanks to constructive regulation and innovations by lenders and community development partners, we have made impressive progress over the past five years in small business finance. Our nation's banks have reaffirmed their traditional role as a major source of funding to the small business community. Small business lending dominates the loan portfolios of many community banks. Commercial banks also provided more than half of all loans used to finance the purchase of equipment and vehicles by small firms. These days, fewer and fewer

small business people are reporting difficulty in obtaining credit. And bankers, for their part, are finding that, as a rule, small business loans perform as well, if not better, than other components of the loan portfolio.

And the evidence suggests that many of our bankers are not sitting back passively and waiting for small business customers to walk through the door. The recent Federal Reserve report to Congress on the availability of credit to small businesses shows a new aggressiveness by bankers in seeking out small business customers, by offering better terms, additional products and services, and more direct marketing. Even while striving to meet their CRA obligations, bankers are moving beyond mere compliance to a recognition that partnerships with small business make good business sense.

Now the time has come to build on our successes and to consider new approaches where we have been less successful than we would like. Unfortunately, many of the gains I have just described have been distributed less evenly than we would like. For years we have heard anecdotes about the special obstacles facing minority small business people in obtaining credit. Considering the importance of small business as an engine for job creation and upward mobility, we must ensure that small business does not face special handicaps just when small business's contributions are most needed.

To help us determine the nature and extent of the problems that minority small business people face — and to begin formulating workable remedies — we have moved aggressively on several fronts. First, as part of CRA reforms, we have begun to collect information on a national basis from every large bank and thrift for the first time — on small business originations — information that we can use to determine where small business loans are going — and, as important, where they are not going. This was an important breakthrough. But the data we have collected tells us nothing about the recipients of those loans — information that we need to determine whether illegal discrimination is preventing some potential small business borrowers from obtaining credit. In fact, lenders are forbidden by the Federal Reserve's Regulation B from inquiring about the race, color, sex, religion, or national origin of an applicant for a non-mortgage loan. If the Fed changed Reg. B, so that creditors could collect such information voluntarily, it would assist us materially in the fight against discrimination. I would urge you to support such a change.

Fact-finding was an important part of the rationale for the OCC's Banking on Minority Business program, which we launched last year in Washington and took on the road to cities all over America. This cross-country dialogue brought together community leaders, minority small business entrepreneurs, and bankers to discuss how to break down barriers and build mutually profitable relationships that will bring economic opportunity to our neglected and ignored communities. As I listened and learned during those visits, a number of points became clear — points whose relevance goes beyond minority small business to the small business community at large.

First, improved communication must exist between bankers and potential small business borrowers. In the home mortgage area, a field we have studied intensively, we have found again and again that merely making a loan to first-time borrowers may not be enough for it to work. The best performing affordable mortgage loans appear to be those accompanied by education and counseling — helping borrowers to negotiate the application process, and helping them understand what lenders expect of them, and to manage a budget, and so forth.

This seems to be true in the small business field. Based on what I have heard around the country, there continues to be considerable misunderstanding among lenders and small business borrowers about what is expected of them. Some would-be entrepreneurs have minimal experience with all of the intricacies of running a financial operation. They need counseling and education almost as much as they need capital. For their part, some lenders have limited familiarity with small business markets generally and with market conditions that prevail in minority communities. If the relationship is to succeed, both parties must think about their partnership in the broadest sense — as one that involves an investment of time and expertise as well as financial capital.

Second, what I heard in my discussions around the country convinces me that we regulators can do more to encourage banks to use those programs that are currently available. Take our low documentation program. At last count, only about 200 national banks are using it, because, I am told, the others continue to believe that examiners will criticize them later for inadequate documentation. Let me assure those of you here today that you can take full advantage of that program without fear of adverse criticism.

This also is true of the public welfare investment authority embodied in Part 24 of the OCC's regulations. Certainly the amount of Part 24 equity investments used by banks generally, and for small business lending and investing specifically, has increased in the last few years. But most national banks are not at their 5 percent of capital threshold for self-certification of qualifying investments, and only a handful are at their aggregate statutory 10 percent limit. It is in your interest — and in that of the small business community — for banks to take fuller advantage of this program. I encourage you to do so.

Although we certainly have obstacles to overcome in the years ahead, the dominant impression I took away from my meetings across the country was one of energy, pride, and optimism. I met many lenders and small business people who, through creativity and perseverance, have became allies in common partnerships.

I learned about organizations, such as The East Los Angeles Community Union (TELACU) — a one-stop resource for minority small business people, which provides counseling and arranges loans — loans with some of the lowest delinquency rates in the entire industry.

I heard about innovations in lending, such as second- and third-look programs, whose operative philosophy reflects a dogged determination to find ways to make loans to worthy borrowers who might not qualify by traditional standards.

I heard about encouraging developments in the use of credit scoring models to reduce the costs of reviewing and monitoring small business loans, while attending to the potential problems of inadvertent discrimination in their use. The reduced costs should help lenders make more of them. And when they do, it may open the door for the development of a secondary market for these loans, with all that implies for increased availability and better pricing.

Most of all, I saw evidence of genuine long-term commitment to community development, broadly defined. In our discussions today, I expect to hear and learn more about those innovations and how we can use them to address the problems that persist.

When I became Comptroller of the Currency five years ago, I made a commitment to do everything in my power to promote fair access to credit and other financial services for all of our people. I think we have made significant progress to that end. One reason we are meeting here today is to help ensure that the momentum continues to build, so that, one year from now, we will have even more striking progress to report. Wherever the future takes me personally, let me assure you that the cause of financial democratization will always be special to me.

*Eugene A. Ludwig is the 27th Comptroller of the Currency. The Office of the Comptroller (OCC) supervises nearly 2,800 federally chartered commercial banks that account for more than half of the assets of the commercial banking system. By statute, the Comptroller also serves a concurrent term as a director of the Federal Deposit Insurance Corporation. In January 1997, he was elected Chairman of the Neighborhood Reinvestment Corporation. The Comptroller is also chairman of the Federal Financial Institutions Examinations Council and of the federal Consumer Electronic Payments Task Force. Ludwig joined the OCC from the law firm of Covington and Burling in Washington, where he was a partner beginning in 1981. He specialized in intellectual property law, banking, and international trade. He has written numerous articles on banking and finance for scholarly journals and trade publications and was a guest lecturer at Yale and Harvard law schools and Georgetown University's International Law Institute.*

**Special Guest Speaker, Richard C. Hartnack, Vice Chairman, Union Bank of California**

I would like to provide some insight into the market size, revenue streams, and changing

competition and technology that we will see in the small business market.

The small business market represents a large and attractive opportunity for banks and other financial service providers. Although this seems obvious today, not many years ago the combination of capital strain, cost tensions, and loss aversion led banks to walk away from that opportunity.

There are 5.5 million small businesses operating in America that conduct up to $10 million in sales. The huge majority of those businesses are small. To tap this market meaningfully, one has to build in a cost-effective and risk-acceptable way for systems, processes, procedures, and a culture to attract small businesses.

This market possesses some interesting characteristics. Turnover in the small business market is relatively large. One-half of all the firms listed in any single year disappear or reorganize in the next five years. Approximately 14 percent of the institutions disappear from the market in any one year, because they go broke, or they are bought, enriching everyone. Approximately 16 percent of the total of small businesses operating each year are start-ups. That is a tremendous number of start-ups.

***The small business market represents a large and attractive opportunity for banks and other financial service providers.***

For a bank or a competitor trying to enter this market, sitting still means falling behind. You can shrink out of this business quickly, if you are not adding to your client set every year by retaining those you have and bringing in new ones.

The nature of small business is changing. Growth occurs mainly in the services and financial services arena, which presents some interesting implications for those who make their living lending money. Service firms use much less credit on average, but more deposit products, than nonservice firms. Understanding the nature of that opportunity is important to servicing those firms most effectively.

The revenue stream is also important. In total, small businesses create about a $33 billion revenue market for traditional banking products. Today, that $33 billion market is dominated, about 93 percent, by America's banks. Approximately 7 percent of the participation by nonbanks in those areas, and most of that participation, is in the area of credit, not core checking products.

The $33 billion revenue stream creates approximately $20 billion and some high return-on-equity (ROE) opportunities for the banks that do this well. Because one does not see 40 percent ROEs routinely posted by banks, one must remember that there are shared costs, shared facilities, and other factors that lower the total at the bottom line. At $10 to $15 billion, however, the bottom line is an interesting market for all participating in it.

Banking revenues are only part of the picture. In addition to banking revenues, there is a sizable property and casualty insurance revenue stream, nearly as large as the banking stream. The life and health insurance stream is approximately one-third as large as the banking stream. But when it is combined with property and casualty, the insurance stream exceeds banking revenues. Some significant competitors, and notably no banks, play in each of those fields.

Altogether the small business and commercial revenue potential in the small business market today totals approximately $78 billion in revenue stream. This is interesting because approximately one-fourth or one-third of that opportunity lies with traditional products, and the rest with nontraditional products.

Also interesting is the propensity of small business people to group their personal and business activities. Indeed, 36 percent of all small businesses bank with their current financial institution, because they conducted their personal business there first. Twenty-six percent conduct their personal business at the same bank in which they conduct their business banking, because their business banking was there first, and 38 percent have split the relationship purposefully.

Small business owners also tend to be more affluent customers, offering a much higher average revenue per retail relationship.

Besides the owners, small business employees represent approximately $33 billion in revenue and approximately $19 billion in product profits when addressed and captured as a whole.

Small business presents an interesting profit story with approximately $33 billion of traditional commercial small business services and another $45 billion in nonbank small business services.

Small business owners' retail revenue is $27 billion. The owners are almost as valuable as the small businesses.

The 83 billion small business employees present to banks a huge opportunity — a $188 billion revenue opportunity. Because nature and a free market abhor a vacuum, that profitable opportunity is forcing competition to change rapidly. We are not the only industry that recognizes that opportunity.

***Small business owners' retail revenue is $27 billion.***

The combination of new competition, technology that encourages new competitors, and regulatory changes creates a different competitive landscape. The message today, if any, is that bankers must think carefully about that competitive landscape.

The average, reasonably well-established small business probably uses brokerage companies, such as Merrill Lynch. Dedicated lenders, such as the Money Store, participate in this market. Leasing participants, such as G.E. Capital, are building huge portfolios. Complimenters, such as AT&T, that provide credit services, leasing services for their own equipment, and long distance services and other telecommunications services become key competitors. Insurance service providers, such as ADP; software providers, such as Intuit, with its Quick Books; such as Fidelity payments people; such as American Express; and investment managers, such as Fidelity, are all trying to split that large revenue opportunity.

It is significant that small businesses adapt to technology nearly twice as fast as consumer households, and that ability allows competitors to reach those clients in a new way. Technology also works for banks and ultimately for the small business customer. The changing credit processes, which include credit scoring and cost cutting methods, have reduced by a huge amount the cost to originate, the turnaround time, and the break-even loan size. Our BAI/McKenzie report noted that Wells Fargo originated more than $1.4 billion in new loans during a two-year period (1996-1997). Those changes enable bankers and others to address this market quite efficiently.

The growth in automated small business lending has two sides, both good and bad. The good scenario shows automated lending lowering the cost to the institution and, ultimately, the hassle factor and the waiting for small businesses. However, it will also lead to securitization, which will make available an almost limitless amount of capital to small business, but will require a new set of skills for competitors to participate.

The message to the banking industry is clear: if you do not like the share of the credit card market that you have today, or the share of the mortgage market that you have left, be careful about the small business market. You might have an equally small share of that market in less than a decade. The standardization and securitization of this product could cause small banks with a huge amount of their total profit emerging from this market segment to be unable to play any longer, as they are unable to do in the credit card and mortgage markets.

All of those issues will change dramatically the way small business people think about their relationships. Some may value convenience and deal impersonally with providers that specialize in convenience. Some may value access to capital more than anything else. Clearly, the less creditworthy you are, the less likely you will be to obtain preapproved credit in the mail. Without that

preapproved credit in the mail, you must value your ability to obtain credit. That may be the number one problem facing a small business person.

Payments — cash, coin, currency, clearing checks, accepting payments — may be a small business person's most major activities and determine where the small businesses will bank. Credit and access may be secondary to the coin and currency and payment services that small businesses obtain. Some businesses may be able to value advice and information and use providers with that approach to the market.

If small business people behave as other consumers of services in our complex, multi-competitor economy, they will make choices based on their own set of values and needs. They will determine, in addressing this market, whether to use providers who build a brand name that establishes value and capability. Alternatively, they may use advisors who make the choices for them. Those advisors could be CPAs or consultants to Internet Web sites. Some businesses may choose to disaggregate their purchases and seek the best of the class in each of the different kinds of services that they provide or require. This would result in a huge disaggregation in the marketplace.

The old way was profitable for everyone, and it worked. It was a fragmented industry of more than 10,000 banks. All businesses dealt with banks. Earlier, we showed that 93 percent of all traditional products are provided still by banks. There was an expensive distribution system that focused on location convenience. It gave small businesses relatively limited access to capital, although good access to debt. There was a high retention of small business, and banks were regulated to ensure a low cost of funds, which provided the profit engine. Industry conduct was directed to high margins, standard products, nonaggressive competition, and conservative loan standards. Geography was the basis of competition. ROEs were high, and one was fairly secure with a stable market share.

The structure of delivery is adapting to changes in technology, competition, regulations, increased lending capacity, and marketing capacity and capability, alternative payment and deposit systems, and electronic delivery. Other changes in the market will be price cutting, newly-packaged products, proactive marketing efforts directed at customers, and a lack of geographic boundaries to competition with the leveraging of the high-cost delivery system.

The end result will be reduced spreads on lending, which can be seen either in lower pricing or in the increased risk that people take; reduced spreads on deposits as sweep accounts and other activities and products are aimed at putting idle balances to work for the small business person; much higher acquisition costs; and more switching. One need look only at the telecommunications industry as the number of active switchers substantially increase the average cost of acquisition.

The status quo will lead to focused players stealing market share in the small business market. Banks that compete in the same way tomorrow as they do today will not increase their market share over time. Their share will shrink.

The Treasury and fee-based payment systems will come under increasing attack by companies, such as ADP, Microsoft, and Intuit. Merrill Lynch, Fidelity, and Vanguard will actively market replacements for traditional deposit products. On the credit side, companies, such as American Express, the Money Store, and G.E. Capital, will grasp parts of the market. That will leave banks with a hammerlock on the low return, high cost currency, and check processing aspects of the business. That is a dangerous place to be.

The small business market continues to be large and lucrative. New competitors are seeking to stake out market share at the expense of current providers. The way businesses buy, the way they are served, and the nature of the value proposition being offered to them will change greatly in the next decade. Banks that do not adapt surely will lose clients, revenues, and ultimately profits.

*Richard A. Hartnack is the vice chairman and head of the Community Banking Group at Union Bank of California in Los Angeles. He is also a member of the board of directors. Mr. Hartnack is the immediate past president of the Consumer Bankers*

*Association (CBA) and the current chairman of the California Community Reinvestment Corporation. He also serves on the boards of several civic organizations, such as the Los Angeles Urban League and Operation HOPE.*

*Last year, Mr. Hartnack became chairman-elect of the Bank Administration Institute (BAI), an organization dedicated to improving the competitive position of banks and financial services organizations. Under his leadership, BAI, in partnership with McKenzie & Company, published a recent report entitled, "Unlocking Winning Strategies to Serve Small Business, Banking the American Dream." He is active in, and extremely knowledgeable about, small business.*

**Q and A Summary**

The issue was raised about the costs for pre- and post-counseling for small businesses. Hartnack said it is difficult to provide five hours of counseling for a $5,000 loan and make a profit. However, it is not possible to make a safe $5,000 loan to some entrepreneurs without good counseling. Institutions must make a reasoned decision on whether counseling for the $5,000 loan pays off in terms of the net present value of all future flows from that business.

Ludwig added that two market approaches are developing. One is a commodity-driven approach using credit scoring in the secondary market; that approach should grow. There also will be those who are adept at the more traditional community and high touch approach. Those people will be successful and will have a valuable market niche to the extent that they emphasize counseling.

