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Capital Access and Financial

Services in El Paso

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Capital Access and Financial Services in El Paso

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EXECUTIVE SUMMARY

This study was undertaken in the spring of 2000 by the Public Policy Research Center at the University of Texas at El Paso on behalf of the El Paso Leadership and Research Council. Using input from a variety of business and community leaders over a two month period, the study was designed with the following overall objective: *to assess the El Paso small business sector's access to capital (debt, equity, and human/information) and the role of commercial banks in this process.* To accomplish these objectives this study looked at multiple aspects of the current banking and lending situation in El Paso, including the role of banks and other lending institutions, as well as firms requiring services from the financial sector.

This study builds on the community's efforts to address the issues of capital access by exploring a number of issues. First, the study details, the role and regulatory environment within which bank and other lending institutions operate. It examines the issue of loan to deposit ratios and suggests new measures for examining community reinvestment using a Community Reinvestment Ration based on the Community Reinvestment Act MSA Aggregate Report on small business lending by county. This alternative also provides for comparisons across markets and to other regions. It also discusses the emerging alternatives to traditional commercial banks that provide a wider range of borrowing options for businesses, including credit unions, e-banking, and the like.

Second, the study explores practices and perceived barriers and strategies to debt financing among over 1600 El Paso businesses that responded to a mail survey in the spring of 2000. It demonstrates that effective demand for capital is sometimes restricted because of financial record keeping systems that do not meet regulatory requirements of lending institutions. In addition, it shows that small firms, relatively new firms, and minority firms are less likely to have the record keeping that meets bank demands and more likely to have been denied a loan in the past three years.

Lastly, alternative strategies and recommendations that will add to the community's policy discussions are put forward.

EXECUTIVE SUMMARY

With respect to the banking and lending sectors, the study shows that:

- ✓ Commercial banks provide vital products/services to individuals, business firms, and government units. Maintaining these functions is crucial to the performance of an overall economic system giving banks a **fiduciary responsibility** to their customers to perform these functions in an efficient and safe fashion. To this end, commercial banking is highly regulated.

- ✓ The commercial lending industry must consider **return to owners**, involving the objective of maximizing the owners' investment in the institution over time. Thus, banks lending and financial investments require assessing the risk/return characteristics of each alternative. This, in turn, requires the bank to obtain an adequate amount of information concerning the loan or investment option in order to assess risk/return trade-offs in a **"safe and sound"** fashion.

- ✓ Banks operate on very thin or narrow margins. Further, they are highly leveraged firms. For both reasons, earnings can be quite sensitive to poor and/or excessive risk-taking decisions.

    - ✓ Banks acquire funds to conduct their business from owners, depositors, and purchased/borrowed/brokered funds. On average 80 to 85 percent come from deposits.

    - ✓ The deposits a bank generates are highly liquid in nature, implying customers can convert the balances into cash or transfer them very quickly, a desirable feature from the customer point of view, but a constrain or limit on use or allocation of these deposits.

    - ✓ In allocating funds, banks will own short-term securities as a second line of defense for liquidity. Securities are also owned to meet **pledging requirements,** for **diversification**, to mange their **tax position**, for **income**, and to meet the **credit needs** of their market. Banks will hold cash assets as a primary reserve or defense to insure the institution is **liquid**. On average, cash assets, short-term and other securities will be 40 to 45 percent of the institution's assets.

    - ✓ The major use of funds by banks is lending. For the typical bank, 53 to 57 percent of total assets are loans. Consistent with Economics/Finance principles, government regulation, and the fiduciary responsibility to owners, bankers make lending decisions after assessing the credit worthiness of the loan applicant. Credit risk is judged along the so-called "C's" of credit – Capacity, Character, Capital, Conditions, and Collateral.

- ✓ Banks are heavily regulated and tested or examined by regulators on a periodic basis.

The structure of the financial sector in general and banking industry, in particular, has changed dramatically over the last 20 years. Key forces of change have been deregulation, technology, and renewed efforts by financial institutions to achieve new levels of efficiency. As a result, customers have more choices than ever before if they look to the **financial services industry** as opposed to only the banking sector.

The issues surrounding small business firms' access to capital are not new nor are they confined to El Paso. The next portion of the report summarized key trends and concerns with respect to small firms based upon selected national, statewide, and local conferences/studies. Basic trends and conclusions were:

- ✓ Commercial banks continue to play an important role in providing financial products to small firms although their market share is declining.

- ✓ Small businesses commingle business and personal financial activities.

