Small Business Lending Patterns:

Getting Behind the Numbers

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The Massachusetts Community & Banking Council

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Overview

This report was prepared for the Massachusetts Community & Banking Council (MCBC) to shed light on interaction between small business owners, financial institutions and public and non-profit organizations in Boston neighborhoods. The report explores lending *dynamics* in order to complement the lending *trends* that MCBC has documented in its annual report, *Patterns in Small Business Lending in Greater Boston*. The most significant finding of the *Patterns* reports over five consecutive years is the persistence of lower lending levels in minority and low- and moderate-income (LMI) census tracts.

Reflecting MCBC's role as a contact point between financial institutions and community organizations, this report is intended to spark dialog that can lead to collaborative efforts to serve Boston's small businesses. Towards this end, the report introduces three lenses that have framed public debate over lending to LMI and minority communities – credit market improvement, discrimination and community economic development. Each lens highlights specific issues and implies different action steps. Using these three lenses, this report asks:

- *How can inter-institutional processes better respond to the credit needs of small businesses in Boston's LMI and minority neighborhoods?*
- *What critical needs can be addressed through collaboration between the banking industry and community advocates?*
- *What is the role for MCBC and for dialog between sectors and institutions?*

Neighborhood Business Composition

This report first profiles the business composition in several Boston zip codes as a means to generate shared understanding. Several highlights emerge:

- In many zip codes, less than half of firms gross over $200,000 in annual revenue.
- The mix of industries varies widely – some zip codes contain very few manufacturing or professional, scientific and technical firms.

- Business density in the most dense zip codes is three to four times the business density in the least dense zip codes.
- A study of three zip codes revealed that over half of the businesses had owners residing within the zip code.

Despite their small average size, neighborhood businesses collectively provide important job opportunities. For instance, Grove Hall has the smallest and least dense business composition of zip codes profiled here, yet local businesses provide jobs equal to one-fifth of Grove Hall's work force.

Findings: Local Credit Markets

Through interviews with business owners in Roxbury, Dorchester and South Boston, several perceptions and attitudes emerged:

- Most small business owners interviewed preferred not to borrow, but many would approach a bank if their business were *struggling*
- Some owners perceived narrow lending criteria to ignore factors in their favor
- Approximately half of the business owners expressed familiarity with technical assistance or alternative lending programs
- Perceptions of discrimination or uncaring treatment resulted in business owners avoiding specific banks

In addition, interviews with expert practitioners revealed a gap in collaboration:

- Public and Non-Profit programs network well with each other and with *specialized* lending staff at banks; however
- Public and non-profit programs collaborate minimally with *branch* staff for referral or marketing

These findings suggest that owners who approach banks when they need help with their business may not be referred to alternative sources of assistance.

EXECUTIVE SUMMARY

Findings: Commercial Real Estate

Rising commercial rents were commonly cited as a critical issue by business owners. Several points underscore the vulnerability of tenant businesses:

- Most tenant business owners complained of escalating commercial rents
- Business owners who owned their commercial building had more flexible options to handle the current economic slowdown
- Commercial building prices have doubled in approximately five years in many neighborhoods making building purchase difficult

In addition, three zip codes were studied to determine levels of commercial building ownership among local businesses. Grove Hall and Roxbury were found to have significantly lower levels of businesses that owned their commercial building, as compared with South Boston.

Recommendations

First and foremost, this report recommends continued dialog between financial institutions and community organizations. Several specific recommendations also emerged:

- Direct small business owners to assistance through denial letters.
- Market alternative programs at bank branches.
- Target "affordable commercial mortgages" to stable local businesses.
- Offer "affordable commercial rents" as part of commercial revitalization.

By nature, MCBC is a forum that promotes better understanding and collaboration between institutions. These recommendations are offered as conversation starters to improve that process, rather than as technical actions steps that can be immediately adopted.

INTRODUCTION

Primary Research Questions

This report asks three central questions:

- *How can inter-institutional processes better respond to the credit needs of small businesses in Boston's LMI and minority neighborhoods?*
- *What critical needs can be addressed through collaboration between the banking industry and community advocates?*
- *What is the role for MCBC and for dialog between sectors and institutions?*

Research Rationale

This report builds on and complements the annual report, *Patterns of Small Business Lending in Greater Boston,* produced by the Massachusetts Community & Banking Council (MCBC). The *Patterns* report documents lending trends in Boston neighborhoods and outlying towns based on data released through the Community Reinvestment Act (CRA). The most significant finding of the *Patterns* reports over five consecutive years is the persistence of lower lending rates in minority and low- and moderate-income (LMI) census tracts.