Ludwig remarked that it is not feasible to have a $5,000 loan that includes $500 worth of counseling time, if you pay people by the hour. However, some institutions have charged up lending staffs on their overtime. They are building a business, which does not work on a dollar-for-dollar basis. The lending business, particularly for small banks, is a small business. When aggressive entrepreneurs spend extra time building their businesses, counseling pays off handsomely in terms of the return-on-assets (ROAs) and ROEs.

A participant asked if a federally-funded partnership for counseling could be established between the banking industry or the financial industry and the government entities operating technical assistance programs for the community. Hartnack responded that this type of partnership can work well. A community partnership to address those most in need of counseling could be formed, even though the government cannot provide technical counseling to 5.5 million small businesses in America.

Also raised was the issue of the market moving toward securitizing small business loans, *i.e.,* small business loans guaranteed by the SBA or conventional products standardized for resale by a bank in the secondary market. Hartnack responded that securitization refers to general market loans. The size of the loan is not a barrier. We will not securitize $1 million loans in the near future, but it is foreseeable that we could securitize $50,000 and $100,000 loans in packages. Wall Street likes to deal with large numbers, such as blocks of $50 and $100 million. This makes life even scarier for small banks, unless they carve out the highly convenience-oriented part of the business that allows them to pay operating fees and the prices. Hartnack also stated that small banks should be concerned about large banks securitizing those loans. The emergence of large banks may reduce the room in each market for the number of community banks and the size and the growth they enjoy.

# 3. Forum Topics

## The Changing Structure of the Banking Industry and Its Effect on Small Business Lending

Bankers from community banks and larger financial institutions discuss the numerous benefits that accrue to them from active small business lending programs, and how those institutions now serve the needs of the small business market. They describe a community bank's successful SBA lending program; how a large bank's small business lending is designed so that banking can be done at the bank's offices, through the mail, fax, ATM, PC or the Internet; and a community development bank, established in 1990, that provides loans and investments to borrowers and community-based projects that typically would not qualify for conventional loans. Barbara Grunkenmeyer, credit risk expert, Credit Risk Policy Division, OCC, moderated the session.

**William Gene Payne, President and CEO, Gateway National Bank**

Gateway National Bank ended 1997 as a locally-owned community bank in Dallas with $97 million in total assets. In January 1994, we started SBA lending and have achieved preferred lender status. Since 1994, we have closed $44 million in SBA loans. In 1996, we were the number three bank lender in terms of volume in the Dallas-Fort Worth district, which is one of the more active SBA districts in the country. In the same year, we were awarded the top lender to women in business award by the SBA, Dallas District, for our efforts in lending to women-owned businesses.

I am here as a proponent of SBA lending for the community bank, although it might seem unusual for a Dallas, Texas, banker to address a forum in Washington, D.C., on best business lending practices. A few years ago, most of the country viewed Texas bankers as something less than positive role models. Gateway National Bank and Gene Payne survived the crisis. Having survived the crisis, I am imminently qualified to address you today on a subject near and dear to my heart: small business banking issues.

I have been in banking for 26 years in some of the more renowned banking organizations in the state of Texas. I have worked in large banks, medium-sized banks, and in the last 12 years or so, in small banks. It is my opinion that small business banking is best understood and practiced by the community banks across America.

At Gateway, we have a basic formula for success. We take seasoned bankers with good business acumen, provide them with quality products and services, put them in front of the customers, and leave them there. Our bank officers do not outgrow our customers; they stay with them. That creates a bond, a sense of trust between the loan customer and the bank, and it reinforces an important role that the banker has played throughout history with the small business community: the "consulting" or "advisory" role. As bankers, we see small businesses face many pitfalls. Most small businesses have one thing in common: the person who established the business either knew how to make it or knew how to sell it. Most are not great business people, although many become great business people. That bond must exist, so that the banker can advise the small business person on how to avoid potential pitfalls in their business.

The middle market is most often described as those companies with sales between $1 to $50 million. The lower end of the middle market, which consists of companies with sales of $10 million or less, is the target market for Gateway.

In the 1960s through the 1980s, Gateway's target market consisted primarily of small manufacturing companies, distributors, and retailers that sold durable goods to consumers. Most of those businesses had qualities in common: strong fixed assets and inventories that we understood well. We knew how to liquidate them and how to lend to them. The market is different today. We have seen an explosion in service-oriented businesses with fixed assets that consist often of office equipment, computers and software, and furniture. Traditional banking must change to lend to companies such as those. We must lend for longer terms on assets that at first blush do not justify a loan term of that length. In other words, computers

do not justify a seven-year amortization; their life span is not that long.

We needed to change to be prudent and to lend to those growth-oriented businesses. One example is Tactica, Incorporated, a Dallas-based computer consulting company that specializes in computer networking systems for businesses. They approached us for a small business working capital line to enable them to fund their growth. Tactica is a well-capitalized business that has experienced management and a strong business plan. However, the company had a nominal operating history. Traditional methods would not accommodate a loan to Tactica. The collateral did not justify it. However, we were able to make the loan through our partnership with SBA. Today, Tactica is a successful business. It employs more than 30 people in our market and makes a profit. It also is a net provider of funds to the bank; in other words, Tactica has more in deposits than it has borrowed from the bank.

Most community banks still lend money using the traditional method, which works well for them. They may let the young companies or the companies without safe, hard collateral choose their competitors. Some of the community bankers may be saying, "Gateway, this is the 1990s. Everything is great. Maybe you are just too conservative in the way you approach things."

In the late 1970s and the early 1980s, we had one of the most dynamic, vibrant economies in Texas. In many ways, it was the envy of many parts of the country. In the mid-1980s, the economic cycle changed in significant ways and created the banking crisis in Texas. In Dallas, the traditional approach did not work alone. Economic changes occurred, even when decisions were made using safe, sound, and tried and true methodologies.

Real estate lending is one example. Does it sound familiar and safe to lend 80 percent of cost to market, 15- to 20-year amortizations, five-year balloons? Shortly in Dallas, real estate values plummeted 25 percent to 50 percent, and more in some cases. Almost overnight, collateral values deteriorated below loan amounts. Those customers able to make their payments continued to do so. Others found themselves unable to reduce their loans to amounts below the loan amount when their loans matured, putting the collateral under water. The result was credit deterioration, nonaccruals, classifications, foreclosures, and business failures. The traditional approach to lending failed many Texas banks. It did not fail Gateway, but we learned a few million lessons.

We looked for an alternative method that would enable us to lend to those emerging growth companies that had collateral insufficient for use as a good secondary source for repayment. We looked for a way to lend money on collateral that recent history had proven was deteriorating in value.

In looking for alternatives, we found a partner in SBA. We did not plan to do a little SBA lending. We planned to be regarded as a premier small business lender in our market, to make a difference, not only in the profit and loss statement of the bank, but also in the community.

Rosa Rodriguez, or Mamma Rosa, is one example. Mamma Rosa immigrated from Puerto Rico in the mid-1980s. In the early 1990s, she became a citizen of the United States and started a small day care center in her home for four or five children. She did well and expanded into a rental facility that took care of 50 children. She operated there for a couple of years, then approached us to assist her in building a 6,000 square foot, state-of-the-art day care center in a lot adjoining her home in southern Dallas County, a lower income area.

We accommodated her. When the construction was completed, she opened at full capacity. She has done very well; as of last week, she had a waiting list of 125 children more than her capacity. Mamma Rosa is a success story, but Gateway could not have made a 25-year, fully amortizing real estate loan to Mamma Rosa without the assistance of SBA.

Through more than 200 loans, 41 percent of which went to women and minorities, our customers have created more than 1,600 jobs in the last four years. There are many success stories justifying our partnership with the SBA. It has been fantastic for Gateway as well. Over that same four years, Gateway's total assets

have grown by 70 percent. Every year, we have improved our profitability compared with the previous year.

There are many benefits to an active, vibrant SBA program in your bank. It increases the economic development in the community — more than 200 loans and 1,600 jobs. It increases community reinvestment opportunities — think of Mamma Rosa. It improves competitiveness with larger banks and nonbank lenders. Gateway can lend longer term against shorter lived assets. It increases liquidity and loan-to-deposit ratio, which are important issues to the community bank, in that an active secondary market exists for the guaranteed portion of the SBA loans. It increases lending limits in the amount that we can lend to any individual borrower because the guaranteed portion does not count against our loan limit internally. The guarantees are useful as security for deposits for public sector funds.

Gateway is a flagship for SBA lending in many ways. As we raise that flag, we also see other opportunities to lend money to non-SBA qualified borrowers. We have also seen growth in our commercial and real estate and consumer products. Over the past four years, SBA lending has represented good business for Gateway National Bank. The SBA is the most significant private-public partnership ever created by Congress.

I would like to comment on the securitization issues discussed earlier. Securitization is not an avenue for community banks. Gateway does not have the large funds necessary to put together securitization packages. More importantly, we need earnings assets to fund and to support deposit growth in our community. Besides, if we sell the guaranteed and the unguaranteed portions of the loan or non-SBA loans in a securitized fashion, what is the motivation to provide small businesses with the continuing advisory or consulting role provided by the banker throughout history: Small businesses need bankers to stay in touch and to advise.

*William Gene Payne is president and CEO of Gateway National Bank headquartered in Dallas, Texas. He has been active in business lending throughout his 26-year banking career, having served in loan administration and lending at Citizens National Bank, Texas Commerce Bank, and Allied Bank before joining Gateway National Bank in 1984. Gateway is a $97 million independent community bank located in three areas in Dallas. It is a top small business lender in its market.*

**Robert K. Kottler, Senior Vice President, Small Business Banking, Hibernia National Bank**

I would like to talk about the activities of a large bank. Hibernia has grown quickly from a bank of $10 billion to $12 billion through two recent mergers. Things are changing rapidly.

Hibernia operates in Louisiana and Texas. In 1992, our new CEO determined that we were missing the opportunity in small business. In 1992, Hibernia with approximately $5 billion in assets, was the largest bank in the state, but the fifth largest small business lender. Basically, we were not lending to small businesses. We told our small business customers that we did not know what to do with them. We decided to change that. In January 1993, Hibernia had 1,000 small business loans totaling $100 million. Today, we have 30,000 small business loans totaling nearly $1.5 billion. In January 1993, Hibernia processed 90 loans through the Small Business Loan Center that we had recently created. Today, we process more than 3,000 small business loans a month. In 1992, 15 bankers were assigned to seek business from small firms. Today, there are more than 150. In 1992, it probably took two weeks to get a $10,000 loan. Today, it takes less than two hours; in many cases, our application serves as our note. You do not even have to come into the bank to get credit. In 1992, our average size loan was $150,000, even though the average small business borrows about $25,000. Today, our average loan size is $35,000. We are making more $5,000, $10,000, $15,000, and $25,000 loans. For the first time, we are making an effort to serve the under $1 million revenue segment of small business that we believe has been underserved.

Self-selection and convenience are important. Our premise at Hibernia has been that customers and potential customers will decide how, when, and where they will obtain information, purchase products, or obtain customer service. The old paradigm was that a customer had to

come into the branch between nine and five to get a loan. We did not come to you. Business could be conducted only face-to-face, and we treated our customers as either commercial or consumer. We did not understand small business.

We would take a commercial approach whether it was a $10 million loan or a $10,000 loan. We required an annual financial statement from every small business. If it was not complete, we sent it back five times until it was completed accurately. We did not understand why none of our small business customers wanted to bank with us.

On the deposit side, we offered a flat fee business checking account for $8 per month for up to 200 transactions. My favorite question to members of small business-owner focus groups is whether participants understand account analysis. They all say they do, but most businesses do not. We reduced the minimum balance for waiving fees to $5,000, and otherwise charged a flat fee each month.

On the loan side, we added business credit cards, check access business line of credit cards, and term loans to make it easy for our small businesses to borrow. We made the documentation simpler and in some cases part of the note. We also began to fulfill through alternate channels, and we took the approach that we want to do business with every small business owner seven days a week, 24 hours a day.

The way we fulfill credit has changed dramatically. I use the concept of my wife as a small business owner. She wants a problem solved immediately; she does not want to be bothered. When she needs a loan for her business, she would likely apply by fax, late in the evening. We decided to provide instant gratification for as many small business owners as possible. Every credit application has three or four items on it. It has an inbound 800 number. If you call us, we will try to make the loan over the phone. It also has a self-mailer. If you are not comfortable talking with us face-to-face, you can mail the application, and we will call back and tell you whether we can do business with you. We also provide a fax number. My wife and I are notorious for using the fax and Internet at two o'clock in the morning when we finally sit down to talk about her business. We will also give you an inbound number and provide our application and information on the Internet.

Arthur Andersen's study indicated that 30 percent to 40 percent of small businesses were started with credit cards. Because we thought many small business owners were comfortable with credit cards, we issued a Visa business credit card with a line of credit that also could be used for purchases. We learned from the credit card experience. On smaller loans, your application becomes the note. After you apply for the loan, you are informed of your approval and asked where you want the money deposited.

Our self-selection services are designed so that small businesses can do business with us at banking offices with dedicated business bankers, and through the mail, the fax, the ATM, the PC, or the Internet. You have your pick.

Some customers still want to come to the banking office. To accommodate this, we moved many of our business bankers from downtown and put them in the branches or in suburban locations where our customers are. That is where our customers feel comfortable and where our bankers are today.

We also have dedicated business bankers who work with our customers. They work on incentive pay: approximately 50 percent of their salary is incentive. If they do not do business, they do not eat very well. That has made a huge difference. At the same time, we also took precautions, so that our bankers cannot get paid for loans approved under their authority. Those business bankers are much closer to the customers, and they act as advisors.

***Our goal is to let people know that we want to do business with them.***

Hibernia sends out more than 1 million pieces of direct mail each year. Recently I bought a light fixture for my house. I went into a small business in the French Quarter in New Orleans wearing my Hibernia shirt, and the proprietor said, "I know you." He said, "I know you want my business. Here is the mail you sent me.

Your telebankers have called me, and a banker stopped in to see me yesterday." Our goal is to let people know that we want to do business with them.

Even after five years, many small business owners still are not convinced that we really want their business.

We have a direct bank operation. We send mail. We make outbound phone calls. We also have inbound sales people, and we do about 20 percent of our business with small businesses over the phone and through the mail. Those customers do not necessarily want to come into the branch or to see a banker. They have small credit needs, and they are willing to do business with us that way.

We have an inbound telebanking group. We find that similar to many large companies, many business owners of smaller firms are satisfied with doing business over the phone, if they can get the information they need quickly and efficiently.

We also use the fax a lot. We have an inbound fax server that allows our customers to call an 800 number, have the fax service send the application, and fax it back to us. We do a substantial amount of business over the fax, and it has worked well.

We have tried the Internet. Our application for credit appears on the Internet, but it still does not receive many hits. The small business section and our SBA page are accessed often. However, we are still not receiving applications at the rate we want.

Technology-based solutions will continue to help the small business market. We use our databases as effectively as we can to identify those people with whom we would like to do business, and we try to use our technology to make applications simpler, faster, and more efficient. One of my biggest fears is that I will wake up one day and my small business customer will be banking with credit card companies instead of me. Self-selection will make a difference.

Training for small business owners also is an important issue. About a year and one-half ago, the University of New Orleans, SBIC, and a company called FASTRAK 2000 visited us. FASTRAK 2000 is not the SBA FASTRAK, but rather a training program sponsored by the Kaufman Foundation in Denver. This is "first-time business owner training," which is the equivalent of first-time homeowner training. We became the lead sponsor of the program, which is conducted in two six-week sessions. We provided advertising and funds. More importantly, we employed business bankers to act as counselors and teach the program. We also offer scholarships to our customers and to some of our prospects who we think would benefit from the program. A person who has been through FASTRAK 2000 is five times as likely to be in business five years from now than the traditional business owner. The money spent to buy this nationally tested program was far better spent than if our own bank had developed a program.

*Robert Kottler is senior vice president and manager of Small Business Banking at Hibernia National Bank. He is responsible for developing small business products and policies. Under his leadership, Hibernia has become a leader in creating innovative products and services for small businesses. Hibernia is a $14 billion bank headquartered in New Orleans. It also has operations centered in Louisiana and Texas.*

**Howie Hodges, Bank of America**
*Michael Mantle was unable to attend the forum. Howie Hodges gave his presentation.*

Bank of America Community Development Bank was established in 1990 as a subsidiary of Bank of America Corporation. We provide loans and investments to borrowers and community-based projects that typically would not qualify for conventional loans. In eight years, we have made over $3.2 billion in new community development loans and more than $500 million in equity investments.

