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ABSTRACT

This paper reviews the literature on statistical disparities in the market for small business credit. The paper begins with a brief legal discussion of the case law on the use of credit discrimination in the factual predicate for a minority business procurement program. The next section provides an overview of the statistical analysis of disparities in loan denials and interest rates by race and gender in the National Survey of Small Business Finance (NSSBF) data. The final section outlines policies to remedy discrimination in credit markets.

Lending Discrimination and the Factual Predicate for Affirmative Action Programs

One of the few instances of federal courts upholding race based affirmative action programs has been public procurement. More significantly, here is case law holding that lending discrimination can justify affirmative action procurement program. In *Adarand v. Slater*, the 10th Circuit federal court of appeals took "...judicial notice of the obvious causal connection between access to capital and ability to implement public works construction projects."[1] The Tenth Circuit went on to state, "Lending discrimination alone of course does not justify action in the construction market. However, the persistence of such discrimination . . . supports the assertion that the forma-

[1] *Adarand v. Slater*, 228 F.3d 1147, 1170 (10th Cir 2000).

tion, as well as utilization, of minority-owned construction enterprises has been impeded."[2] Similarly, the district court in *Northern Contracting v. Illinois* noted:

> IDOT[3] also presented evidence that discrimination in the bonding, insurance, and financing markets erected barriers to DBE[4] formation and prosperity. Such discrimination inhibits the ability of DBEs to bid on prime contracts, thus allowing the discrimination to seep indirectly into the award of prime contracts, which are otherwise awarded on a race- and gender-neutral basis. This indirect discrimination is sufficient to establish a compelling governmental interest in a DBE program.[5]

After weighing the criticism by the plaintiff's expert, the district court concluded in *Builders Association*:

> Out of the welter of statistics and other information, a strong basis in evidence emerged that African-American construction firms in the Chicago area are victims of discrimination in the credit market that Asian and Hispanic firms probably encounter some discrimination in that market and that women may possibly encounter some discrimination there.[6]

Review of the Literature

There is a vast academic literature on discrimination in home mortgage lending (e.g., Munnell 1996). Evidence on discrimination in credit markets is more modest. However, analysis based on national databases and surveys does exist on disparity in small business lending. Most of the research has relied on surveys, data from the Characteristics of Business Owners (CBO), the National Survey of Small Business Finance (NSSBF), and Community Reinvestment Act (CRA) data.

There have been national and local surveys supporting the findings of discrimination in lending. An early study in Faith Ando (1988) found that only 61.7 percent of African American commercial loan applications were accepted as compared to 89.9 percent of commercial loan applications from whites. A 1983 U.S. Department of Commerce (1986) survey of 1,300 firms

[2] *Adarand v. Slater*, 228 F.3d 1147, 1170 (10th Cir 2000).
[3] Illinois Department of Transportation
[4] Disadvantaged Business Enterprise
[5] *Northern Contracting v. Illinois*, Mo 00 C 4515 (ND Il 2005), at 47. See also *Builders Association of Greater Chicago v. City of Chicago*, 298 F.Supp.2d 725 (N.D. Ill. 2003) ("A higher interest rate may make it impossible to submit the lowest bid in this highly competitive industry, or, indeed, to survive").
[6] *Id.*

found that, after controlling for debt ratio, credit rating for businesses with sales in excess of $500,000, education, industry, and experience, African American businesses had a 17 percent lower success rate of obtaining loans than whites did. A 1996 Denver survey (Colorado Center 1996) found that after controlling for sales, age of business, and net worth, denial rates were three times higher for African American firms than for non-minority firms. The survey was, however, of a small sample and did not control for creditworthiness. In a NBER[7] paper Blanchflower, Levin, and Zimmerman (1993) found that African Americans were more likely to report that credit was a serious problem (31 percent) than non-minorities (13 percent).

A number of local disparity studies have asked questions in surveys about disparities in lending. These studies typically report substantial anecdotal evidence of problems in credit markets by minority business owners. The evidence here is mixed, but a number of studies have found differences in loan denial rates. For example, a recent study of Atlanta contracting found that over 60 percent of the respondents reporting loan denials in the sample were African American firms, although African American firms made up only 30.4 percent of respondents (Griffin & Strong 2006). Denial rates were also higher for African American respondents as a proportion of the number of respondents who had applied for a loan. However, these studies generally have not controlled for the creditworthiness of survey respondents.

