LOANS FOR BLACK BUSINESS

by

Roberta Kimmel

The notion of business development as a partial cure to the economic condition of blacks is not a new one, but black leaders have never unanimously agreed that business ownership is an effective instrument of economic success. The violence and civil disorders of the 1960s, however, spurred strong interest in programs to develop and promote both urban black business and black-owned and controlled financial institutions that attracted members of all points on the political spectrum. The goals of these programs, broadly stated, were to integrate the ghettos into the economic mainstream of American life, to raise the living standard of ghetto residents, and to give blacks greater economic self-determination.

In a new study, *Financing Black Economic Development,* Timothy Bates and William Bradford clear the air of numerous misconceptions about the recent progress of black businesses and financial institutions and the problems that have beset their development.[1] Much of the volume is given to empirical analysis of black-owned and controlled banks and savings and loan associations—institutions that, it is made abundantly clear, are given shape and substance by the banking habits of the black clients they serve, by the unique characteristics of black entrepreneurship, and by government-sponsored financial intermediaries. The questions addressed in this article concern the last influence: What role has the government played as financial intermediary for black entrepreneurs, and what policies can help develop and expand black businesses in the future?

From Builders to Bankers

An active black entrepreneurial class has long existed in this country. Even in the days of slavery there were black-owned businesses, most of them in the North, which dealt primarily in the building trades or personal services such as food catering. From the period after the Civil War until around the turn of the century, notable strides were made by black banking and insurance ventures. The business activity stimulated by World War I in the nation in general peaked in the 1920s—the most successful period for black businesses. Black corporations sprang up, producing merchandise that ranged from chemicals and household appliances to movies. That decade also gave rise to black building and loan associations, real estate agencies, and import and export houses, not to mention a variety of wildcat schemes. Between 1900 and 1940, progress was steady but, in contrast to earlier times, limited almost entirely to a segregated market. Black businesses that had previously served whites exclusively, such as deluxe barber shops and catering firms, went under in the face of keen competition from whites; in manufacturing, the problem of steep competition was exacerbated by a dearth of technical efficiency and access to capital. Since World War II, banking and insurance have again become the most impressively successful fields of black business endeavor. Other large businesses that have established healthy bases include bus lines, chain grocery stores, cosmetic firms, record companies, and machinery manufacturers, to name but a handful.

Capital Markets and Business Development

In various surveys of black business conducted in 1944, 1964, and 1968, several constants emerged. Black firms were (and still are) typically small, labor-intensive, service-oriented enterprises requiring little capital and concentrated in a small number of industries. Traditional lines of business include barber shops and beauty parlors, restaurants, groceries, cleaning and pressing shops, shoe shine and shoe repair shops, and funeral businesses. This pattern is changing with the addition of many newer black firms of types that frequently require large injections of capital. These Bates and Bradford describe as emerging lines of business. Examples are manufacturing, wholesaling, contracting services, retail apparel, and retail furniture. The stimulus for these new kinds of operations, the authors hypothesize, may lie in government programs that suddenly generate a large increase in the availability of business loans and encourage black entrepreneurs to break away from their traditional operations. Bates and Bradford predict that "if capital markets remain open, the black business community of the future may be characterized by a relatively greater number of large firms competing effectively in all lines of business."

There is a large difference in rates of profit between traditional and emerging lines of black enterprise; this implies to Bates and Bradford that financial capital is not being utilized efficiently within black inner-city areas. They suggest that ghetto businesses might prosper more if financial intermediaries existed to facilitate the flow of funds from overcapitalized to undercapitalized segments of the black business community.

Government as Financial Intermediary

The most active government agency to serve as a financial intermediary for minority businesses has been the Small Business Administration (SBA). The SBA's lending effort, however, has evolved in a direction that Bates and Bradford see as detrimental to the development of viable black businesses, as a survey of the programs shows.

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FINANCING BLACK ECONOMIC DEVELOPMENT

by

Timothy Bates and William Bradford

Academic Press (September 1979)

Prior to 1964 the SBA made no concerted effort to reach out to potential minority borrowers. In that year an experimental program was initiated that offered loans with a 6-year maturity and a $6,000 ceiling to assist disadvantaged owners of very small businesses. The following year that program was replaced by the Economic Opportunity Loan program (EOL). EOLs had more generous terms (15-year maturity, $25,000 ceiling) but, rather than being specifically aimed at minorities, they were vaguely conceived to aid "those who had been denied the opportunity to compete in business on equal terms." From 1969 to 1972 about two-thirds of all SBA loans to minorities were EOLs, but the value of the government's minority enterprise program remains seriously in doubt (an issue we will discuss at length in a later section).

Project OWN, established in 1968, sought to increase the proportion of minority business owners by stimulating increases in private-sector lending to these entrepreneurs. Guaranteeing bank loans was its *modus operandi*. In 1969 the Nixon administration renamed the program Operation Business Mainstream and made two changes: (1) loan approval procedures were simplified and a simplified guarantee arrangement with banks was instituted, and (2) the proportion of equity financing required of a borrower was lowered for minorities, and rules prohibiting loans to finance a change in ownership were relaxed. As a result, loans to minorities under the Mainstream program increased steadily. Still, the number and amount of *minority* loans as percentages of total SBA loans have declined since 1970, at the same time as the loan dollar volume of all SBA programs has increased over threefold.