The market's acceptance of our products and service has been spectacular. Last year alone, we originated more than $1 billion in new loans, nearly double the amount we booked two years ago. We are determined to do even more. Last year, Bank of America Corporation pledged $140 billion for community lending over the next decade. A large portion of this commitment belongs to the Community Development Bank. Over the next 10 years, we have

set an objective of $10 billion in government-assisted small business lending and $13 billion for multifamily affordable housing.

There are several reasons for our success. We have absolutely the best, first-rate staff. Long ago, we determined that it is easier to turn a community activist into a banker than to turn a banker into a community activist. That decision continues to drive our staffing decisions, and it has given us a better understanding of community development organizations and what they need from a financial services institution.

Another reason for our success is aggressive market expansion. We now have offices in 33 cities and 25 states across the country. Last year, we opened a new office in Atlanta, and two years ago, one in the District of Columbia.

As the bank moves into markets, we have continued to introduce additional products. In 1997, we began to offer tax exempt private placement financing for affordable housing.

I am proud of those accomplishments, but none of our initiatives could succeed without help from federal agencies in Washington, D.C., in the form of partnerships, a critical ingredient of our success.

To a great extent, our success depends on initiatives from economic development and public sector support from such agencies as the SBA, the Department of Housing and Urban Development (HUD), and the United States Department of Agriculture (USDA). Those agencies help companies, such as mine, to pump resources into neighborhoods that desperately need more jobs and better housing. They are catalysts for better communities and perform a critical role in the economic development of our nation.

At different times and for different reasons, companies may find it hard to obtain loans. This may happen at the start-up phase or during periods of rapid growth. It might occur as a result of economic recession or unforeseen operating problems. Regardless, the business that cannot overcome those challenges will not survive, and that is why the SBA is so important.

It has developed several dynamic and pioneering ways of placing capital into the hands of the traditionally underserved markets.

The Micro Loan Program, which uses intermediaries as lenders to businesses seeking loans up to $25,000, allowed hundreds of businesses to secure financing at a reasonable cost and terms, particularly during California's recession several years ago. The SBA should consider expansion of this program.

The Low Doc Program has reduced paperwork and enabled hundreds of banks to make SBA loans to small business owners in amounts below $100,000. The introduction of the minority and women prequalification programs has increased the availability of capital to both of those historically underserved markets and, perhaps more importantly, has sent a strong message that the credit window is open to everyone. This program is important particularly in light of the dynamic growth of minority and women-owned businesses throughout the United States.

***The business that cannot overcome those challenges will not survive, and that is why the SBA is so important.***

Not long ago, the National Foundation for Women Business Owners saw that businesses owned by Hispanic, Asian, and African American women were growing three times faster than all the U.S. firms combined. The survey also concluded that firms owned by minorities and women employed more than 1.6 million people and generated approximately $184.2 billion in sales. That is a market worthy of some attention.

The SBA is not alone in supporting small businesses. The USDA is joining it in helping in the economic development in rural communities. Jill Thompson and Dayton Watkins are serving well the department's Rural Development Agency. Last month, Bank of America's Community Development Bank became the first nationwide certified lender under the Business and Industry Guaranteed Loan Program, which finances new and existing rural

businesses. Many people do not realize it, but the USDA makes a significant contribution to the growth of small businesses. Last year, the Program guaranteed $815 million in loans and created or preserved nearly 30,000 American jobs. At Bank of America, we hope to add to this program's effectiveness by helping to streamline the application process and shorten the turnaround time for rural borrowers.

Virtually all government agencies, including the SBA and USDA, are now being asked to do more with less, and this challenge presents them with excellent opportunities to introduce some fundamental changes.

Initiatives have been taken to complement the continuing efforts of both SBA and USDA to save money and leverage capital. First, those agencies should encourage representatives of each district office to meet with participating lenders to develop goals and strategies tailored to local credit needs. Financial institutions must assess under the CRA the needs of their geographic markets and report small business lending patterns. Each SBA district office should perform a similar assessment. Lending patterns also should be reviewed alongside CRA guidelines to determine whether credit needs are being met. We must stretch every dollar as far as it can go, and that means doing a better job of steering borrowers toward more appropriate and cost-effective products that present less interest rate risk and require less taxpayer subsidy.

An example is the SBA's 7(a) product, which is designed to provide small companies with working capital. Often, however, it is used to finance the acquisition of commercial real estate. This use of the 7(a) product typically adds unnecessary risk and expense. For commercial real estate transactions, the SBA should mandate the 504 program whenever it is the least costly alternative to the client and to the government.

The SBA also should look at gain on sale premiums and loan origination. I read almost every week about another conference aimed at teaching lenders how to maximize returns by converting conventional small business loans into SBA 7(a) loans. They will teach you to increase dramatically your rate of return by lengthening prepayment schedules and selling loans into the secondary market. These premiums are being collected at the expense of both the SBA and its borrowers. To boost gain on sale premiums, lenders often offer 25-year repayment schedules to companies that need government-guaranteed credit for only a few years. As a result, their loans remain on the books long after the company's assets are depreciated. This does nothing to help the borrower's debt-to-worth ratio or the SBA's risk exposure. We can put the taxpayers' money to better use.

SBA lenders deserve a fair return, one that reflects the risk of a conventional small business portfolio. However, some of those premiums are hard to justify; in fact, the current rates of return sometimes exceed 50 percent. If one-half of the SBA 7(a) loans are sold in the secondary market at a 10 percent premium, the federal government relinquishes $500 million a year of revenue that could be used to expand capital formation. Instead of inflating gain on sale premiums, we should return the money to the SBA for additional economic development activities.

Many people argue that the SBA loans will not be made if lenders cannot make money. The truth is that for a long time many of them did not want to deal with the SBA's bureaucracy. SBA has remedied that problem. Today, banks are making small business loans, and the proper compensation of government for credit enhancement could add billions of dollars to the pool of capital available to small firms.

Government agencies can better leverage their resources by applying their guarantees more creatively. For example, the SBA might issue loan guarantees with annual insurance premiums in a manner similar to the Federal Housing Administration (FHA) Title 1 home improvement product. This would keep the SBA from issuing guarantees that remain in place long after the need for credit enhancement expires. If Microsoft Corporation had borrowed under the SBA 7(a) program in 1980, the technology giant could still carry an outstanding loan balance guaranteed by the SBA. Under the annual insurance premium option, lenders typically would drop the SBA credit enhancement after the borrower's financial conditions had improved.

One final recommendation is that the SBA should require the disclosure of all loan referral

payments made to third parties. Most SBA borrowers probably are not fully aware of the amounts that brokers receive from lenders. I believe that they are entitled to this information.

The Comptroller points out that virtually all working class Americans were once considered unworthy of credit. Today, credit is widely available. Innovation has reshaped attitudes, leading gradually to the recognition that most Americans know how to use credit when they are given a chance. The democratization of credit has enabled millions of Americans to enjoy the benefits of home ownership and asset accumulation.

The CRA has made a big difference in recent years. The financial services industry has redoubled its efforts to make credit more easily available in distressed and underserved communities. Consider several examples. Between 1993 and 1996, mortgage lending to minorities has grown at twice the rate for all borrowers. Small business lending nationwide has skyrocketed 144 percent during the last five years, and since 1993, banks and thrifts have made CRA commitments of more than $270 billion.

There is much work to be done throughout the United States in disadvantaged areas and particularly among low-income and minority borrowers. The need for capital from the Bronx to South Central Los Angeles is still acute. We must find a way to raise capital from emerging enterprises. This is still one of the greatest challenges in lending. All of us must think about the challenge of stimulating capital formation in distressed communities.

***If our society can develop a successful incentive for the creation of affordable housing, we can do the same for small business lending and economic development.***

Society has made a start through the introduction of empowerment zones and other initiatives, but we must keep working at it. It may be possible to apply to economic development many of the same principles behind our nation's low-income housing tax credit. The tax credit has generated billions of dollars of what I refer to as "synthetic equity" for affordable housing.

Since its creation 11 years ago, we have witnessed the development of more than 90,000 units of safe, decent, and affordable housing. Demand for tax credits has increased significantly as community development organizations learn how to use them in leveraging private investment. If our society can develop a successful incentive for the creation of affordable housing, we can do the same for small business lending and economic development.

It will take cooperation among banks and community organizations, government officials, business leaders, and religious and social organizations. Together, we must exercise our imagination. We must redouble our commitment, and we must stretch every dollar as far as it can go.

*Howie Hodges is a regional vice president for Bank of America in its Community Development Bank in Washington, D.C. He and his group are responsible for small business lending throughout the East Coast. Before joining Bank of America, Mr. Hodges worked for the Department of Commerce in the Minority Business Development Agency.*

**Q and A Summary**

Several questions were asked about services provided to small business customers. Payne said that the company employs 10 lenders, who are trained for SBA lending. A special division of three lenders focuses on SBA lending. In addition, the company employs a credit analyst and a closing clerk, who work with local attorneys. The loan department handles most of the volume.

Kottler discussed the turnaround time on loan decisions and paperwork requirements. Hibernia has a one-page application only for unsecured loans less than $50,000. Hibernia either calls or writes customers to inform them if the loan has been approved. Loan approval takes about 15 minutes. Loan processing takes more time to close if collateral is needed. Hibernia will fund the loan the next day, if the applicant has a checking account. If the applicant does not have a checking account, Hibernia will ask the applicant to open one.

A participant commented that the audience is supportive of the SBA. However, Bank of America may not have the perspective of the majority of program users. For example, Gateway could not afford to participate, because the financial return would be removed and the credit risk greatly increased, which would drive the majority of the 7,000 banks from participating in the program. The participant asked how can that be balanced with the present trend of reducing public funding for these enhancement programs. Hodges responded that a number of nonbank lenders have used the program or the products inappropriately, placing people in the wrong SBA program and thereby using up the credit and the guarantee. Bank lenders and regulated lenders must be aware of marketplace occurrences as they compete against many nonbank lenders in the small business area. When a portfolio of small business loans is sold in the secondary market, the fees paid should be disclosed fully as is required for packaged and sold home loans. Many small borrowers are unaware of the fees that lenders, banks, and nonbanks pay to referral sources for leads on small business loans. Those fees can be dropped to the bottom line for the loan amount, or should not be collected at all.

A participant asked about the effect of credit scoring on capital access for minority businesses. Kottler commented that Hibernia would not have grown its small business portfolio without credit scoring, would not have increased its loan volume from 1,000 to 30,000, and would not have decreased its average loan size from $150,000 to $35,000. Mr. Kottler also told the story of how Hibernia hired a new community development banker from another bank. The banker assumed that Hibernia would not make a loan unless the credit scoring rating was perfect. He looked at 100 loans based on credit scoring. Of that total, he found only one that he would have made in his position as a community development banker. Clearly, credit scoring did not seem to limit access to capital.

Payne noted that 9,000 community banks exist in the country, the vast majority of which do not practice credit scoring. A large majority of small businesses will continue to avoid it. Hodges stated that Bank of America does not credit score — it is still an old-fashioned banker, making one loan at a time. Bank of America takes a second look at any declined loan applications. Because the Community Development Bank is a specialized unit within Bank of America that focuses exclusively on small business lending, it conducts credit reviews one at a time using the five Cs.

A participant asked about the securitization of small business loans in the Hibernia and Bank of America portfolios. Kottler responded that at Hibernia there is not a large amount of pressure on capital or liquidity. As a result, it still keeps the earning assets on the books. However, Hibernia will consider securitization should either its capital requirements or its ability to fund itself change.

Hodges stated that Bank of America does not have capital problems. Bank of America has a portfolio of all of its small business loans. The mission and history of the Community Development Bank leads us to think that it probably will not securitize or sell loans. Bank of America believes strongly that each small business may need special guidance to adjust to the ups and downs of the economy. Bank of America wants to assist with that guidance. However, if the bank were to securitize and sell, it would be unable to provide that service.

## Bank Small Business Investing Issues and Opportunities

Experts from a financial institution, community development corporations (CDC), an equity pool, and the public sector discussed how financial institutions provide equity capital in innovative ways to help small businesses expand. The panelists described four options: the multibank community development corporation; the bank subsidiary corporation; the equity fund, in which the bank serves as a limited partner; and the SBIC. All of the speakers focused on the power of partnerships in serving the small business market successfully. Janice A. Booker, former director, OCC Community Development Division, moderated the session.

**Jean L. Wojtowicz, President, The Cambridge Capital Management Corporation**
Cambridge Capital Management Corporation is a manager of nontraditional sources of

financing. In that role, company employees have found many unique ways to work with regulated financial institutions to provide risk capital to businesses.

Before I tell you about some of those options, I would like to describe a printing company in northern Indiana. The company was started in 1951. The entrepreneur with whom we worked, Hank, purchased it in 1987. In 1994, he approached us, because of tight cash constraints; his current ratio typically fluctuated from .22 to .58. He lost money in 1991. He was profitable in 1992 and lost money again in 1993. When he approached us in 1994, he again showed a loss for the first six months, although four of the months were profitable. His debt to net worth ratio was 14 to 1. The balance sheet would have been considered upside down. Previously, Hank had been a major shareholder in another printing company that filed bankruptcy. Of 90 employees in the current company, 18 pressmen had voted recently to become unionized. Hank wanted to restructure $2 million in debt, including the payment of past due property taxes. He indicated that his existing bank was willing to take a haircut by reducing the loan repayment by $536,000 to have it paid in full. It is a credit story from which most lenders would run.

We will return to Hank later. We manage five different funds under our Cambridge Capital Management umbrella. The first is the Indiana Statewide Certified Development Corporation, an SBA 504 lender. The corporation, formed in 1983, was structured a little differently than most 504 lenders. This is a private, for-profit company, which has had nearly 127 bank shareholders. In the first 15 years, we have provided fixed asset financing to more than 400 companies, and the portion of the financing that we have provided is now more than $120 million.

The Indiana Community Business Credit Corporation and the West Virginia Capital Corporation are considered multibank community development corporations, in which banks pool their capital to take risks that might exceed their normal parameters. For the Credit Corporation in Indiana, we have 33 banks that pooled $19 million. With that pool of capital, we have provided mezzanine financing to 57 companies. So far, 29 of the companies have paid their loans successfully. Similarly, in West Virginia, 55 banks pooled $7.5 million dollars to provide mezzanine financing to businesses.

Lynx Capital Corporation was funded by nine bank investors and 11 other corporate investors. We were asked to provide subordinated debt and equity financing to companies owned by racial minorities in our community. Those private investors put $3.5 million into equity in this fund, and we have now been able to leverage up additional financing from the state government.

Cambridge Ventures is a small business investment company. Our venture fund, the SBIC, has 88 limited partners, two of which are bank investors. The $6 million in equity that we raised enabled us to leverage an additional $2.5 million from the SBA through its debenture program and an additional $1 million from the state of Indiana. To date, we have invested with the SBIC more than $8 million in 22 companies.

All of this is interesting. But, take for example that if you are a parent, it is difficult to describe to your child what you do. I started by telling my preschooler that I was a venture capitalist, and I received a glazed look. Then I said, “Well, we do mezzanine financing,” and I got the same glazed look. I finally told my daughter that we provided money to businesses, and when we did that, it made their dreams come true. That new phrasing enabled her to understand. That was proven to me when I went to her preschool graduation. As the children were walking across the stage, the MC asked them what they wanted to do when they grew up; most of the kids talked about being teachers or doctors or Ninja turtles. When Jenny walked across the stage, she said she wanted to make people’s dreams come true. I may have been the only one who understood that comment.

I believe that risk and cost cannot be unbundled in an unsubsidized environment. Therefore, for perspective, I would suggest that measuring those funds on a spectrum of risk with a scale of 0 to 10 would be useful, with zero being fairly low risk and low cost and 10 being high risk and

high cost. If I were to allocate a number to each of those funds, I would suggest that the Statewide Certified Development Company, the 504 lender, would tend to have a risk rating of perhaps zero to one. The two mezzanine funds would typically fall into a five or six rating on risk, and the Lynx and Cambridge Ventures, our venture funds, would have a risk rating of eight or nine.