This report explores lending *dynamics* at a micro-level in order to complement the lending *trends* documented in *Patterns.* The basic question asked repeatedly by members of MCBC's Economic Development Committee and other professionals was "how can we help small businesses to thrive?"[1] This report takes that question seriously in both a narrow and broad sense. Narrowly, the report examines neighborhood-level and institutional processes at work in small business lending. More broadly, the report presents characteristics and critical economic development needs of neighborhood business districts. The report highlights one salient need in this area, namely affordable commercial rental and ownership opportunities.

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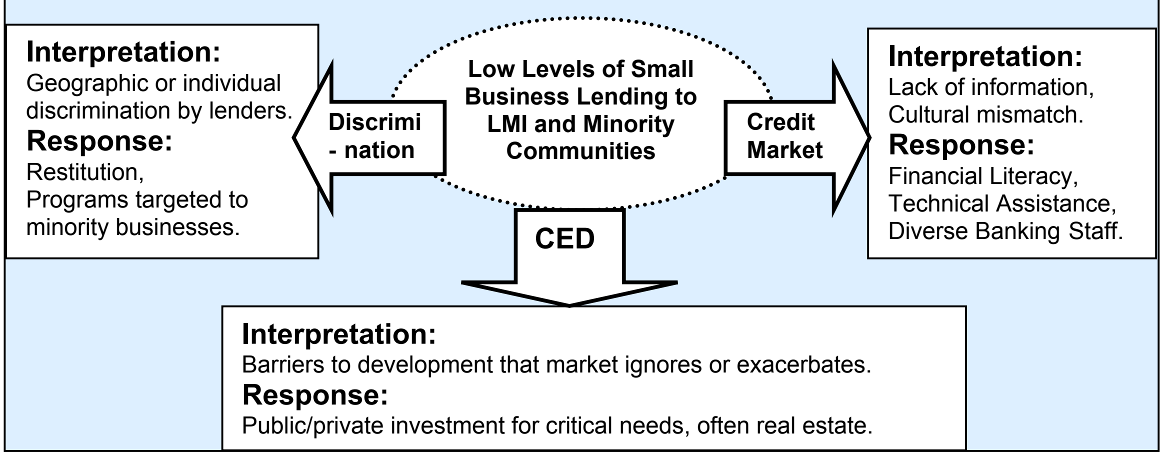
[1] This intent was expressed by MCBC Economic Development Committee co-chairs Esther Schlorholtz and DeAnna Green, and Manager Kathy Tullberg. Numerous interviewees echoed similar sentiments.

INTRODUCTION

Lenses and Secondary Questions

How should the *Patterns* findings be interpreted and acted upon? This depends crucially on the lenses used by lenders, researchers, community advocates and policy makers. This report organizes questions and findings according to three lenses: credit market improvement, discrimination and community economic development, as a means to promote shared understanding on the issue of low lending levels. Moreover, varying interpretations imply different responses, as represented in Figure 1. A more lengthy discussion of these debates is included in Appendix A.

Figure 1. Low Lending Levels Interpreted through Three Lenses



Credit Market Improvement

The lens of credit market improvement frames low lending levels as mismatches in information or culture that hinder private market processes. If credit markets suffer from imperfections, then viable small businesses that need credit may not obtain it. Remedies include reducing risks or improving information in small business lending. Boston has a rich array of organizations that aid this process. Over the course of this research, large gaps in perception became apparent between small business owners and other participants in credit markets, suggesting continued information problems. This report probes how interactions can be improved between small business owners, financial institutions and business assistance programs.

INTRODUCTION

This report asks the following questions about credit market dynamics:

- *What are the characteristics of neighborhood businesses operating in Boston?*
- *What are small business owners' lending preferences and experiences?*
- *Are lending processes meeting the needs of neighborhood business clientele?*
- *What gaps exist in pathways of referral between organizations and institutions?*

Discrimination

Discrimination remains a charged topic for lenders, public agencies and communities of color. The lens of discrimination frames the problem of low lending as differential treatment in banking interactions based on race or geography. A focus on discrimination implies the need to gather evidence (for instance through statistical analysis or random testing) and to secure remedies (for instance through lending commitments and restitution). This report was not designed to unearth evidence of discrimination. The seriousness of that charge demands rigorous inquiry through detailed information about finances, owner characteristics and local markets.