- ✓ Providing minimal **financial information** and having a **relationship** with a bank is critical to obtaining credit.
- ✓ Trends of bank consolidation and bank credit scoring have not restricted firms' ability to obtain credit from the financial services industry.
- ✓ Loan denial rates to minority versus other-owned firms are higher. Additional research is needed to identify factors influencing the probability of loan application success.

Key concerns/issues are:

1. Increase business support services and availability of information concerning financing alternatives and lending criteria. Very small or micro-firms, young, and minority-firms show a higher level of concern in these areas; especially with respect to debt financing.
2. Market conditions and Government Regulation/Taxes issues dominate concern levels of small businesses. Availability of credit is typically rated lower. But it is always on the list of concerns.

Commercial banks continue to play a large role in financing the credit needs of the market/community they serve. Given this, a natural question is: how effective is the banking sector in supporting the financing demands of its market? A conceptually sound approach is to measure the dollar amount of funds the bank collects from the community and compare this to the dollar amount the institution channels or reinvests back into the market. For decades the standard statistic employed to measure and summarize this complex process was a bank's (or the banking sector's) Loan to Deposit ratio (L/D). However, the study suggests that this static, one-dimensional ratio provides little information or insight with respect to a bank's community "reinvestment rate."

An adjusted L/D ratio or a "community reinvestment rate" is also considered. Given data limitations and/or significant time lags, the CRR of a bank or banking sector also has problems as a regular monitoring device. If such analysis is desired, data from the Community Reinvestment Act MSA Aggregate Report on small business lending by county can provide valuable information.

This analysis was performed for banks reporting business loan production figures to the CRA. Specifically, banks in El Paso, Cameron (Brownsville/Harlingen), Hidalgo (McAllen/Edinburg), and Webb (Laredo) counties were reviewed concerning business loan production in 1998. Key findings were:

- ✓ Banks in the combined Texas-Mexico border region made over $585 million in business loans in 1998. This represented roughly seven percent of their deposit base. On average, banks in the region made one business loan for every $1.25 million in deposits for the year.

- ✓ The El Paso banks analyzed compared favorably to those in Webb and Hidalgo counties. Local banks, on average and individually, ranked below the Cameron county institutions.

The CRA business loan data base also provides information concerning lending activity to firms with annual revenues under $1 million. Analysis of this subset of business lending by commercial banks in the border region revealed that:

- ✓ Border area banks loaned over $300 million to small businesses in 1998. On average, two thirds of business loans were to "small" firms; one-half of loan volume involved small businesses.

- ✓ Bank of the West and Wells Fargo banks in El Paso are in line with overall border average figures. Chase Bank in El Paso as well as Cameron and Hidalgo counties are below border averages.

From one perspective, the CRA data analysis conducted may be superior to a traditional L/D calculation of the following reasons:

- ✓ The approach focuses upon business lending; the central issue being addressed in the study.

- ✓ The method adjusts for market size differentials and considers competitive conditions to the extent possible.

- ✓ The technique adopts a dynamic perspective to assess the dynamic characteristics of bank lending.

On the other hand, there are some drawbacks:

- ✓ Obtaining timely local market deposit data can be a problem. In addition, banks under $250 in assets do not report business lending activity consistent with the CRA data.

- ✓ The technique does not adjust the deposit base of banks for international or other imported deposits nor does it consider the presence of public deposits on the institutions balance sheet.

- ✓ The method does not integrate the business credit extension activities of non-bank subsidiaries of a holding company that are active in the market being studied.

The final part of this section noted that it is the financial services industry, not just commercial banks, that offers alternatives to small business firms. At present, there are over 100 lending/financing firms in El Paso. Accessing Internet sources increases the number of alternatives significantly. The Community Reinvestment Act MSA Aggregate Report shows 47 firms extending credit to firms in El Paso County; 32 providing $100 thousand or more; 19 lending $500 thousand or more. In addition, credit unions in the area have a deposit base over $1.25 billion; offering a major alternative to small firms who co-mingle personal and business financial activities.

This study had many goals that were considered to assist community leaders and the business community in general in developing a more orderly approach to the issue of debt lending and capital access. Primarily the study:

- ✓ Profiled the El Paso business sector with respect to the financial services they utilize along with the sources of these services.

- ✓ Identified and ranked the opinions of businesses concerning a variety of capital access and other issues they face in the region.

- ✓ Generated data and analysis concerning the level of **effective demand** for debt financing, where: Effective demand is based upon a on a firm's legitimate need for funds consistent with its business plan and operating strategy within a particular industry; it's willingness to provide all the necessary data and supporting financial information to a lending institution necessary to meet the lending institutions regulatory body demands, including the *costs* of meeting these requirements, such as certified financial statements and business plans; has collateral it is willing to offer as security; is credit worthy and can provide information about the past, present and prospective financial condition of the business or its principals (i.e., sole proprietorship).