Our mezzanine fund with the longest history is the Indiana Community Business Credit Corporation. The credit corporation is now beginning its twelfth year. At the start, not every bank investor was a believer; some might have said they were coerced into investing. By the second annual meeting, however, those same detractors said, "You know, I was one of the first ones in." We were able to convince the bankers that this was a market niche that we could address and provide with capital effectively.

The fund was formed in 1986. It became profitable in 1988, reached consistent profitability in 1992, showed positive retained earnings by 1993, and since 1992, its return on assets has ranged from 1.2 percent to 6.1 percent and has averaged 3.5 percent. That is attractive for a lender. To be prudent about the risk we take, our loan loss reserve over the last five years has ranged from 5.3 percent to 8.8 percent and has averaged 7.4 percent of outstandings.

The type of borrower that seeks mezzanine financing is a company of great potential, although possibly one that is growing too quickly. The bank's or commercial lender's reaction to that growth is, "Let's pull in the reins and get this back under control." Alternatively, the company could be a borrower who wants to diversify its product. Again, the bank's reaction might be, "Stick to what you know. Don't go into unchartered waters." It certainly could be true that the company is too highly leveraged, its collateral is viewed as inadequate, or it might be experiencing an early turnaround.

A typical project will possess seven of the 10 items that a loan officer knows his committee wants to see. In the case of the shareholder who I referred to earlier as Hank, he did not even have seven items to be reviewed. Loan officers are not rewarded for being champions of tough credits. If they work, nobody notices. If they do not, the loan officer is tainted as marginal.

The Credit Corporation has marketed itself as a bank's mezzanine department for smaller credits. There are plenty of places to turn if you need mezzanine financing for $2 million or more, but few sources if you need risk capital, that is, mezzanine financing in the $100,000 to $750,000 range.

We have the experience to evaluate those credits and the flexibility through this fund to structure transactions that compensate for the risk. Our targeted return for each of those transactions is 18 percent to 22 percent, and of the 29 credits that have now been repaid, our returns have ranged from 11 percent to 37 percent.

Occasionally, banks will approve a loan on the basis of insufficient information, but they are not being compensated for the risk they are taking. They try to disguise the loan as a prime plus two credit and hope that no one notices.

Our bank partners that have embraced this concept use it wisely. It allows them to meet a customer's needs and, hopefully, to build loyalty. Ideally, when this company's balance sheet regains some strength, the bank will be able to refinance the mezzanine dollars and reduce the borrower's overall cost of financing. Some banks have invested in the Credit Corporation only as a defensive measure to be on the list that we send to potential borrowers. In that way, they appear to be in the game, but are clearly missing opportunities.

In launching the two venture funds, Lynx Capital Corporation and Cambridge Ventures, we believed a portion of the market was underserved as a market niche. Many equity sources are available to entrepreneurial companies, if they need $2 million or more and plan to go public in five years. However, we believed that some interesting opportunities were available for companies that needed less capital. Therefore, we invest in some companies that most venture funds would scoff at, "boring" companies that only make money "day in and day out." Those

companies can consistently hit singles and doubles, perhaps not home runs, but they will not often strike out either. This strategy makes our returns to investors quite acceptable.

An example is helpful. Through our SBIC, we provided financing for a company that makes tombstones. An audience of finance people might think about the lucite type — I mean the type in the graveyard. This company had a $40,000 line of credit to support $400,000 worth of inventory; they were struggling. We provided some patient money to allow this company to grow. Three years after we made that investment, we had identified for the company an acquisition opportunity, another manufacturing plant located 35 miles from the existing facility. We provided all of the equity dollars to bring that acquisition to fruition and were able to leverage up more traditional senior debt. The company made burial vaults; we saw the loan as a chance to integrate this company vertically. The company has grown significantly. We expect they will be able to repurchase our warrants in 1999, and that our average compounded return on this investment will exceed 20 percent. It is a low tech company, a "boring" company that "day in and day out" makes money.

Often we can use a variety of our financing sources to craft a balance sheet strategically for a company, allowing us to price the money to minimize the overall cost of capital to the borrower, while obtaining the appropriate level of return for our investors. This approach has allowed us to be viewed as a real partner and a resource to commercial lenders. This partnership is important. All of us, consumer or business borrower alike, are taught that if we need money, we go to the bank regardless of the type of money we seek; for that reason, we become a resource to the banks. They become our marketing arm, and we help to prevent them from saying "no" to their customers, and to say at least, "No, but."

Let us return to Hank and his printing company. We financed this transaction through the Credit Corporation, our mezzanine fund. We provided $400,000. A new senior bank provided $630,000; coupled with the debt forgiveness from the former bank and some additional equity, we were able to restructure the balance sheet. The company was profitable in 1994, but lost money again in 1995. In the fall 1996, Hank called me and said, "I have to meet with you tomorrow." Those of you in the lending business know that is usually not good news. After I hung up the phone and scheduled the appointment, I frantically went through the file to locate any exceptions. I found a few, nothing too serious, although some of the statements were not as current as I would have liked them to be — his personal statement had not been updated. I created my list and went in to the meeting.

The next day, Hank and I sat down at the conference table. He told me about the 180-day union strike that he had lived through the previous year. He indicated that 1996 was starting to look as if it might be a good year. He also said that the reason for his trip was to sit down across the table, look me in the eye and say, "Thank you," and request a payoff figure. He said that without us he would have lost his company and would not have been able to make his dreams come true.

*Jean Wojtowicz is the president and founder of Cambridge Capital Management Corporation in Indianapolis. Her firm manages the Indiana Community Business Credit Corporation, which is a multibank CDC, aided by national bank and other bank investors. Cambridge Capital also helped develop the West Virginia Capital Corporation, which is modeled after its Indiana initiative. It also works with two venture capital funds to provide capital to small business clients.*

**Gail Snowden, Group Executive, Community Banking Group, BankBoston, NA**

What is needed for a financial institution to be a catalyst for wealth creation in low- and moderate-income, underserved, and emerging markets? What does it take to be innovative in banking services, partnerships, programs, and investments for small business? And what does it take to be a visible leader in implementing a holistic approach in economic development?

BankBoston meets those challenging questions directly through its Community Banking Group, which links the businesses of our nationally modeled First Community Bank, BankBoston Development Company (BBDC), and Urban Developmental Real Estate.

We believe that it is a powerful approach to the challenges of our distressed and underserved urban neighborhoods, and an approach that infuses the same dynamism, optimism, job creation, wealth creation, and business ownership in those emerging markets as is the case in the broader community.

We do not have all the answers, but we certainly have the passion for seeking solutions. We must heed the call of respected leaders, such as the Comptroller of the Currency Eugene Ludwig, who has been a long-time advocate of investing capital in inner cities. Urban neighborhoods need equity investments from venture capitalists. Also needed is a partnership with development groups, local government, churches, and not-for-profits. Finally, innovative loan products can make it easier for consumers and business owners to qualify for credit.

***Urban neighborhoods need equity investments from venture capitalists.***

A few days ago, Federal Reserve Chairman Greenspan said, "Unless minorities can have access to all forms of capital from which to create wealth, they will be denied the full benefits of our vibrant economy in which all should participate." At BankBoston, we accepted this challenge eight years ago. First Community Bank represented our "bank within a bank" concept. It was our response to community leaders who pointed to the banking industry's lack of enthusiasm in the inner city. We planned to enter those markets, provide services, share in the revitalization, and deliver shareholder value; after all, we are a business measured as any other business. BankBoston's First Community Bank began with the belief in the viability of such urban areas as Boston's Roxbury and Dorchester neighborhoods. Because we had never left the community, we launched this concept with seven branches.

The business, now growing and profitable, has more than $1.6 billion in deposits and has expanded to 44 branches across three states. Our customers are a diverse reflection of the cultural mosaic of our urban areas. We are serving substantial Hispanic, Asian, and African American populations in 13 cities. Our staff reflects the diversity in each of our locations. Daily we face the task of reaching out to those populations and providing education on financial basics. The market is large. As Michael Porter of Harvard Business School has concluded, high population density translates into substantial purchasing power and a large market, even though average incomes are relatively low. Not only is the low- to moderate-income (LMI) urban market large, it is young and growing rapidly. Minority consumers represent a major growth market. First Community Bank has positioned its branches strategically. They serve as financial service centers that offer all of the advantages of our larger regional banks, including mortgage, consumer, and small business lending.

With the additional component of our community development outreach staff, this unit reaches out to our consumers and small business owners with financial seminars and access to banking services. At the end of our seventh year, the total group had an operating profit of $17 million and $12 million pre-tax. When I report to the bank's board of directors, as I do twice a year, I can always say the business is a great business. It is profitable.

We realized that there was so much more to be done, and the next step in this evolution was to launch a commercial bank, BankBoston Development Corporation (BBDC). I visited the streets of Grove Hall and Roxbury, the neighborhood in which I was raised. There I saw an underutilized center that had seen its share of economic and social tailspins, and something was missing. What was missing was the economic vitality of downtown Boston two miles away. The economic engine was misfiring. No one was investing in small businesses or real estate projects; entrepreneurs who lived there were extremely frustrated.

The challenge of investing in the fabric of urban neighborhoods needed a solution. Our response was the creation of the first urban investment bank in America, chartered by a

commercial bank. Through it, we are investing in, and being an innovative provider of, capital to businesses and not-for-profits that benefit LMI and disadvantaged communities in our New England base and beyond. BBDC promotes community stabilization, housing, job development, equity ownership, and wealth creation in a sustainable and profitable manner. When we launched BBDC nine months ago, Comptroller of the Currency Gene Ludwig was there. He said that the new BBDC represents an extraordinary and creative commitment by BankBoston to inner city markets. The BBDC is the key to unlocking an untapped potential in LMI and urban neighborhoods by investing in and nurturing an indigenous business class through a powerful incentive, equity capital. We seek to be partners with our businesses.

Immediately after our launch, there were a large volume of calls on our 1-800 number. We were overwhelmed; we had started with three people that expanded immediately to a staff of 14. It proved that there was a great need for working capital in these markets.

Although BankBoston had performed community development lending on a more diffuse basis for a number of years, we wanted to do more. We wanted to be innovative and set up our own company. We set it up as a subsidiary of the bank, so that we could book assets at the bank level. The OCC regulations gave us more flexibility in structuring our products. Gene talked today about 12 CFR 24; those regulations offered a conducive climate to innovation and allowed us to do more in the CRA area.

We knew from experience that business ownership and the development of this entrepreneurial base are hindered by inadequate capital, limited opportunity to network with the larger business community, and inadequate capacity and scale to compete effectively. Our response through BBDC was to invest in LMI and disadvantaged communities with an eye toward community stabilization. Our target markets are businesses located in LMI tracts, disadvantaged businesses, minority-owned and women-owned businesses, and worker ownership opportunities.

We are making $100 million available over the next four years, targeting business growth and real estate development in our primary markets in Massachusetts, Connecticut, Rhode Island, and New Hampshire. This approach emphasizes equity investments in companies that provide jobs and services.

Our means of investment include business equity, real estate development equity, joint ventures, and investing through funds. We have other products, such as low-income housing tax credits and debt products.

BBDC strengthens the ability of urban communities to be active participants in the broader regional and global economy. BBDC's $100 million commitment is projected to stimulate an estimated one-half billion total dollars of new financial resources in urban areas. Our goal is to help transform and grow companies, particularly those that are minority or women-owned.

It is a three-pronged approach: capital, capacity, and access. First, BBDC targets companies with sales in excess of $500,000 for direct equity, provided they possess the potential for significant growth. Because of our decision on these minimums, we are a later stage investment company. We realized that we would be best at creating wealth in communities, and we were targeting mid-sized companies that had significant growth potential. However, we addressed start-ups and smaller companies by investing in funds.

Second, BBDC works in conjunction with the BankBoston line lenders to assist a broad spectrum of companies, whose credit needs range from as little as $5,000 to as much as $5 million. We fill the gap by providing debt that often works like equity.

Third, we help businesses overcome information and operational barriers that can hinder growth and development. Sophisticated technical assistance, business management training, networking opportunities, and other consulting services are offered. We have developed and used a Spanish language one-page application to assist that market.

We look at 20 to 50 deals for each one we approve. Someone mentioned that our lenders and equity folks must have a passion for this business, because it is a lot of work. The types

of businesses range from construction developers to flower shops. Our initial capitalization is $300,000, with an additional commitment up to $10 million.

In his strong support for this business, BankBoston Chairman Chad Gifford noted that it presents a significant opportunity for the bank. We would not be successful if we did not have the support of top management. He said that BBDC is viewed as a principal partner in creating commerce, economic ownership, and jobs. We are managing for value.

There are many successes. On the equity side, we have eight approvals totaling almost $4 million. We recently approved a direct equity investment to a minority-owned construction, management, and development company based in Roxbury. They needed short-term equity financing to secure a surety bond to compete for an $8 million HUD demonstration disposition construction project. BBDC approved an $800,000 equity infusion into the company. We also allocated up to $50,000 for technical assistance to create a long-term strategic focus for this company.

Another example shows how we meet the needs of smaller businesses and start-up businesses. It is represented by our $500,000 investment in the Boston Community Loan Fund. It would be impossible for us to run a direct equity investment business that invests amounts as low as $25,000 or $50,000. However, we are the largest investor in this loan fund and several other funds that address the needs for micro-equity and the significant hand-holding often necessary to nurture those businesses. With 10 percent of our equity earmarked for those types of funds, BBDC can be a partner's partner.

We use our resources to do what we do best: to grow existing businesses significantly, while we strengthen the ability of local partners to invest at the grassroots level.

We also provide low-income housing tax credits. A unique low-income housing tax credit partnership resulted in a ribbon-cutting event last week when BBDC became sole partner in a 17-unit LMI housing project in New Hampshire. For the first time in that state, the general partnership joined a not-for-profit and the local housing authority in an investment of $775,000. This innovative arrangement resulted in new housing for LMI families. The low-income housing tax credits averaged in the low teens in returns. However, these are front-end weighted, which helps with the overall portfolio balance.

***We use our resources to do what we do best: to grow existing businesses significantly, while we strengthen the ability of local partners to invest at the grassroots level.***

To date, we have made $27 million in new commitments, which created more than 1,000 units of new affordable housing. We also have a co-lending product in addition to a continuous evaluation process. We have made 13 co-loans totaling $1.4 million with our line business partners, BankBoston.

An owner-occupant of a popular restaurant in a low-income neighborhood requested a $205,000 loan at a bank branch to pay out an existing loan and obtain additional working capital. The previous year, the borrower was severely ill and fell behind in many personal obligations. His credit bureau report did not look good. Although the owner brought the existing loan current, his bank demanded payment of the total amount four months later. Our First Community Bank lender capitalized on this opportunity to help stabilize this customer. A BBDC co-loan was used to bridge the gap on the 75 percent estimated market value and the request amount. This resulted in a First Community Bank senior debt of $160,000 and a BBDC co-loan of $45,000 subordinated for a total of $205,000. Today, the business is doing well.

We cannot do our job without partnerships. A good example is the South Hartford initiative, a partnership investing in small businesses in that region. The partnership among our First Community Bank, the state of Connecticut, and the SBA created a not-for-profit CDC. We work with partners to leverage funds available to that

CDC by the state. The CDC that can take a higher risk portion of the loan joins the bank, which provides the lender origination and service. We also were able to get the SBA to guarantee our portion of the loans. The result is that we make available more money than the partners could provide individually. This has proven an interesting model. In its first four months, the South Hartford initiative has committed $735,000 to four customers: a restaurant owner, two contractors, and a distributor, customers to whom the bank would not lend ordinarily.

Another approach to finding effective ways to strengthen businesses is the "Open for Business" program. To encourage economic change in one Boston neighborhood, we forged a partnership to conduct seminars to help small businesses sharpen their effective business practices. This initiative is unique, because our partners were a not-for-profit housing development organization; a Latino merchants association, which provided the people attending the sessions; the Latino Grocers Association; and a neighborhood agency that provided programs and business development. Our small grant of $25,000 purchased a 20-week seminar that graduated 17 small business owners. The owners were instructed in finance, accounting, computers, taxes, cash flow, and dealing with banks. Before the seminar, most of those owners had used minimal skills that they had learned in their native countries to run their businesses. We believe this training has made a difference in inner city neighborhoods, particularly for Latino businesses.