This report addresses perceptions of discrimination as encountered in interviews with business owners, rather than gathering statistical evidence. The study asks:

- *What are minority business owners' perceptions of discrimination in small business lending?*

Community Economic Development

The lens of community economic development frames the problem as barriers to investment and wealth creation that private market mechanisms alone cannot solve. The questions posed by the *Patterns* report run deeper than just improving lending markets. More fundamentally, the report's comparison of *geographic units* implies that some business districts thrive or face greater risks relative to other districts. This report focuses on one dynamic that threatens businesses and neighborhoods differentially. Specifically, increased investment revitalizes neighborhoods but drives up commercial rents.

This study questions further critical needs of businesses and districts:

- *What are common critical needs cited by business owners?*
- *What differences in dynamics can be detected between business districts?*
- *What differences exist in real estate assets across neighborhoods?*

About MCBC

MCBC is a non-profit organization comprised of volunteer members. Members include lenders, community organizations, city officials and other interested groups or individuals. MCBC provides a forum for these groups to communicate about housing and economic development issues in the Boston region.

MCBC originated as part of the resolution to confrontation between community advocates and financial institutions over disparities in home mortgage lending across Boston neighborhoods.[2] MCBC's original mission included lending and policy research to promote investment in minority and LMI communities. In addition, MCBC was charged with monitoring a large lending commitment known as the Community Investment Program (CIP) announced by the Massachusetts Bankers Association. MCBC is meant to serve as a "permanent point of contact" between financial institutions and community groups. Towards this end, MCBC maintains standing committees in four areas of community investment: mortgage lending, affordable housing development, banking services and economic development.[3]

Methodology

This study emphasizes microanalysis of lending processes and business districts. Four methodologies comprise the research approach. These include primary interviews with small business owners, secondary interviews with staff from lenders and public

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[2]Home mortgage lending disparities were documented in several studies released by the Federal Reserve Bank of Boston in the early 1990's, precipitating community protest.

[3]See Tullberg (2001) for a detailed description of MCBC's history.

programs, site observations including supplemental inquiry of employees and neighborhood residents and analysis of publicly available data sets.

Primary Interviews

In-person interviews with business owners served mainly to solicit ethnographic information. Owners were asked about business priorities as well as borrowing preferences and experiences. Some responses are quantified in this report, but the businesses should not be construed as a representative sample for statistical purposes. The interview questions are attached in Appendix B.

Several census tracts in Dorchester, Roxbury and South Boston were chosen based on lending rates, local programs supporting small businesses and particular interest by MCBC Economic Development Committee members. Appendix C describes the characteristics of census tracts chosen and businesses interviewed.

Secondary Interviews

Expert practitioners from private, public and non-profit organizations were interviewed to synthesize a variety of perspectives on assisting small businesses. Also, staff at several bank branches were interviewed about specific lending processes. The interviews were used to clarify organizational relationships, lending and assistance processes and referrals. Interviews were supplemented with program materials and reports. Appendix D lists individuals interviewed for this report.

Site Observations

Observations of three neighborhoods were made in order to add context to interviews. Characteristics noted include: types and spatial concentrations of businesses, building activity (including renovation, signage and vacancy), and traffic. Casual inquiries of employees supplemented information about business turnover, activity and ownership.

INTRODUCTION

Data Analysis

Data analyzed for this report consists of two components:

First, this report uses data from County Business Patterns and Dun & Bradstreet to develop a portrait of the composition of businesses in Boston zip codes.[4] These data are juxtaposed with lending rates based on Community Reinvestment Act (CRA) data aggregated over census tracts and averaged for multiple year periods. This study uses lending rates to Very Small Firms (VSF), since the vast majority of firms encountered fall into this category.[5] *The comparison of lending levels and business composition is meant to be suggestive. Differing geographic units used by the various types of data prohibit most statistical analysis.*

Second, this report calculates the percentages of business owners that 1) own the commercial building in which they do business and 2) live proximate to their business. Three Boston zip codes are examined: Roxbury (02119), Grove Hall (02121) and South Boston (02127). These percentages were calculated by matching address and business ownership data from "Doing Business As" certificates (DBA's) from the Boston City Clerk with building ownership information from the City of Boston's online assessing database.[6] Appendix E contains a more detailed data analysis methodology for calculating building ownership and residential location.