This study points out that effective demand is a dominant factor in determining capital access issues, ranging from individual firm abilities to how a community should respond to needs and policy options. Furthermore, businesses are faced with supply conditions that have implications that stem from macro-economic factors to industry factors to variables within the financial industry itself. These combine to establish capital supply conditions that cannot be separated out from the demand for capital.

To explore these issues, the study reviewed banking practices and the key issues that underscore banking practices, thereby establishing the parameters for lending and credit. In addition, a mail survey instrument was designed to generate information on local firms concerning their legal structure, size, age, type of accounting system employed, ownership, and principal bank. This questionnaire requested data with respect to a firm's use of a variety of financial services and products, their experiences with debt financing, along with their opinions and concerns on a number of capital access and other business-related issues.

Highlights of the survey are:

- ✓ The sample is dominated by sole proprietorships, partnerships and sub-chapter S corporations; typically relatively small firms.

- ✓ Over 25 percent of the respondents have revenues below $100 thousand per year; roughly 60 percent under $500 thousand; 90 percent with less than $5 million in annual sales.

- ✓ Almost 70 percent of the firms have fewer than 10 employees; 94 percent with fewer than 100. Over 98 percent of the businesses have less than 500 employees; the threshold commonly used by the Small Business Administration to define a small business.

- ✓ The respondent group has an age distribution of relatively new or "young" firms, "middle-aged" and well established or "mature" businesses. More specifically, approximately one-third are less than 10 years old, roughly one-fifth have operated for 10 to 15 years and the remainder for over 15 years.

- ✓ Well over one-half of the sample consists of minority-owned firms; two-thirds of the businesses are family owned.

- ✓ Approximately 25 percent of firms utilize a basic, low cost record keeping system which allows a year-end compilation of information for tax returns. While requiring minimal time and expense, this method will not generate financial statements. Such information can be critical when seeking a loan from a commercial bank. Another 11 percent employ a system which generates year end financials only.

- ✓ Commercial banks continue to be dominant providers of personal/business checking and certificate of deposit accounts to firms. Banks provide 40 to 55 percent of various business loans to local firms. Roughly 85 percent of responding firms have at least one account or relationship with a local bank.

- ✓ Other financial institutions play important roles in financing firms reflecting the fact that businesses do have alternatives to commercial banks.

- ✓ Over the past three years, 40 percent of firms have applied for one or more loans. The overall acceptance rate was 71.4 percent.

- ✓ By combining percentages concerning the record keeping system employed, loan application, loan denied, and reason for not applying for credit, a maximum of 19.9 percent of firms in the area may have had a demand for credit over the last three years which was not met. The minimum or lower limit to answering this question is zero firms.

- ✓ A number of groups/organizations/agencies have offered business support services including assistance in applying for credit. Local firms show very low utilization rates for virtually all of these services.

- ✓ Of a variety of basic, general issues faced by firms as they begin the year 2000, "Taxes" are of the greatest concern with "Sales" coming next. Over 50 percent rate these issues as extremely important. "Financing and Interest Rates" is the lowest ranked issue; nevertheless about one-third of the respondents rate the issue as extremely important.

- ✓ Firms rated 15, more specific issues they face entering the new year. "Market Conditions" issues dominate, especially the "outlook for demand." The "Regulations and Taxes" cluster of items is next in order of concern, most notably the "state and local taxes" and "workers' compensation costs" areas. The "Financing" group is of least concern with less than 20 percent rating this collection of issues as extremely important. The exception in this area is "short-term/working capital financing" where over 25 percent of firms are very concerned.

- ✓ In evaluating potential "Barriers" to obtaining financing, 20 percent or less of firms believe that lack of understanding bank lending requirements, lack of information concerning access to financing, and lack of alternative financing sources are serious potential barriers. Approximately 30 percent perceive that lack of competition in the lending sector is a serious barrier.

- ✓ Concerning the usefulness of various "Strategies" for improving access to capital in El Paso, more "small business support programs" and better "access to information on bank lending" are ranked as the best strategies with "greater sensitivity to minority lending needs" and "educational outreach efforts by the banking community" being the next best strategies.

The study also generated information on a number of subsets of the overall response group. Specifically, analysis of firms by size, age, ownership, and principal commercial bank revealed the following:

- ✓ Small, relatively young, and minority-owned firms utilize the basic, low cost, year-end compilation accounting system more than their counterpart groups.