We have committed over $100,000 to conduct this training for the first four years. In less than two years, at the end of 1998, $90 million has been made in commitments for the entire BBDC portfolio. On the debt side, we extended reserve credit at BankBoston to 100 small businesses and leveraged with the bank a total extension of more than $6 million in working capital.

We want to forge partnerships with others. We have a field study underway by students of the Kennedy School of Government to gather information and assist us in finding partners. Our current partnerships include the not-for-profit Community Enterprise Fund, the Boston Community Loan Fund, low-income housing tax partnerships, and a HUD partnership.

We expect 25 percent to 30 percent returns and a seat on the board of the company when we exit in three to five years.

Our experience in meeting the needs of small business owners has been successful. It benefits community economic development and meets new challenges. Our scenario for the future envisions other financial providers entering small business lending and sharing CRA responsibility.

Our own commitment exceeds CRA, because BankBoston wants to be a leader in community economic development, and we are meeting our responsibility through example. We need initiatives, such as low-income housing tax credits, and economic development tax credits, to facilitate capital flow to the inner city.

That is where we stand today. We are constantly looking for ways to enlarge this business and to meet the needs of our inner city community.

*Gail Snowden is the group executive for the Community Banking Group of BankBoston, a multistate group that focuses on meeting basic banking and credit needs of inner city residents and women- and minority-owned businesses throughout New England. She directs product development, advertising, community development lending, construction, financing, housing construction, and commercial loans. Last year, BankBoston was authorized by the OCC to establish BankBoston Development Company as a subsidiary of the bank. This is an investment bank for urban communities that focuses especially on venture capital.*

**Jerrold B. Carrington, General Partner, INROADS, Inc.**

We formed INROADS almost four years ago to invest in growing businesses, typically overlooked by private equity firms, particularly those owned or operated by minority or female entrepreneurs. Our investors are primarily pension funds. The District of Columbia Retirement System is an investor, and three banks contribute about 10 percent of the $50 million fund. They are: LaSalle Bank, Northern Trust,

and Bank One of Ohio. They were able to receive CRA credit by investing in our firm, even though our investment focus is national. They had to apply for that certification; they could not self-certify. In essence, we are the only private equity fund in the United States that has that type of regulatory approval.

We target small businesses for investment for six reasons. First, small businesses comprise a growth engine in today's economy. A tremendously large number of exciting and profitable growth products and services is provided by those firms. Second, we face less competition from other private equity firms and the lending community that generally target larger companies. Third, many more investment opportunities exist, because the small businesses outnumber larger companies. Fourth and most important is that less competition means lower purchase prices. On average, we pay four times earnings before interest and taxes (EBIT) compared with six to eight times EBIT for larger companies. Nonetheless, we believe that we possess the same quality of management. Fifth, it provides us with an opportunity to add value. The partners at INROADS have financed collectively more than 70 small businesses. We are experienced in guiding a company during its growth phase.

The sixth and final reason for targeting small business for investment is simple: profit. I am always amazed by the number of investment firms that invest in ideas that are not profitable.

One would ask, how have banks participated in the development of the small businesses, in which we have invested since 1985. The three banks that have invested in INROADS have provided to our seven portfolio companies more than $125 million in senior debts. One bank has already recouped its entire investment in fee income in only 18 months of a 10-year partnership. This does not include interest income or the fees earned by providing related services to our investments.

***One bank has already recouped its entire investment in fee income in only 18 months of a 10-year partnership.***

Many of our companies never have seen that level of bank support. For example, the owner of a woman-owned company had requested from her banker a $500,000 increase in her credit line. The company was earning $20 million in revenue and netting $2 million a year. The bank refused. She came to us and said, "I must have an equity investment so I can obtain this $500,000 credit line." We replied, "We want to invest in your business and make it a $100 million business." We called the senior officer of the bank and said, "We are prepared to invest $7.5 million dollars of equity in this company, and we would like you to provide $15 million of debt instead of $500,000." Needless to say, that investment was approved, and the company is happy with that investment today.

The second way that banks participate is that they can market their fee-based services, which is important to all banks' profitability as they begin to increase their ROAs.

Third, and most importantly, they have gained insight about, and access to, a profitable, yet often overlooked and misunderstood, customer base.

Banks can access this market profitably in four ways. It is excellent to invest in, and partner with, private equity firms with a demonstrated record of success in the small business market. Banks may earn high economic returns on their investment in that market through capital gains. There are three more important reasons, however, for banks to gain access to this market.

First, banks can secure a safer and more efficiently deployed loan portfolio that has been screened rigorously by a private equity firm. This rigorous screening process provided by your private equity partner to any investment opportunity is valuable for banks.

Second, banks can focus on what they do best, which is lending money and providing related banking services. It is a hassle to deal daily with entrepreneurs. Entrepreneurs need technical support, company-building resources, and someone with whom to talk. On average, we talk to our company executives four to five times a week. This is impossible if you have a loan portfolio of hundreds, perhaps thousands of companies.

Third, banks also can receive CRA credit, subject to regulatory approval.

INROADS is committed to the small business area, because it is extremely profitable. We will raise our next fund this summer to focus once again on this area, and we will invest in, hopefully, numerous new small businesses. This time, our target is $200 million instead of $50 million. Many profitable opportunities are created by focusing on what one does best and partnering with people who know what they can do.

*Jerrold Carrington is the co-founder and general partner of INROADS Capital Partners, a $50 million private equity investment firm based in Evanston, Illinois, and authorized to operate nationwide. It is a small business equity pool, in which a national bank took the lead in participating as a limited partner. INROADS provides growth and acquisition equity capital for small- and medium-sized businesses. Its limited partners include highly respected pension funds, banks, and many successful people.*

**Saunders Miller, Senior Policy Advisor, SBIC, SBA**

The SBA has the Small Business Investment Company Program, which has been almost invisible to most banks. However, a knowledgeable group of banks has benefitted from the program for many years, some for almost four decades, and they have found it to be highly profitable.

SBICs are government-licensed venture capital firms that invest solely in small businesses. For the purpose of this program, a small business is defined as one with $6 million or less of after-tax income and $18 million or less of net worth. SBICs derive many benefits through licensing. For banks, one of the primary benefits is an exemption to the Glass-Steagall Act, which enables them to own voting equity in nonfinancial institutions that exceed the 5 percent limit otherwise imposed by the act.

Over the past 10 years, the banks that have invested in SBICs have earned an average 13.1 percent return on investments, on realized returns; they have earned this return during the past two decades. This translates into 13.1 percent over a 21-year period through many economic cycles.

Rarely has one set of mandatory government regulations benefited another government program. That day has now arrived. All banks can obtain CRA credit by meeting the financial needs of your business communities and, simultaneously, earn high returns. This is accomplished by investing in SBICs. As Dr. Pangloss said in *Voltaire's Candide*, "This is the best of all possible worlds."

I have made an important discovery from my involvement in CRA during the past 12 months largely owing to the OCC's Community Development director and division. For the past 25 years, an entire body of lenders, investment bankers, and state and municipal governments, working together with development companies and neighborhood nonprofit organizations, has learned how to layer various types of financing and tax benefits to achieve social goals that make financial sense in the area of housing and real estate development. This creative financial layering, however, only recently has begun to be applied to financing for small businesses. One proven tool in almost four decades of use should now become more widely available through the innovative financing of the SBIC program.

This program is a public-private partnership that works. It can be used for economically targeted investments. The huge California state pension fund, CALPERS, invested in a California-targeted SBIC in Los Angeles where, in spite of the city's size, there is a dearth of equity venture capital for small businesses. In New York City, various New York City pension funds invested in a city-oriented, early-stage, high-tech SBIC. In Maryland, the state made an investment in an SBIC that targets minority investing.

Although SBICs may be used for economically targeted investments, their primary motivation or goal still must be to earn fully risk-adjusted profits, and any applicant receiving a license must have fully qualified venture management. We believe you do good by doing well.

The median size investment by all SBICs in fiscal year 1997 was $150,000; for that subset of bank SBICs, it was $430,000. Some SBICs are making $50,000 financings to laundromats and to dry cleaners; others are funding multi-million dollar companies. Fifty percent of all

financings are made to businesses less than three-years-old.

The majority of financings are equity investments, consisting of debt with warrants, preferred stock, or straight equity. The better-managed SBICs receive ROIs that exceed 20 percent without risk of overall portfolio loss.

If an SBIC is managed properly, the goal of high returns with acceptable risk should be fully attainable. The key is "managed properly." History tells us that the most successful SBICs are those run independently of the related bank. Commercial lenders are not venture capitalists. Bankers look at past performance and at making loans based on cash flow, financial statements, and collateral. Venture capitalists look at future potential, and they make investments based on the quality of management, because the financial statements usually are weak. If the statements were not, commercial lenders would provide all of the necessary financing.

To keep good SBIC managers, compensation must be oriented to the long term. SBIC managers are usually paid more than commercial loan officers, and they do not fit into the compensation structure of the parent bank.

Currently, 79 bank-dominated SBICs participate in the program. All, but four, rely solely on their parent bank's own capital to finance their SBICs, because its cost of capital is lower than that obtained through the SBA. However, the program's appeal for all nonbank SBICs and the four exceptions is the ability to obtain up to three times their private capital by borrowing from the public market at a rate of approximately 175 basis points over the 10-year Treasury rate. The funds are backed by the full faith and credit guarantee of the U.S. government.

Leverage is the capital that comes through public market financings. Two types of leverage exist in the SBIC program. The traditional type of debenture leverage requires semiannual interest payments and principal repayment at the end of the tenth year. A second, newer type was introduced in 1994. It is known as "participating securities" and has a similar interest rate spread, although dividend payments are made only when an SBIC has positive retained earnings. This enables an SBIC to make long-term equity investments without having to pay dividends before it has positive cash flow. With participating securities, the SBIC also gives SBA approximately 10 percent of its profits. We are truly partners in your SBIC.

For a profitable SBIC, its internal rate of return can increase by 600 to 800 basis points. The leverage, however, can cut both ways. If your ROI falls below about 11 percent, you would probably be better off without it.

In 38 years, SBICs have invested more than $17 billion through 113,000 financings. In fiscal year 1997, there were 2,731 financings in 47 states and the District of Columbia and Puerto Rico. Interestingly, 90 percent of the funds that were invested had equity features. At the end of fiscal year 1997, we had 300 licensees with $5.1 billion of private capital compared with $2.2 billion of private capital in 1993. The new program was implemented in 1994. That amount is more than a doubling of capital in four years. During this past four-year period, more new capital flowed into the program than during the prior 30 years. The program is demonstrating its success.

At the end of 1997, bank-dominated SBICs represented 68 percent ($3.5 billion) of the program's private capital. Clearly, both banks and private investors are demonstrating their faith in the future of the program.

The program has had many successes. In Fortune Magazine's 1996 list of the 100 fastest-growing businesses, 18 had received SBIC funding. Early examples included Federal Express, Intel, Cray Research, and Apple Computer. More recent well-known examples of public companies include America Online, Staples, Amgen, Callaway Golf, Microcom, and Gymboree. However, most of the businesses financed are private, are much smaller, and do not grow to that size.

But it was not a smooth road from 1958 to the present. The program shrank during the 1980s. There were $600 million of gross leverage liquidations before recoveries that are now running at approximately 60 percent. In 1990 and 1991, the Senate held hearings to consider whether to eliminate the program. To

deal with that issue, the SBA formed an investment advisory committee composed of venture capitalists who were not with SBICs. They found that the program was basically sound, and that it had a high return to the taxpayer. We would like to emphasize that Federal Express or Intel pays more taxes in one year than the entire cost of the program since it began.

A number of identifiable problems existed, however. First, the program was plagued by inadequate management. Second, the capital base of most SBICs was too small to be economically viable. Third, portfolio valuations were performed poorly, which led to inaccurate reporting and false credit evaluation by the SBA. Fourth, debt leverage was being used to finance equity investments, causing a mismatch of funds flow. Those problems were corrected by new legislation in 1992 and by new regulations finalized in 1994.

"Management, management, management" forms the core of our philosophy today as does "location, location, location" in real estate investing. Therefore, we admit only qualified management. We have the philosophy of licensing hard and regulating rationally.

The current minimal capital requirements now are based on economic viability, which encompasses the need for SBIC management to afford sufficient expenditures to perform adequate due diligence and continuing oversight. Thus, to obtain a participating securities license, a minimum of $10 million of private capital is required under most circumstances. This enables SBIC's management to perform sufficient due diligence, oversight, and marketing.

***Your biggest decision should not be whether to invest, but how much to invest.***

For a debenture licensee who may make loans in a smaller geographic area, as little as $5 million of private capital is sometimes sufficient. By law, however, only $3 million of private capital is required for a non-leveraged bank-oriented licensee, because SBA is not at financial risk, and overhead often is absorbed by the bank. However, we do not recommend this small an amount.

This is a great opportunity for bankers.

Your biggest decision should not be whether to invest, but how much to invest. Your greatest challenge is to find good management. We would suggest that you start by investing in a consortium SBIC where outside fund managers are hired. You may ask, "Where do we find such managers?" At the SBA, we cannot make specific recommendations, but we can help you get started and point you in the right direction. You can call me at (202) 205-3646. SBA will be glad to help you get started.

*Saunders Miller is a senior policy advisor for the SBA's Small Business Investment Company Program. The program is designed to meet a market need for risk capital that is larger than that provided customarily by some private investors and to finance active small operating companies of a size not generally assisted by private venture capitalists. Miller is responsible for the modernization of the SBIC Program, including its policies and regulations, and establishing a rigorous licensing process and other important initiatives.*

**Q and A Summary**

A participant asked about the infrastructure appropriate to start an SBIC, *i.e.*, if you require $5 to $10 million to capitalize one and it takes several years to invest the capital, the ROI will be greatly reduced over a period of time sitting in money market accounts. Wojtowicz said that legally you can draw the money down over time if you have firm commitments, which reduces the idle fund drag that often occurs in the early stage of funds. The minimum capital necessary for licensing and to continue to increase capital also can be obtained. Since Cambridge was licensed in 1991, it has continued to sell additional partnership units to increase the capital base. Typically, venture fund partnerships have a 10-year life, because that is expected by the institutional investor, although a venture fund may have to exit an investment before reaching the company's ultimate top earning period. Cambridge engaged in a 15-year investment that gave it five

years to leverage up and invest private capital — five years of active leveraging with SBA and other investors, and an additional five-year period to begin harvesting those investments. Cambridge did not have to exit the investment before reaching maximum return.

A participant asked about the type of overhead and management needed with an SBIC. Wojtowicz stated that Miller's comments were extremely important. As a venture fund, Cambridge looks first at management when making an investment, and investors that invest in venture funds should look at the same. A smaller SBIC can operate only in a shared overhead environment in which people on the front-end review investments and, most importantly, from which they may obtain the money easily. It is much harder to add value and find an appropriate way to exit from those investments.

Another participant asked about the typical ROI and a predetermined amount of equity required for an investment. Carrington responded that INROADS generally looks for a return of a minimum of four times its money in a five-year period. That equates to roughly a 38 percent or 39 percent IRR. The minimum amount of capital required depends on how much capital the company will need over time, because growth companies usually exhaust capital. In general, INROADS invests with partners, but it likes to contribute up to $4 million over the life of the investment on equity.

Wojtowicz stated that the typical hurdle rate is at least a 35 percent annual compounded return. If that is not possible, Cambridge usually will contract it, because they know they will not always reach that percentage. On the amount of investment capital, Cambridge looks at how much it will take to meet its business plan objectives; it will invest only if it can keep one-half available for reinvestment. For example, if it will take $2 million, Cambridge will invest only $1 million on the front-end, knowing that it might have to reinvest around $2 million or $3 million. A venture fund gets into deep trouble if it does not have the capacity to return for rounds two and three. At that point, the fund has lost its negotiating position and can be diluted significantly in the next rounds of financing.

## The State of Small Business in America

Aida Alvarez, administrator of the SBA, said in her presentation that the OCC and SBA are moving in the same direction. The SBA is advancing its ability to serve underserved communities and, at the same time, deliver services in a cost-effective way. The SBA is preparing itself and its small business customers for the economy in the 21st century, which will be diverse, technologically driven, and global in scope.