Characteristics of Business Owners (CBO) Database

In a series of papers, Timothy Bates has analyzed disparities in loans received by African American firms. In an article based on 1982 CBO data, Bates (1991) found that non-minority firms received larger loans on average than African American firms after controlling for firm characteristics. Grown and Bates (1992) found fewer loans going to construction firms in the CBO data. In a study using the 1987 CBO data, Bates (1997) found that banks lend more per dollar of equity to non-minority-owned firms than to similarly situated African American-owned firms. As would be expected, Bates found that firms that start with more capital tend to have higher survival rates. Bates (1997) found that survival rates for black start-ups matched white start-ups in the CBO data controlling for access to bank lending, but ignoring firm location.

National Survey of Small Business Finance (NSSBF)

Loan Denials

The most detailed analysis of disparity in small business lending has used

[7] National Bureau of Economic Research

the NSSBF. Cavalluzo and Cavalluzo (1998) found that African American males were 13 percent less likely to secure loans than non-minority males in the 1988-89. Denial rates for African American-owned firms were 35 percent higher than for firms owned by non-minorities, controlling for credit risk characteristics. However, the sample of minority firms in the 1988-89 NSSBF was small.

This pattern continued in the 1993 NSSBF data, where Blanchflower, Levin, and Zimmerman (1998) found that after controlling for creditworthiness, African American firms were 28 percent more likely to have a loan denied than non-minority firms. In fact, the gap between African American and non-minority denial rates for small business loans was three hundred and fifty percent greater than the gap in home mortgage loans. Blanchflower et al. (1998) concluded that the "results suggest that even black owned firms with clean credit histories are at a significant disadvantage in getting their loans approved, holding constant other characteristics." Blanchflower et al. (1998) did find a smaller difference in loan denial rates between races for trade credit (from suppliers and credit card companies).

In a paper using the 1998 NSSBF data, Blanchflower, Levine, and Zimmerman (2003) found that African American-owned businesses were about twice as likely to be denied loans after controlling for creditworthiness and other factors. The 1998 NSSBF included Dunn and Bradstreet credit ratings as well as housing and non-housing personal net worth data_ data that were not available in the 1989 and 1993 NSSBF.

Cavalluzzo and Wolken (2002) found substantial unexplained differences in loan denial rates between minority and white-owned firms after controlling for credit characteristics and personal wealth variables. While personal wealth was associated with a lower probability of loan denial, they found large differences in denial rates across demographic groups remained after controlling for personal wealth.

Loan Applications

There are mixed results on disparities in applicant behavior. In a study using the 1993 NSSBF data (which had a larger sample of minority firms), Cavalluzo et al (2002) found evidence of a "discouraged borrower effect"—that is, minority firms did not apply for loans because they assumed that they would be denied. Coleman (2002) also found that black and Hispanic-owned firms were significantly more likely to avoid applying for loans because they believed they would be denied. In their study of 1993 and 1998 NSSBF data, Blanchflower, Levine, and Zimmerman (2003) found African American-owned firms were less likely to apply for credit than firms owned by non-minorities were. On the other hand, Cohn and Coleman (2001), relying on the 1993 NSSBF, found that black-owned firms were no less likely to apply for a loan than white-owned firms were.

In a more sophisticated analysis, Mitchell and Pearce (2005) estimated a model of loan denials jointly with a model of loan applications. They separated out banks from non-banks (finance companies, government agencies, factoring companies) and separated out relationship loans (line of credit loans) from transaction loans that require collateral and have less soft information. In this analysis, they found that Hispanics and African Americans were less preferred borrowers for all outstanding loans and all transaction loans. They did not find this to be the case for female or Asian owned firms. They found loan denial probabilities significantly higher for black owners than otherwise identified white males.

Interest Rates

Blanchflower et al. (2003) also found differences in the interest rate charged to African American borrowers. Controlling for creditworthiness, African American borrowers were charged an average of one percentage point higher interest. Even African American firms with good credit were charged higher interest rates.

Patterns of Financing

The Small Business Administration's Office of Advocacy (SBA 2003) used the 1998 NSSBF to study patterns of lending by race. The SBA found that Minority and Women Business Enterprises (MWBE) had a different pattern of financing as compared with all small business in general. The SBA could not determine whether the different sources of financing were due to the reduced availability of certain types of credit to MWBEs.