- ✓ Loan denial rates are higher for small, young, and minority-owned firms; especially the latter group.

- ✓ Of the firms in the sub-groups who did not apply for loans, 75 to 85 percent either did not require financing or obtained the necessary funds elsewhere.

This report offered, to the extent possible, some insights towards understanding the loan denial rate differential between minority and other-owned firms. A greater proportion of minority firms are small, relatively young, and utilize a year end compilation record keeping system compared to other firms. Firms with some or all of these characteristics experienced higher loan denial rates. There are, of course, other factors which could play an explanatory role in resolving the differential. Clearly, and following in the same vein as the Federal Reserve Banks activities at the national level, more research is called for.

The final portion of the survey analysis compared firms' experiences with their principal commercial bank. Specifically, depository institutions were grouped into a "Large Bank" category consisting of Bank of America, Chase Bank of Texas, and Wells Fargo Bank or an "Other Depository Institution" collection of remaining local banks, credit unions, and other out-of-area commercial banks. A comparison of these two groups revealed virtually no significant differences in loan application and denial rates, reasons for no loan application, ratings and rankings of general/specific issues facing firms as well as potential "Barriers" to accessing capital and "Strategies" to improve access.

Policy Recommendations

A major theme emerging from the opinion portion of this study revolves around the need for increasing the human capital stock of many El Paso firms. Specifically, there is a demand for additional information, knowledge and understanding of debt financing alternatives and the procedures involved in seeking such funds so that business operators can meet the criteria of effective demand. Yet, a large number of agencies/groups/ institutions have sought to provide such information with only limited success. In addition, there is concern that the local banking sector is not competitive thus constraining a firm's ability to acquire debt capital. Based on our review of current practices and opinions of the business community some policy considerations can be put forth.

Policy Recommendation #1

A One Stop Capital Access Center

Such a Center would result from the consolidation, repackaging, and delivery system modification of current business support services in the community.

The Center would:

a) Identify the Debt Needs of an Individual or Firm – Start-up, Acquisition, Working Capital, Equipment, Vehicles, Land/Buildings, Consolidation, Multi-Purpose

b) Discuss Financing Alternatives – Commercial Banks (local and out-of-territory), Credit Cards (business and personal), Credit Unions, Mortgage Companies, Finance Companies, Leasing, Brokerage Firms, Micro-Lending Institutions, SBA-Backed Lending Institutions.

c) Explain, Arrange/Provide Assistance Concerning Data Requirements and Costs of Financing Alternatives - Business Plan, Financial Information, Record Keeping System, Credit History, Collateral, Equity in Firm, Relationship with Financial Institution, Interest Rate Costs

Such information would demonstrate that there *are* alternatives, and that commercial banks are not necessarily the only institution a firm has to deal with. Moreover, such an effort would point out that in some cases alternative sources may be more cost effective than traditional commercial bank options

Policy Recommendation #2

Community leaders and decision-makers should consider continued or expanded support of lending programs in which bank credit risk is shared or transferred, or where there are clear Community Reinvestment Act implications. A long-term community strategy in this area should be considered among all impacted parties. Examples include: SBA lending programs, ACCION, the City revolving loan program and various Community Development financing entities.

Policy Recommendation #3

To the extent a community wishes to evaluate banks with respect to their "investment" in the local market, the traditional Loan to Deposit ratio no longer provides adequate or accurate information concerning the "reinvestment rate" of banks. Under ideal conditions, the Community Reinvestment Rate concept provides the necessary information. However, severe data limitations and time lags make the use of this approach impractical on a regular basis. As a compromise solution, the Community Reinvestment Act MSA Report on Small Business Lenders provides data on number of loans and dollar amounts overall and to business firms with annual revenues below $1 million. The data is available with a six month lag. If inter-region comparisons are to be made, an adjustment for size of market and the degree of competition from non-bank firms should be taken into consideration.

Policy Recommendation #4

Occasionally, there has been discussion concerning implementing local government policies which place certain requirements upon banks in order for them to acquire public funds. Local government entities should beware of imposing requirements on banks which run counter to the efficient allocation of funds, the fiduciary duty of bank managers to owners, bank management incentive systems, and/or bank regulations. The near-term results may be to increase the "exportation" of local funds and to diminish the attractiveness of El Paso as an investment alternative for banks as well as other industries.

Policy Recommendation #5

Finally, the loan denial rate difference between minority and other-owned firms raises some interesting and quite important issues. Therefore, we suggest additional research and community efforts be undertaken to further investigate the causative factors of the loan denial rate differential between minority and other-owned firms in El Paso, Texas.