**Aida Alvarez, Administrator, SBA**
It is a pleasure to be here today at this OCC conference on small business. As administrator of the SBA, I must applaud the efforts of Gene Ludwig. He has shown an outstanding commitment to this topic during his five-year tenure as the Comptroller of the Currency. We cannot thank him enough for his work on the credit availability program and leadership in the CRA revision. After a five-year stint in an extraordinarily demanding job, Gene is looking forward to a break in the private sector. I must express some sadness because we will miss his leadership. He has made a great contribution, has been a great Comptroller, and has been good for the small business community. We can only hope that his successor will follow in his footsteps.

The SBA and the OCC are moving in the same direction. Gene mentioned my prior tenure as the financial regulator of Fannie Mae and Freddie Mac, during which time he was a great colleague and helped me to think about doing that job effectively. There was always a balancing act between protecting the interests of the taxpayer and ensuring that the entire country would be served by a thriving business community, that the business community would not be impeded at the same time that we were looking out for the taxpayer. At all times, we were protecting the public mission.

Let me reiterate. The SBA and OCC are moving very much in the same direction. We are advancing our ability to serve the underserved communities, while at the same time delivering our services in a cost effective, sophisticated

way, with an increasing reliance on our financial intermediaries and private sector partners.

At the SBA, we are preparing ourselves and our small business customers for the 21st century. It is not only rhetoric, it is real, it is happening, and it takes some preparation.

The rapid changes in our economy give us some indication of the shape of the future economy if we do the right things. The economy in the 21st century will be more diverse, technologically driven, and global in scope. Today, I will address the meaning of those changes for the SBA, for the small business community, and for small business lending.

SBA's principal objective is to create opportunities for small business success. We achieve this objective for small business by supporting access to capital and credit by expanding federal procurement opportunities, by providing a wide range of counseling and education programs, and by serving as its voice.

Last year, SBA provided record levels of loan guarantees, $10.9 billion, and record levels of venture capital financing, $2.4 billion. We supported more than $40 billion in federal contracts for small business and provided counseling, training, educational services, and technical assistance to more than 1 million small businesses.

SBA is already prepared for the 21st century. We are serving an increasingly diverse business population and have set in motion a number of initiatives to increase our penetration into rapidly growing markets of women-owned and minority-owned businesses. We are at the forefront of technology, serving small businesses in smart, sophisticated ways and are well on our way to becoming a paperless organization. We are expanding our understanding of the global marketplace and increasing our ability to help small business find opportunities in the international arena.

SBA has changed and will continue to change, as the banking and financial community has changed. I invite all of you to take another look at SBA and join us in our mission of serving America's small businesses.

Our first challenge is to prepare for a more diverse America. The Census Bureau projects that by the year 2050, there will be no more racial or ethnic majorities in America. It will, indeed, be a very diverse country.

The face of small business also is changing rapidly. Minority- and women-owned firms are growing faster than all other firms. The Census Bureau has found that minority-owned businesses grew at a rate of 62 percent over the 1987-1992 period. Women-owned firms grew at a rate of 43 percent, compared with 26 percent for the overall population. I strongly believe that the SBA must be in the forefront of serving those growing business communities. Simply put, it makes good business sense.

SBA has already done a good job of increasing lending to its more diverse American business community. Since 1992, SBA has more than doubled its loans to African Americans and to Hispanic-owned firms and almost tripled lending to women-owned firms. We have achieved those levels of growth, while improving our credit quality. While increasing our lending to those underserved communities, we have lowered our program's cost to the government. That linkage is important. We can do both.

In 1992, we estimate that the cost to the government was $4.85 for every $100 we guaranteed through our 7(a) loan guarantee program. Contrast that to today's cost, which has been reduced to $1.39 for every $100 we guarantee. That is going in the right direction.

***Women-owned firms grew at a rate of 43 percent, compared with 26 percent for the overall population.***

Our record shows that loans to minority-owned businesses and women-owned businesses are good business. Nonetheless, we have much further to go.

Although African Americans make up 12.6 percent of the population, they own only 3.6

percent of all businesses. Hispanic Americans make up 10.3 percent of the population; they own only 5.6 percent of all businesses. SBA wants to close this gap and increase minority and women business ownership. We want to increase our loans to this fast-growing sector of the population and see a huge need for coordinated economic and business development strategies in other parts of the country.

SBA has launched a series of initiatives to do a better job of serving those increasingly diverse communities, and it extends everywhere from building on goals. We have had goals for our field structure, our 69 district offices; those date from Erskine Bowles' days. He introduced them, and I am building on Erskine's good idea by establishing aggressive three-year overall goals for all eight of the lending categories. These categories include African Americans, Hispanic Americans, Asian Americans, Native Americans, women, exports, rural, and veterans. Those are the categories where we are pushing the frontier. The entire agency, not only our field offices, is being held accountable for those goals.

I have announced a marketing and outreach effort through which SBA is identifying new partners to help us develop and improve relationships in the minority and business communities. Last week, we signed a memorandum of understanding with a statewide organization, the Texas-Mexican American Chamber of Commerce, composed of 27 chambers of commerce, 11,500 members. They will work with us and with our lending partners to bring in more business. This is good business. Hopefully, we will find more customers in the Hispanic American community through those partnerships.

We have learned a lot. We have had good meetings with our lenders and our trade associations on what constitutes best practices to expand lending to those diverse communities. We will continue that dialogue and make sure that our success is everyone's success. We have learned a lot of lessons from CRA, and there is more to be learned.

Finally, we are reviewing our products and practices. Our Low Doc Program, for example, is a huge success. The idea behind the program is to reduce our paperwork requirements to one page for loans under $100,000. Since its introduction, SBA has guaranteed more than 72,000 Low Doc loans, and it continues to serve thousands of small businesses.

SBA's Low Doc Program is successful particularly in providing credit to underserved communities. According to our Chief Counsel for Advocacy, Jerry Glover, we have seen a phenomenal growth rate in private sector loans under $100,000. Since SBA introduced the program, the stock of loans under $100,000 held by private banks has grown from $97.6 billion in 1994 to $112.2 billion last year. That is a growth of $14.6 billion in those smaller size loans. This is the real success of the Low Doc Program: we gave the private sector confidence that these loans could be done efficiently, economically, and practicably. We showed the private sector the way.

The marketplace has changed. SBA's Low Doc Program needs another look. John Gray is in charge of our Capital Access Financing Program. He and Jane Butler, Jim Hammersley, Jean Schater and others, are examining the Low Doc Program. They are thinking about ways to upgrade the program and make it more competitive in the marketplace.

Our fifth strategy for reaching the underserved business community is to do a better job of linking our capital and credit programs with our vast entrepreneurial development services. We have an enormous network of business education, counseling, and training programs across the country. This network is somewhat of a secret to many of us in Washington, although if you travel around the country as I do, you realize the presence and importance of our 1,000 small business development centers, our 69 district offices, our 41 business information centers, 60 women's business centers, 14 one-stop capital shops, and more than 13,000 retired executives who volunteer their time to counsel small businesses through our SCORE Program. It is a daunting presence.

The figures last year were impressive. The network provided counseling advice to about 1 million entrepreneurs whether or not they received an SBA guaranteed loan. We want to

continue to open up our doors to small businesses through counseling, and especially to the underserved communities.

We have a prequalification program that is successful. It allows us and our intermediaries to help women and minorities work through their business plans and loan applications. By the time they get to the bank, they already have an SBA guarantee attached to their loan application. It makes life a lot easier for the customer, the lender and the bank. I want to expand that into a nationwide program.

We must use technology to access our customers directly. We have a great success story. On January 5 of this year, the Vice President inaugurated our online Women's Business Center. It is free, interactive, and provides information on business development strategies and SBA services. You need only to get online. In the few weeks since we inaugurated this site, it has received more than 250,000 hits, which we estimate is at least 4,000 visitors per week and visits from representatives of more than 45 different countries. We now operate in an international arena through the Internet. We help many people, not only our own citizens.

We have a new online product called PRONET. Today, we have a bank of 171,000 small businesses on our PRONET, which links them with our federal contract procurement officers. Last year, we granted $40 billion in federal contracts to small business. That number is rising, probably to $46 billion, because we now have increased the set-aside for small business in the federal government from 20 percent to 23 percent of all federal contracting. PRONET is an unbelievable way for federal contracting officers to access small businesses and for small businesses to access one another. The possibilities are endless. ACE-net is another way in which we use the Internet to link small firms that have capital needs with equity investors.

Technology is important as SBA pursues its mission. We also know that small businesses must be technologically smart if they are going to compete in the world economy. This will be a major focus of my attention.

We already have 41 business information centers (BICs) that promote technological sophistication among small businesses. We have had a partnership with the U.S. Chamber of Commerce and Microsoft to educate small businesses on how they can be more sophisticated in their use of the Internet and all the technologies associated with the World Wide Web.

There also is the issue of the global economy, in which you can participate if you are technologically sophisticated. You cannot have one without the other, but do you know that small businesses comprise 96 percent of all the exporters in this country? However, they are bringing in only 30 percent of the export revenues. The goal is to maintain that high involvement by small businesses and to allow them to bring in more dollars by exporting.

We are working actively, and will continue to do so, with our lenders to expand the use of our Export Working Capital Program, which is a 90 percent guaranteed program. You cannot get much better than that, and we will introduce a new online risk management support system. We already have 19 U.S. Export Assistance Centers, and we are entering into strategic binational relationships that will promote joint venture exporting opportunities for small businesses from our country and other nations.

Many good things are happening at the SBA. It is an exciting place to be. All of those good things are reflected in our fiscal year 1999 budget, which is good news for America's small businesses. It offers small businesses unprecedented levels of capital in credit; in total, $15.3 billion. Our fiscal year 1999 budget proposes $11 billion for the 7(a) general business loan guarantee. It proposes $3 billion for our 504 Economic Development Program, and we have been able to decrease fees in the 504 program for the second straight year. We are proposing $72 million in microlending, $60 million for direct loans, and $12 million for loan guarantees, and we are requesting $1.1 billion for the SBIC Program. All of these are the highest program levels ever achieved. The capital and credit will help strengthen the small business sector for the future.

We also have requested $112 million in training and counseling funds, an 11 percent increase over fiscal year 1998. I am particularly pleased that the President has agreed to more

than double our funding for the women's business centers. It is good news, because we are working on integrating counseling services with lending. That is really the key to success. Overall, the budget request represents only a 1 percent increase. What a bargain. We are able to achieve this because we have been blessed with a wonderful economy, and we have done a great job of managing our programs better.

The subsidy rates that measure the costs to the government for our programs continue to decrease. For the 7(a) program, we project that the subsidy rate will drop from 2.14 percent this year to 1.39 percent next year. We will keep working on lowering that number. This is a tribute to our management of credit risk and increased attention to our servicing of the portfolio. One of my principal goals is to transform SBA into a 21st century leading-edge financial institution, one that delivers smart, innovative products to its customers and manages its risks to the highest standards.

SBA has improved its program management by relying more on our private sector lending partners. For example, we have improved our processing through our Preferred Lender Program (PLP). Under the PLP, lenders make the credit decisions and undertake all of the liquidation and servicing of loans. SBA approves loans for guarantees in less than 24 hours. PLP has been successful, and that has made a fundamental change in our business. In 1994, 16 percent of our 7(a) loans were granted through the PLP program. Last year, more than 52 percent of our loans went through our PLP program. We are growing our programs while the cost to the government is decreasing. Approximately 400 lenders have qualified thus far as PLPs.

SBA continues to delegate responsibilities to the private sector. Beginning this year, all of our lenders will be required to service and liquidate our 7(a) loans. This fall, we will begin a program of asset sales starting with a $150 million sale.

We have been working hard to improve the management of the SBA, and it shows in the increasingly efficient delivery of our services. We are providing better products at a lower cost to the taxpayer.

All of this is good news. I am confident that SBA is on the right track. Take another look at the SBA if you are not doing business with us. Take a look at our lending programs. Get involved in our community outreach efforts. Those activities will be good business. Link up with our district offices. Talk to our lending partners. Ask them what their experience has been. Talk to our small business development centers. Take a look at forming a bank-owned SBIC. I know that Saunders Miller made a good presentation and a good case for our bank-owned SBIC program. Take another look at the SBA.

I would like to quote Gene Payne, who said this morning that SBA is the most significant public-private partnership in the government. We are getting smarter and more sophisticated every day. Partner with us. Together, we can serve the increasingly diverse small business community. Help us prepare the small business community for the technology-driven economy of the 21st century. Work with us to give our small business customers opportunities in the global economy. At the SBA, we will show small business the way to success into the 21st century.

**Q and A Summary**

Alvarez commented that SBA will review the FASTRAK (SBA Express) Program. The SBA is looking for ways to go beyond the pilot and expand the program. She emphasized that it is a good program.

In response to a question on the prospects for working with the proposed reduction in the subsidy, Alvarez said that the SBA has gone from $9.2 billion in fiscal year 1998 to $11 billion in fiscal year 1999. SBA works hard to keep the subsidy rate low. Some of the improvements discussed in terms of partnering with the private sector will continue to reduce the subsidy. There is a direct relationship: the smaller the subsidy, the greater the loan capacity.

Alvarez said that her comments did not address a large portion of the SBA portfolio: the 8(a) contracting program. The SBA has regulations that will be published shortly that will streamline the 8(a) process, the mentor protégé idea. SBA also will use nationally in pilot form an electronic 8(a) application that will streamline that process. Recent legislation has created hub

zones, another category of firms that will be involved in the procurement process. These firms will be sole source contractors with price preferences, if they can demonstrate that they can create jobs in these zones, which are similar to SBA's empowerment zones. If the firms can hire 35 percent of their employees from a community having high unemployment, they become eligible for the same type of opportunities as 8(a) companies. The procurement landscape is becoming more interesting.

A participant wondered if SBA is planning an evaluation of its fee structure to differentiate between community bank lenders and larger banks. Alvarez said that SBA is working on the issue. Alvarez also pointed out that SBA has been focusing on ways to facilitate small bank entrance into the PLP.

## What Are the Future Issues of Small Business and Banking and How Should They Be Addressed?

Experts from banking, small business, academia/research, and securities markets shared their innovations and visions for the small business and banking arena. The speakers explained how community banks can best serve their customers in a competitive marketplace; the benefits of capital access lending programs; ongoing problems in lending and borrowing from the small business perspective; and keys to understanding the minority small business market. Eugene A. Ludwig, former Comptroller of the Currency, OCC, moderated the session.

**Dr. Emma C. Chappell, Chairman, President and CEO, United Bank of Philadelphia**
My comments today are predicated upon more than a decade of research and personal experience in developing — from scratch — a unique minority-controlled, commercial community development bank. I sometimes subtitle it, "*A Thriller in Philly*."

Anchored in the cradle of American liberty — a scant block from the Liberty Bell — United Bank of Philadelphia is celebrating its sixth anniversary and unprecedented growth from an idea to a more than a $113 million-asset, full-service, commercial and community development bank. The bank has six branches, a 26 ATM network, strong asset quality, and a 70 percent loan-to-deposit ratio. United Bank opened its doors in March 1992 and remains the only minority-controlled, full-service, commercial community bank within the Greater Philadelphia Region (Pennsylvania, South Jersey and Delaware — the nation's fourth largest metropolitan area and fifth largest city).

United Bank was born in the troubled decade of the 90's, as many banks were leaving urban neighborhoods and becoming megabanks through mergers. As a result, economic growth declined, businesses moved, and commercial areas deteriorated. Homes were boarded up and abandoned, because no one was putting investment dollars back into the community. Crime and drug traffic increased; resulting in despair, fear, and all-pervasive poverty. A 1987 survey revealed that the six major banks in Philadelphia collectively invested $387 million in mortgage loans. Only $8 million of that loan money was granted to minorities and less than $2 million went directly to women of all races. A 1995 survey conducted by the Rand Think Tank reported that banks, savings and loans, and credit unions denied mortgage applications received from: 33.4 percent of African Americans; 31.6 percent of American Indians; 23 percent of whites and 12 percent of Asians.

United Bank was founded to foster community development by providing quality, personalized commercial banking products and services to businesses and people in the Greater Philadelphia region, especially African Americans, Hispanics, Asians, and women. United Bank provides innovative financial products and services within a primary market comprised of 111 census tracts, in which more than 73 tracts are low- to moderate-income; 28 tracts are moderate income and only 10 are designated upper income.