Mitchell and Pearce (2005) also found minorities were more likely to have transaction loans from non-banks and less likely to have bank loans of any kind. They found greater loan denial probabilities for blacks and Hispanics for transaction loans from banks and non-banks. They state, "While virtually all past research has likewise found evidence consistent with discriminatory lending practices against African American and Hispanic firms, our contribution is to hint that discrimination may be specific to particular segments of the loan market rather than general problem."[8] They did not find evidence that lenders require less preferred borrowers to exhibit superior owner or firm characteristics In theory transaction loans should be more objective than relationship loans.

Blanchflower et al. suggest that if there was discrimination in small business lending this may be reflected in African American business owners' greater reliance on credit cards. In a subsequent regional study, Blanchfower

[8] K. Mitchell and D. Pearce (2005), at 46.

(2001) found that while African Americans were more likely to use credit cards, the differences were not statistically significant and there were no racial differences in credit card balances.

Regional Analysis

Regional analysis from the NSSBF has been conducted for other local agencies using a methodology similar to Cavalluzo and Blanchflower et al. A study of the NSSBF data for the NSSBF South Atlantic region, found that after controlling for creditworthiness, African American firms were 28 percent more likely than owned-owned firms to have their loan request denied (NERA 2001). The study also found that African American-owned firms with good credit history were charged a percentage point more in interest rates on small business loans. Similar findings were found for the southern region in other studies (Griffin and Strong 2006).

Small Business Lending in Minority Neighborhoods

There have been other studies of disparities in small business lending by race of neighborhood, as opposed to be race of business owner, relying on CRA and Home Mortgage Disclosure Act (HMDA) data.

The *Greater Philadelphia Capital Access Report* (2000) found that only 1 percent of small business loan dollars went to neighborhoods that were 80 percent African American. Race remained a significant variable in small business lending after controlling for other neighborhood characteristics, such as income and industry mix. Similarly, Canner (1999) also found that minority tracts, after controlling for income, firm and residential population, industry, and regional location, receive fewer small business loans than non-minority tracts.

Daniel Immergluck has conducted a series of studies of small business lending by race of neighborhood using CRA data. In a study of Chicago, Immergluck (2003) found that predominately minority areas receive fewer small business loans after controlling for firm density, firm size, and industrial mix. In a study of Philadelphia using 1998 CRA data Immergluck (2002) found that after controlling for income, firm, and residential population, industry, firm size, and credit history, African American census tracts received far fewer loans than nonminority tracts.

Bostic and Lampani (1999) added economic characteristics of a firm owner' locale and geographic information, such as race of the neighborhood, to the NSSBF data and found that the race of a neighborhood negatively affects small business loan denial rates. In their study, the disparity in denial rates by race of neighborhood increased after the neighborhood income was included in their statistical analysis.

Remedies

A number of state and local governments have addressed these lending disparities with lending programs. To date these lending programs, even when race conscious have not been subjected to legal challenge, as have the programs promoting minority business procurement utilization. Some of the principal lending programs have been the following:

- **Federal Programs.** The federal government has made efforts to make loans to minority businesses at least since the 1960s. The primary federal vehicle has been SBA lending programs, the 7(a) and 504 loan programs.
- **Loan Guarantees.** Loan guarantee programs typically provide guarantees of up to 90 percent of the principal on the loan. The loans often cover lines-of-credit for accounts receivables and inventory, working capital, and fixed asset purchases. Most loans are in the $25,000 to $150,000 range, with the largest loan to date seldom being beyond $250,000. Loans below $25,000 are the province of micro-lending programs
- **Contract Financing.** These programs provide loan guarantees and direct working capital and equipment loans to socially or economically disadvantaged businesses that have been awarded public contracts.
- **Collateral Enhancement**. These programs involve placing a collateral reserve account at a bank. The business is then required to secure financing from a lending institution, which may be conditioned on receipt of additional collateral supplied by the agency program, which is generally 25 percent of the loan amount.
- **Linked Deposit.** Agencies use linked deposit programs to subsidize lower rates for business by accepting a lower rate on their deposits with participating financial institutions. The benefit to lenders is that they have a new loan product resulting from public agency deposits at a reduced rate.

Conclusions

Existing data confirms that there are large unexplained disparities in small business credit for African Americans and for African American neighborhoods. While there have been a number of policies introduced to address the problem a review of the more recent NSSBF data that recently arrived is needed to gauge the success of those efforts.

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