The Office of Minority Business Enterprise was established in 1969. One of its first efforts was to launch, in conjunction with the SBA, the concept of the Minority Enterprise Small Business Investment Company (MESBIC). MESBICs are privately owned, privately managed corporations licensed by states. They have four objectives: (1) to provide venture capital by purchasing an equity interest in minority businesses, (2) to lend long-term capital to minority businesses, (3) to guarantee third-party loans, and (4) to provide general management and technical assistance. The general consensus is that MESBICs have promised a great deal more than they have delivered. Most of them, Bates and Bradford observe, are unable to handle the risk inherent in financing small minority businesses, and they often generate a negative cash flow while waiting for their investments to pay off. Their tendency to avoid the equity investments they were mandated to provide, and instead to favor loans, has denied businesses the significant development opportunities that had been heralded.

During the period 1965-1969, 30% of the SBA's business loan volume represented loans that were originated and funded by banks, and guaranteed against default risk by the SBA. By 1973 that proportion rose to 82%. One might ask what difference it makes where the businesses get their money from, so long as the loans are made. Minority business borrowers face a serious disadvantage in their dependency on the (predominantly white) banking industry to approve their loan requests. In times of tight money, such as 1974, the loan applications of black borrowers face heavy competition from big corporate borrowers. Moreover, when loans are obtained, they are under much harsher interest and maturity terms than those granted directly by the SBA, and hence that much harder to repay.

SELECTED PAPERS

Timothy Bates, "The Potential of Black Capitalism," Institute for Research on Poverty Reprint no. 102.

Timothy Bates, "Employment Potential of Inner City Black Enterprise," Institute for Research on Poverty Reprint no. 151.

Order forms for FOCUS and other Institute publications are at the back.

The Economic Opportunity Loan Program

The EOL program provides relatively small loans. In 1973, for example, the average loan was about $19,800; under all other SBA programs the average was $61,200. It is, however, marked by incredibly high rates of repayment failure and delinquency. Bates and Bradford examined loan application information for a sample of 554 black SBA loan recipients (in New York, Chicago, and Boston and for a comparison group of white recipients).

Their analysis consistently revealed both a low predicted probability of repayment (based on loan application information) and a very high actual incidence of delinquency: 70.2% of all *de novo* black firms—those starting from scratch—proved delinquent or defaulted; this type of firm clearly presents the worst risk. Ongoing firms under present ownership for less than nine months are worse loan risks than established firms.

In its present form, Bates and Bradford believe, the EOL program presents a paradox:

> The strongest loan recipients frequently succeed in business but these entrepreneurs come from high-income groups and they should thereby be disqualified. . . ; the truly disadvantaged loan recipients fail in droves.

Another problem is the poor set of criteria that are used to evaluate EOL and other government programs for financing minority businesses. Rather than looking at the number and dollar amounts of loans given directly or guaranteed, Bates and Bradford recommend that these programs be assessed in terms of (1) the number of firms that are assisted and remain viable, and (2) the economic value to the minority community of the various types of businesses assisted (for example, whether a significant number of new employment opportunities be generated by a loan).

Nonetheless, they found that "the EOL program was chiefly responsible for the high overall incidence of firm failure observed among government-assisted minority enterprises"—a failure rate that seriously undermines the credibility of the entire federal effort to finance minority-owned businesses.

What is the solution? Bates and Bradford suggest that if the SBA refused to lend to applicants whose probability of default exceeded some acceptable cutoff point, then the character of its lending would change and a chain of events beneficial to both the program and the borrowers would ensue, namely: (1) *de novo* firms would receive fewer loans; (2) the EOL program would be appreciably diminished; (3) non-EOL loans to ongoing and existing firms would increase; (4) the incidence of loan delinquency and default would drop sharply; (5) the SBA would not be financing the creation and perpetuation of a high proportion of nonviable and marginally viable firms; and (6) additional loan funds would be freed to finance a greater number of more viable minority-owned businesses.

Summary

The great progress in loan availability to black entrepreneurs in the 1960s has dwindled in the 1970s. The SBA has increasingly promoted black entrepreneurship via a reliance on guaranteeing bank loans against default risk, rather than through direct loans. Consequently, black borrowers have been forced to obtain loans at much higher interest rates. MESBICs, designed to provide venture capital to minority businesses, have in fact made only very small equity investments.

The credibility of government programs has been eroded by the high delinquency rates among borrowers because of the EOL philosophy which requires them to be bad credit risks, combined with recessionary conditions of the 1970s. The result was sharp cutbacks in EOL loan approvals to minorities, declining from a peak of 5,791 loans in 1972 to 2,551 loans in 1976. Bates and Bradford make a strong case for concentrating direct loan and loan guarantee efforts on businesses with reasonable repayment prospects. Tradeoffs are then inevitable: Some potentially successful operations will be denied the long-term credit that could make the difference between success and failure; *de novo* firms, which present the greatest credit risk, also offer larger incremental employment opportunities than do established firms undergoing a change in ownership. Therefore, the authors recommend some flexibility in establishing a cutoff point for approving loan applications whose probability of delinquency or default appear high.

The role of black-owned and controlled banks and savings and loans as financial intermediaries for black entrepreneurship is beyond the scope of this article, but it is treated fully in *Financing Black Economic Development*. The potential of these banks, especially via the relatively low risk medium of SBA guaranteed long-term loans to established, community firms, is viewed by Bates and Bradford as particularly instrumental to the future of black enterprise. ■

[1]Timothy Bates is an associate professor of economics at the University of Vermont; William Bradford is an associate professor of finance at Stanford University Graduate School of Business.