United Bank has been rated "Outstanding" in community reinvestment by the Federal Reserve Bank for each consecutive year of operation — objective evidence of the bank's ability and commitment to fulfilling its mission.

In May 1997, the U.S. Treasury Department certified United Bank as a Community Development Financial Institution (CDFI) — the first and only bank in the Commonwealth of Pennsylvania to receive that designation. The U.S. Treasury also was awarded a $500,000 grant, matched with funds from the University of Pennsylvania, which will provide technical assistance and education in the community.

The nonprofit Community Development Corporation (CDC) affiliate of United Bank — Philadelphia United — was founded in 1998. Together we seek aggressively to unleash private capital to motivate, rebuild, connect, and humanize economic development. This approach is grounded in education, advocacy, and a four-phased plan designed to increase significantly:

- Neighborhood revitalization.
- Minority business growth.
- Employment opportunities.
- Community stability and wealth.

Bold and innovative strategies — such as those now pioneered by United Bank of Philadelphia — are absolutely essential for economic stability and redevelopment in urban America to become a reality in the 21st century. The accomplishments of six ground breaking years of experience could serve as a national model for urban banking. This background of experience should be enhanced by the following government and private industry incentives.

- **Tax incentives** — Provided to businesses depositing in, partnering with, or borrowing from minority-controlled financial institutions engaged in community development.
- **Low-interest government loans** — Made available to minority controlled institutions to establish, maintain, or acquire branch facilities located in or serving predominantly minority neighborhoods.
- **Earnings credit** — To be used by regulators in evaluating minority-controlled financial institutions. The appropriate federal regulator should add the cost incurred in providing community services (e.g., the high cost of maintaining high transaction, low balance accounts) to earnings. This process would allow the bank to be compared equitably to other institutions that are not delivering comparable social responsibilities.
- **Community Reinvestment Act (CRA)** — Expanded, so that participating (investing) institutions can receive *continuing* rather than one-time credits for capital infusions in minority banks based on the level of their investment.
- **Overhead expense ratio** — Increased for minority banks that must provide greater staffing in servicing typically low-balance accounts.
- **American Bankers Association's "Minbanc"** — Required to function as originally legislated, i.e., as a pool of funds collected from majority banks that would be invested in minority banks.

Private sector support measures and initiatives that should also be encouraged are:

- **Capital infusion** in minority banks helps to ensure stability and growth. New capital allows for expansion of branch networks, deposits, and loans. Non-cumulative preferred stock investments would provide additional equity without jeopardizing the minority status of those financial institutions. Investments also could improve financial institutions' CRA ratings.
- **Grants** to nonprofit CDFI's (Community Development Financial Institutions) affiliated with minority banks would expand education and training services within the community and provide much needed assistance to new homeowners and entrepreneurs.
- **Pro bono services** would assist cost control strategies and ensure operational profitability of minority banks. The cost of operating a minority institution is higher than that for traditional financial institutions, because of high volume/low balance accounts and the need to educate customers. Pro bono services enhance minority banks by increasing profitability and ultimately, shareholder value.
- **Loan syndication** for large corporations provides much needed loan activity for

minority banks, generating loan interest, fee income, and, ultimately, profitability. Minority banks have the ability, capacity, and desire to lead and/or facilitate loan syndication with other minority banks and can service the facilities as well as majority banks.

- **Large corporate deposits** in minority banks help mitigate the cost effect of high volume/low balance accounts that plague those banks and threaten their bottom-lines. Those deposits also provide growth and the ability to make more loans in urban communities. Major corporations often put large amounts in majority banks, but cap deposits in minority banks at $100,000 (the FDIC insurance limit). Since many minority banks are well capitalized and stable, the risk of loss of deposits in excess of insurance limits is no greater than that of majority banks.

Finally, I am most concerned about creating a new type of "social" fund to funnel investment money into the small business community, similar to the socially conscious mutual funds. The fund could obtain credit or an incentive from the government in the initial phase. As the fund invests in small businesses, everyone would benefit, because they would receive a certain return.

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**Michael R. James, Executive Vice President, Wells Fargo Bank, N.A.**

I am a credit guy at heart. I grew up doing traditional lending. However, for the last eight years that I have worked in Wells Fargo's small business banking group, I have learned a lot about credit scoring, behavioral scoring, and the new generation of loan decision models that are beginning to be used on much larger credits in the United States.

I want to congratulate the Comptroller's Office for publishing data on where small business loans are being made. Although this data does not tell us to whom these small business loans are being made, it does show the neighborhoods benefiting from the growth in small business lending. Wells Fargo is the number one small business lender in low-income neighborhoods in the United States today. We could not have achieved this status without credit scoring.

I would like to focus my remarks today on the concept of a national capital access lending program — why we need this type of program and what it is.

Right now, times are good: the economy is great, loan losses are down, and bank earnings have attained record levels. Nevertheless, there are clouds on the horizon. We are not reaching as many small businesses as we should. We do not have scalable lending programs that appeal to the small, near bankable business.

I am concerned that during the next economic downturn, and it will come, small businesses could face another credit crunch, much like the one we experienced in the early 1990s.

And finally, I am concerned about the risk associated with credit scoring and lending through alternative distribution channels. Many small business lenders have jumped on this bandwagon, and I am not sure they understand how to manage and monitor this risk.

When we have an economic downturn, we may see many lenders withdraw from the small business market. That would be a shame, given what we have accomplished in the last five years.

A national capital access, small business lending program could help us in an economic downturn. Also, such a program can help us reach businesses that are near bankable today. Capital access involves taking risk. It is about taking more loan losses than a traditional bank or even the SBA. Currently 20 state-sponsored capital access programs exist in the United States, one of which is the California capital access loan program. This program allows one to build a small business loan portfolio that has a loss rate of 8 percent.

Here is how the program works. The loan loss reserve is funded by the bank through a portion

of its future income stream on the loan. In California, it is 2 percent. The money is given to the state of California to create a reserve. The borrower, who does not qualify for traditional bank credit, also pays a 2 percent fee into that reserve. The state contributes 4 percent, creating a 8 percent loan loss reserve.

The reserve is lender-specific. The lender can access only the reserve — and this is important — to cover loan losses. If a business does not take enough risk, it cannot use all of the reserve. If the business takes too much risk, the bank is responsible for any loan losses that exceed 8 percent.

This type of program works, because it is market-driven. If a borrower qualifies for conventional financing, a bank will not enroll the borrower in the program, because it will lose the business to another competitor. I believe lenders will use this type of program only when no other way exists to make the loan, such as SBA or conventional bank financing.

Even though the capital access fees sound high, they are actually low versus factoring your receivables or some of the other ways you can finance your business. Also, capital access loans are less expensive than using venture capital. As we learned today, little venture capital lending occurs at the $25,000 loan level.

The second reason capital access programs are attractive is that they are easy to use. All types of loans can be enrolled. In California, a one-page application is used to enroll the customer in the program. If you incur a loss, you can claim your money from the state using a one-page claim form.

The capital access program gives the borrower two benefits: One is access to capital. The other is that it eliminates third parties. The participants are the borrower and the bank. The state is not involved. The bank handles the loan approval and the credit monitoring. In a work-out situation, the borrower deals with the bank. There is no third party. It really is the bank's loan program.

The benefits of the programs to the bank are many. Importantly, the capital access program has a low transaction cost. Most government loan programs are two to three times more expensive to administer than a conventional bank loan. The offset to that is risk. You get a guarantee. The capital access program allows lenders to say "yes" to more borrowers, and it leverages public funds 25 to 1.

There are also benefits to the public. Besides the leverage of public funds, the government risk is limited to 4 percent, versus a guarantee of 50 percent to 80 percent. Although subsidy rates are lower in SBA right now, the SBA will see larger loan losses in the future that will require higher subsidy rates. There is minimal government overhead. One person runs the state of California program. That is because the bank uses all of its own processes.

Another important benefit of the program is that it teaches lenders how to take more risk. I would not suggest that anyone try to lend billions of dollars through this type of program; however, I think one can learn how to structure a small business loan portfolio with higher than traditional bank loss rates.

The program accrues additional benefits to the banking industry. The most important one is that lenders can take additional risk and that allows them to make more loans. If you ask small business people what they need, they will say access to capital and fewer hassles.

I would like to see a standardized national capital access program across all markets instead of dealing with the different state programs. This would make the program even more efficient and provide geographic risk diversification, which is critical for portfolio insurance. That is what this is: portfolio insurance.

Wells Fargo's experience is relevant. We currently participate in the California, Colorado, Oregon, Texas, and Utah capital access programs. We are new to all those programs, except for California. The California program started in 1994; and through the end of 1997, Wells Fargo has made 1,400 loans, totaling $201 million in its program. This is $201 million in loans that we would have denied.

Our net loan losses in this program are $11.6 million, which is 5.8 percent of commitments.

We are on track in building a loan portfolio with 8 percent loan losses.

I believe capital access could be an attractive program to many small business lenders. It should be especially attractive to government, because it is elegantly designed to address increased credit risk at negligible administrative cost to either lenders or government partners.

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**William J. Dennis, Senior Research Fellow, National Federation of Independent Business Foundation**

I began in this business about 23 years ago, when I walked into my office at 490 L'Enfant Plaza East. For those of you who know the OCC, its address was also 490 L'Enfant Plaza East, fifth floor or sixth floor. NFIB's office was on the third floor and I would sneak upstairs to use the OCC library. One day, I ran into someone from the OCC; we chatted and during the conversation decided to conduct a conference on small business, perhaps on some unusual approaches to small business lending. Janice Booker was in charge of the conference, and we gathered in a small OCC conference room. Only one person attending the meeting was from out of town, a fellow by the name of Pete Hanson, from California. He had developed the loan loss reserve program. Sixteen years later, the program was adopted in California. Look at what we have today. What a contrast, and what a pleasant one.

From the small business perspective we live today in a golden age of lending or borrowing. A couple of years ago, NFIB conducted one of its periodic studies, in which it asked the members to rank their business problems. Borrowing short-term and borrowing long-term ranked 64th and 65th on a list of 75. In other words, 63 other issues were more important than lending or borrowing money.

NFIB conducted other research. As late as December, it found that of those people interested in borrowing, seven could get *all* of the money they wanted for the one person who could not, and that the one person who could not get all the money desired usually could get a large share of what he or she wanted.

In Wells Fargo/NFIB study, we examined new businesses. Today, only 25 percent of those brand new businesses, not operating businesses, say that capital is their primary problem in starting that business; the rest point to other issues, such as marketing.

Right now, times are good. However, we should take a longer perspective to identify the gaps in the entire system. I have identified six gaps.

The first gap involves starts, particularly larger starts or those of $100,000 or more. Clearly, there are problems with this group. The amount is too small for venture capital financing and too large for people to use their own resources.

The second gap is in rapidly growing businesses. They are voracious consumers of capital. On the other hand, they are risky and tend to grow in a snake-like pattern or a sine curve rather than in a straight line. That pattern makes lenders rightfully nervous.

We have business cycles. At some point, we are going to enter a recession, and it will change balance sheets. When it changes balance sheets, it alters creditworthiness and, therefore, the availability of credit.

We also go through transitions: mergers and other activities of that nature. Not too long ago, we also had certain regional problems, and they can cause problems, too.

Then we have the marginal, the close call. If you think of the turndown point as Point A on a straight line, the objective is to slide Point A toward the turndown side. But there always will be a turndown point.

Finally, we have the troubled businesses. Even an advocate, such as myself, clearly recognizes that some businesses exist, for which, unfortunately, bank credit or debt credit is not appropriate for either side.

In the last few years, we have seen major changes. Credit scoring has been enormously positive. We have not heard much on securitization from the private side, but probably we will. Large businesses are buying commercial paper. The international market is rocky. Consumer credit is highly competitive. So what is left? You found small business, and found it was a marvelous market. We are appreciative.

From the small business owner's perspective, there still are problems. Unfortunately, I have more problems than solutions. A few of those problems should be familiar.

The continuing restructuring of the industry is compounded by personnel practices within many banks, in which personnel changes constantly, both within and among banks. To a small business owner, this means a disruption of the banking relationship, and that makes the customer unhappy. A survey conducted several years ago, showed that a large portion of the public was dissatisfied with banks that had merged, mostly because they disrupted the transition process. That suggests that enormous tension is placed on the transition, because most small businesses that change banks are pushed away from their old bank rather than attracted to the new one.

The second point is that there will always be a high touch market (personal customer service). I am a great believer in credit scoring. It has been marvelous for small business, but there will always be a need for someone to offer more personal attention. I had a conversation about this issue with two business owners this morning. One owner thought she would like the high touch side; the other thought she would like the high tech side. All of our surveys tell us that customers want to know their banker and their banker to know them. The question is whether they are willing to pay for it. Some are willing, some are not.

The third point is technology. Last night, I walked into my son's bedroom. He is 15, and I said, "What are you doing, son?" He was on the computer, and he replied, "Well, I am really doing this, Dad. It is really neat, I want to tell you about it." I sat down. I put on my wisest look, and I listened for 10 minutes. As I was walking out, I said, "Boy, son, that is really terrific. You did something really great." When I got outside, I said to my wife, "I do not have a clue of what he was talking about. He lost me in the first 10 seconds." The point is that a technology revolution is going on. Who knows where it will take us? Small business owners are trying to join. About 75 percent of the owners use computers in their businesses. Ninety percent of firms with 10 to 15 employees have computers. Beyond that, virtually everyone has them. However, only 20 percent of the firms have Internet connection. So this is a learning process that has implications for everyone in the banking business.

Think of something as simple as exporting, which most small businesses do not do today. But imagine when everyone is trading internationally on the Internet. Think what that means for the need for financial services.

Another issue is how we conduct transactions without collateral. To some extent, that question has been answered partially by those who are lending a lot based on personal characteristics and personal record. However, we are becoming increasingly a service economy where thoughts and ideas are the value of the company. The owner of those ideas is the owner of the company.

Moreover, we see what I had always thought was an important source of collateral stagnating in value: home ownership. This stagnation occurs not necessarily in the number of homeowners, but rather in the value of their homes. The value of those homes is not rising quickly and will not be the source of the collateral that it has been.

Finally, we need to change the bankruptcy laws. I expect major legislation this year, or at least proposed legislation. The increasing bankruptcies over the last few years cannot be sustained in a good period. As a small business advocate, I am on two sides of this issue. Clearly, small business will not receive money unless lenders can be assured that the collateral they hold can be repossessed, if necessary. However, a distinguishing characteristic of the United States, as an entrepreneurial society, is the capacity to fail and to not be penalized so severely that it leaves the individual stigmatized and outside of

the entire process. The balance now appears to lay in favor of the borrower/debtor.

We also need a continuing review of our subsidy programs. By definition, government finance programs are subsidy programs. That means we must consistently ask, what is subsidized, how much, and why? Some of the answers may be pleasing, some may be troubling. However, they must be asked.

Finally, the gap in funds needed sometimes may be filled best by equity. The question is how do we handle the problem or situation. This morning, this issue was discussed by a panel, which had some fascinating ideas on the subject. Mike James talked about an entirely different group of people and a different approach to the situation, but clearly equity is part of the answer.

One of the government's most innovative activities is SBA's ACE-net Program. For lack of better terminology, it is an Internet matching service between lenders and borrowers or between investors and business owners. It has just started. It will be a marvelous service, and there is no reason why bank subsidiaries of one kind or another cannot participate actively in it.

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**Dr. Margaret C. Simms, Vice President for Research, Joint Center for Political and Economic Studies**

I am not in the banking business, so I cannot give you the detailed advice that some of the other speakers have; however, I would like to draw a slightly larger picture and return to some of the themes that arose during the luncheon address.

During the speech, we heard from Administrator Alvarez about a number of demographic changes that will have a much greater effect as we move into the 21st century. Increasingly, the population will be diverse. We will see some growth in the African American population, and much more rapid growth in the Hispanic and Asian populations. Those changes have implications for employment, product markets, and investment opportunities.

We often hear reference to Census Bureau numbers on the growth in minority- and women-owned businesses. Those numbers only scratch the surface. I do not want to cast any negatives on the way in which the Census Bureau calculates the numbers. They have the most comprehensive figures for minority- and women-owned businesses, but they do not include regular corporations. Subchapter C corporations are missing.

I would like to give you a sense of what that means. A few years ago, the Joint Center conducted a mail survey of firms at the high end of the minority business market. The survey included about 500 to 600 firms surveyed by Black Enterprise, when it compiles its BE-100, and firms in a number of state regional councils of the National Minority Supplier Development Council. In that survey, approximately 53 percent of the firms were regular corporations. Although that does not indicate that you can double the Census Bureau number for a true sense of minority businesses, it suggests that a whole world of minority business exists about which we know only a little.

That knowledge is important for lending, because you want to bet on sure things. Those are businesses that will continue to grow and develop, particularly minority businesses. They make large contributions to their communities, which many of you probably know because you are involved with minority businesses.

The Joint Center survey was conducted in part to look at the willingness of firms to recruit in low-income neighborhoods. The difference between minority and nonminority firms in terms of their willingness to recruit in those neighborhoods was astounding, even to those of us who entered into the program knowing that these firms were much more likely to employ minority workers. We are continuing to

do research in that area, so that we can examine further what makes some see people from low-income neighborhoods as good workers, when others seem to think that those workers are not the kind of people they want to hire.

How can we pick the ones that will be the equivalent of the BE-100 or at the top end of their market? I was reading in the business section of the *Washington Post* this week about Network Solutions. How many of you know that Network Solutions used to be a black-owned firm? Here is someone who had the monopoly on assigning Internet addresses, a man who was looking to the future. He had some assistance from the government, but the owner was someone who could take an idea on the cutting edge, ahead of the curve, and work on it. He sold the bulk of the business to move on to other ventures. We must find those people when they are on the upswing, when they can really make a contribution. It is important, because both you and the community get a return.

When we look at the effect of minority firms on employment and inner city development, we find that the firm's characteristics and not their location determines whether they hire people from the inner city.

Danny Boston, on the faculty at Georgia Tech and one of my colleagues on the Black Enterprise Board of Economists, is promoting an idea called 20 by 10. The idea consists of the concept that, if in 10 years we can grow minority businesses, in particular black-owned businesses, by 20 percent each year, those firms can provide a significant amount of employment in communities that would otherwise have large unemployment. Boston has compiled some national figures based on adjusting the Census Bureau numbers. The results are modest, but in terms of capital the investment will be significant. A few weeks ago, he published an article in the *Atlanta Journal Constitution* on the concept for Atlanta and for Georgia. Boston has reinforced the findings of the Joint Center on people employed by those companies. He proposes to raise by 3 percentage points the growth rate for those businesses. With that, you could affect the community significantly; that means, however, that these firms will need the capital to grow.

Finding the winners rather than the losers makes a big difference. Nobody wants or would encourage you to invest in losers; identifying the winners is important. I would like to promote an idea that no one has offered so far, although it has been alluded to: investing in people. By investing in people, I mean the next generation of bankers. When we look at the demographics, the young population is emerging increasingly from non-white groups. Those are your workers of tomorrow. They are the people who will make the connection, who will be those high touch people at the firms that will make a real difference in our inner cities and urban communities.

This concept is easier said than done, because many young people are in educational institutions that do not provide them with the kind of foundation that we would like to see. On one hand, you may be required to invest your time. In the long-run, however, the payback should be a good one. As we look at the banking industry, we must make available mentorships and apprenticeships for young people. A number of communities are developing school-to-work programs, in which young people at the high school level combine classroom learning with work-based learning. Because those programs proceed at different rates around the country, it is hard to talk about a typical school-to-work program. The programs often lack employers willing to participate in developing curricula and to provide opportunities for young people to learn the work of a banker.

You should identify the right people and invest in them, even if you do not pay them. Clearly, the most important cost to you is the time that you and your employees take to train, develop, encourage, and keep in touch with those people after they have left your employ and move along in their educational careers.

I receive great satisfaction from having my past research assistants reappear in my life in different ways and at different ages; I might add that a former student of mine is in the audience. We talk about people who return, and at times need help that is time consuming. When you invest in them, however, you invest in an improvement in your industry. It is a special contribution to find those winners who will build your profits and your community.

*Dr. Margaret Simms is vice president for Research at the Joint Center for Political and Economic Studies in Washington, D.C. She has conducted research on minority business development issues for many years and has numerous publications to her credit, including "Is the Inner City Competitive?," appearing in the Review of Black Political Economy. Dr. Simms has served on the faculty of Atlanta University and the University of California at Santa Cruz. She has been a member of the Black Enterprise Board of Economists since 1987.*

**Paul L. Pryde, Jr., President, Capital Access Group**

Small business credit problems are not problems of money — they are problems of organization. Credit delivery involves eight major functions: marketing, product development, loan origination, loan underwriting, loan funding, loan servicing, credit enhancement, and liquidity. In a well-organized market, people or organizations exist that perform each of those eight functions well. In underserved markets, inner cities, small and minority businesses, those functions are not performed adequately.

In a well-organized market, you have aggressive marketing. For example, many of you receive 8 to 10 credit card solicitations from various banks each month. In addition, a high degree of product innovation exists in a well-organized market. In the mortgage market, there is a 125 percent loan-to-value loan. B&C mortgages and other new products have been developed to serve customers better.

Many people originate loans. There is credit scoring and disciplined underwriting. Numerous sources of funding are available for those loans as well as large and efficient servicing organizations. Private mortgage insurance companies, credit supporters, and capital markets provide liquidity.

Generally, none of those activities are taking place in the inner city and other underserved markets. In two cities, we work to create a partnership that solves the organizational problem that inhibits the delivery of credit to small businesses. The partnership has four principal participants: local government; community development loan programs (CDFI's for short); commercial banks; and a special purpose "securitization" conduit.

As is true of any partnership, each participant should do what that participant does best, is comfortable doing, and needs to do to make money, if profit is part of the motivation. We have assigned each participant a role in each of the eight functions I mentioned earlier. For example, the city has no role in marketing, origination, underwriting, funding, or servicing, but has an approval role in product development to the extent that public money is being used. The city has a role only in credit support; it has no role in funding or providing liquidity for loans.

Most city officials no longer make loans. They have been in that business for a long time. And now, they want to get out of it. They want the private sector involved. This partnership structure accommodates the inclusion of the private sector. Private originators and private lenders, however, want the city government to take the risk that they are unwilling to take. This is relevant to Mike James' discussion of the California Capital Access Program.

The principal role of government is credit support. We have said to the banks: you can help design the marketing program. You have the human and other technical resources to help design an aggressive marketing program to find borrowers. You can help in designing the pricing of a product.

I cannot emphasize too much the need to design products appropriate to the market. One problem in an economy increasingly comprised of service businesses is that credit products dependent upon large amounts of collateral and short maturities will not work. You have to design products appropriate to the borrowers. You do not want to be the only business that says the customer is always wrong.

Banks can play a role in origination, depending upon their preferences. Some banks want to originate small loans, others do not. If we want the banks to fund credit lines to loan originators, they must approve underwriting standards. Banks have large servicing capabilities in some cases. By contrast, banks provide no role in credit support.

We put most of the emphasis on local community development loan funds, community development banks, and similar organizations carrying out the program. Those organizations originate and underwrite loans and advance funds to borrowers. They can act as subservices, but they do not have the money to act as credit supporters or to provide liquidity in the marketplace. Essentially, they find the borrowers, package the loans, make the loans in accordance with agreed upon underwriting standards, and fund the loans.

My favorite part of this partnership is loan securitization. We have asked a couple of cities to create a "secondary market" organization, using existing loan assets. This corporation essentially buys loans from the originators, packages them into securities, and resells the senior piece of the securities to the banks.

***With respect to CRA, they can meet the investment test or the lending test, whichever test they wish to meet.***

Securitization transactions involve putting the loans in a pool or in a trust and dividing them into two pieces. You have $10 million in loans. You divide the loans into two pieces, a senior piece and a junior piece. The senior piece has a priority on the cash flows of a pool of loans, and the junior piece has subordinate interest. We want the banks to invest in the senior piece, and the conduit or someone else to hold the subordinate interest. The result is a system that places the banks in three roles with which they may be comfortable: originating loans, funding loans, and investing in senior securities. With respect to CRA, they can meet the investment test or the lending test, whichever test they wish to meet.

In Miami and Atlanta, we are looking at existing community development block grant loans to capitalize the secondary market vehicle. The cities admit that some loans have not been well-managed. We are trying to improve their management, and we are going to sell those loans. The city will place the money in the special purpose corporation. It is "found" money for them. Once again, it will use the capital to purchase loans from the originating community development bank. The special purpose corporation or conduit will package those loans into securities and sell them to local banks.

As long as the pricing of loans is appropriate and the losses are not too severe, this program can replenish continually the amount of lending in that community. We call it our perpetual credit machine, because you replenish continually the amount of capital flowing through the system. There is plenty of liquidity in the system. The bankers I know do not have problems with funding loans. They have excess liquidity. They are looking for earning assets. That is their big problem. Investors come to us all the time since the Resolution Trust Corporation closed. There is a huge appetite for new types of assets and no one to supply them. There is a huge amount of money looking for deals.

The partnership that seems to work has a structure that places the city or government in the credit support role, assigning the origination responsibility to competent organizations that exist in profusion in cities to originate and service loans, and putting the banks in the position of investor that funds credit lines to the originator. We have tested this in conceptual form, given banks in a few cities term sheets, and said, "Will you do this?" So far, we have had a good response.

*Paul Pryde, Jr., is president of Capital Access Group, a limited liability company, a financial advisory and consulting firm, specializing in financial innovation for lenders in underserved markets. He has more than 25 years of economic development and finance experience. He is the author of several publications, including "Black Entrepreneurs in America." He also is a consultant to and a board member of several national policy development organizations. Most recently, Mr. Pryde has focused his energies on small business loan securitization.*

**Q and A Summary**

Mike James provided additional detail on capital access programs, which exist in 20 states. The program in Michigan was begun

first in 1986 and is the largest. Most states began those programs after the credit crunch of the late 1980s and early 1990s. The programs are relatively new. The second largest program is in California.

A participant asked James if the 2 percent reserve was passed on to the borrower and whether the 8 percent reserve is a portfolio reserve, rather than a loan-specific reserve. He responded in the affirmative, noting that the borrower pays a 2 percent fee, and the bank pays 2 percent from its future income stream; the municipality pays 4 percent. He added that the reserve exists for the portfolio, not for the specific borrower.

For credit scoring, James stated that capital access is not a product, but rather a government enhancement of credit risk. The program could be used on any type of loan, from a line of credit to a term loan or equipment loan to a real estate loan. He also stated that credit scoring allows one to standardize underwriting. When you underwrite 1,000 loans at a certain score, a certain loss rate is expected. Credit scoring helps determine the composition of an 8 percent or a 4 percent loss portfolio. It allows one to track the portfolio.

A participant asked about management of the use of the SBA Low Doc and FASTRAK Programs with the capital asset role. James answered that people are learning how to use those different programs. Wells Fargo participates in only five access programs, although it lends money in 50 states. FASTRAK exists in more states. At times, they complement each other. Both are relatively new programs, and both have pluses and minuses.

Often relationship-building opportunities with small business borrowers can be lost when community banks do not securitize loans. A participant asked if the relationship can be preserved. Chappell responded that it can be preserved even after loans are securitized and sold. United Bank maintains the relationship and sells other services to the customer. Many of the customers do not see that United Bank assembles the portfolios and sells them in the secondary market. Chappell also stated that the only barrier to securitization by community banks is that the banks must build their fee income as must other banks. It is even more important for a smaller bank. Sometimes United Bank does not obtain the pricing needed to make securitization cost effective, although securitization helps liquidity. United can sell the loans and obtain new capital to make more loans. In that way, United Bank continues to serve the community. Because community banks often have difficulty accumulating deposits in the face of the competition among large banks, this is one way community banks can leverage existing deposits and maintain liquidity.

Pryde responded that three problems of price have become evident in this area. One problem is the opportunity cost for the investment banking community. The investment bankers do not want to transact smaller deals with small community banks when it can transact $100 million credit card deals. The second problem of price is that the market does not exist at this time. We do mainly private placement deals. The market is not really efficient, and one may not get the desired pricing, although interest is increasing. The third problem is that it is costly for a small bank to transact its first securitization deal. A small bank may only want to use the securitization process as a funding alternative, or when it will improve the return on equity.

A participant asked Dennis if the consolidation of regional banks into super regional ones will affect the efforts toward community development. Dennis said that it may not make a great difference. Over the long term, it will depend on the leadership on both sides. The consolidation can be a positive experience, if the leadership in the larger firms and in the banks is inclined to consider it a profitmaking activity, and one that is worthy, workable, and useful. As a practical matter, there probably will be some downside.

Comptroller Ludwig asked Simms for her opinion on the small business environment today versus 10 years ago. Simms responded it is a better environment for a number of reasons. One reason is that the overall economic growth is generating opportunities that allow those firms to present themselves more favorably to lenders. It is not such a stretch for lenders to see those opportunities as profitable ones. Education or learning has cast some minority firms in a more positive light in the lending community, but a

significant gap exists. The most recent numbers show significant differences in the treatment of minority entrepreneurs, who have the same characteristics as white ones.

Comptroller Ludwig asked panel members for their opinions on the need for government enhancements and education. Pryde stated that government credit support reduces the anxiety over inaccurate pricing. For example, all of the mortgages being securitized and sold were government guaranteed. People no longer needed government guarantees after they became comfortable that they could price the risk accurately and knew exactly how a particular type of asset would perform. The credit enhancement is a short-term need over a period of time. For certain types of loans, you will not need any enhancement. The market will be efficient. Enhancement is a temporary need in the small business marketplace.

Simms stated that the question of whether a government role is defined, in part, by whether one believes the market captures everything necessary in terms of the lending experience. If a social purpose or social benefit exists, one could argue that the government may not have to withdraw completely. The nature of the government support might be different.

Dennis stated that the education function can be built into the price of the loan, although the delivery does not necessarily have to be performed by the bank. He said that he thought that had been assumed, but is not necessarily true. In fact, he said the bank may not be the best place to do it, since it is not usually equipped to perform that function. In a few places there have been cooperative ventures.

James pointed out in terms of government subsidy that when you are pricing for risk, not enough knowledge exists yet on how to do an 8 percent loss portfolio. The data must be obtained. When that occurs, it can be priced. Technical assistance and education is a critical issue. Chappell disagreed in some respects. She noted that she is a practitioner of this entire piece. Small businesses cannot afford the many services that they receive. Because they were not able to obtain financing for many years, the government could fund various nonprofit groups to provide pre-mortgage counseling and other activities. The CDCs provide that funding and so could CDFIs. Some CDCs would offer education and training, if they could pay for it through a grant. It would be better than tacking it onto the loan, because that means less money available to put into the businesses. Because many businesses are start-up businesses that create new jobs, the less expenses involved, the safer and sounder will be the business.

A participant asked Chappell if her bank is experiencing such bullish returns as its counterparts at Wells Fargo. Chappell answered in the negative. According to Chappell, the community must be educated on the importance of dealing with minority banks. United Bank is specific about its mission, which is returning those dollars directly to the communities it serves. One of the greatest difficulties is that minority banks typically have high transaction, low balance accounts. So United Bank must educate the community, because once people enter the middle class or upper middle class, they do not see the importance of dealing with minority banks. United Bank was founded by 3,000 shareholders, people who believed that they traditionally and historically had been locked out of the system. They had been redlined and otherwise treated unfairly. They lined up and bought stock at $10 a share. Most shareholders never owned stock, but they own stock in United Bank because they saw a need. It has been difficult to tell the other part of the community that United Bank will be successful, if people who have sizable accounts bring them to the bank to balance the low balance, high transaction accounts. It has been a delicate balance. United Bank's returns are not as large as they ought to be, but there is a major improvement. It all boils down to education and communication.

Comptroller Ludwig said that everyone can make great strides from what was learned at the forum. He emphasized that the OCC has set out on a mission to partner with banks and small business enterprises and associations, in particular low- and moderate-income and minority organizations. And he said, that the OCC is in for the long haul. The OCC, he pointed out, will continue to deepen this partnership and to foster this important area of economic development in the nation's economy.

# Appendixes

## Appendix A —

Forum Attendees List

## Appendix B —

Small Business References

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