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[4] Community Reinvestment Act data is available through the Federal Financial Institutions Examination Council (www.ffiec.gov). County Business Patterns data is available through the Bureau of the Census (http://www.census.gov/epcd/cbp/view/cbpview.html). Some of the Dun & Bradstreet data used for this report was provided privately through Stuart Ryan, author of the MCBC *Patterns* report. Additionally, Dun & Bradstreet provides some of their data free of charge (www.zapdata.com).

[5] Very Small Firms (VSF) are defined under CRA and in the MCBC report as firms with less than $1 million in annual revenue.

[6] Every third DBA entry was sampled and compared with assessor information. DBA entries include new registrations, re-registrations, location changes and withdrawals. Withdrawal entries, financial institutions and businesses engaged solely in rental of residential units were omitted from the sample.

THE SETTING: COMPOSITION OF BUSINESSES

Overview

This section highlights composition of neighborhood businesses to complement the composition of neighborhood resident demographics analyzed in *Patterns*. The section is intended to generate a shared understanding among financial institutions and community groups.[7] Zip codes profiled here reflect Boston's neighborhoods as opposed to downtown business areas.[8] Two salient points emerge from this analysis:

- Neighborhood businesses are predominantly small and not attempting to grow.
- Several neighborhoods rank consistently across indicators as having the smallest, least dense, least capital-intensive and most locally-owned businesses in Boston.

This portrait contrasts somewhat with common portrayals of inner-city business districts as dynamic growth engines constrained by lack of capital. Nevertheless, small businesses are a vital contributor to neighborhood jobs and health.

Size of Businesses

Most of the businesses in Boston's neighborhoods are very small in terms of revenue and employees. Businesses encountered during this study typically employed fewer than five people and grossed under $1 million in sales. The same trend appears at the zip code level. In most of the zip codes shown in Figure 2, *less than half of firms gross over $200,000 in annual revenue*. These are tiny firms relative to costs of doing business in Boston and relative to typical commercial loan amounts. This finding accords with national patterns; 41 percent of businesses in 1998 grossed under $100,000 in revenue.[9]

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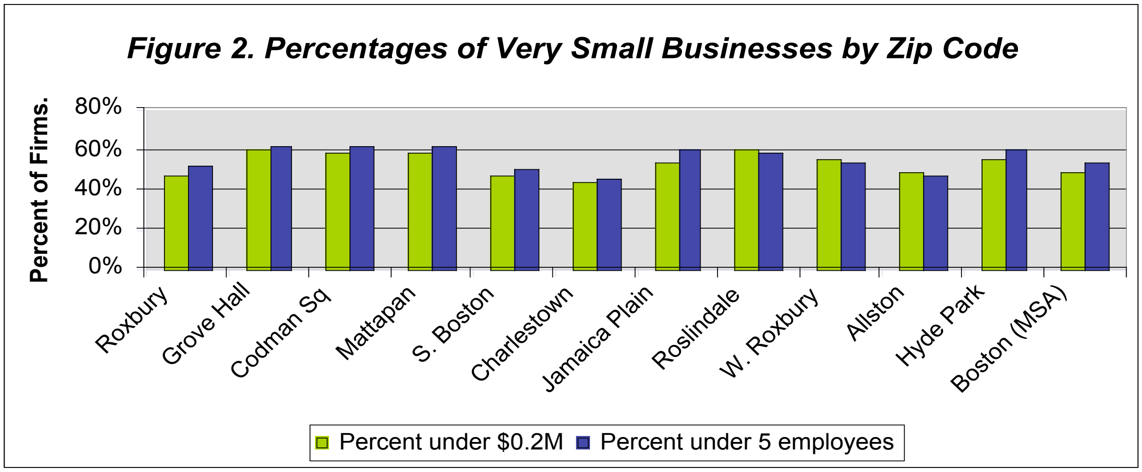
[7] Several interviewees suggested that banks and community groups do not refer to the same population when using the term "small businesses."

[8] See Appendix E for an explanation of the choice of zip codes.

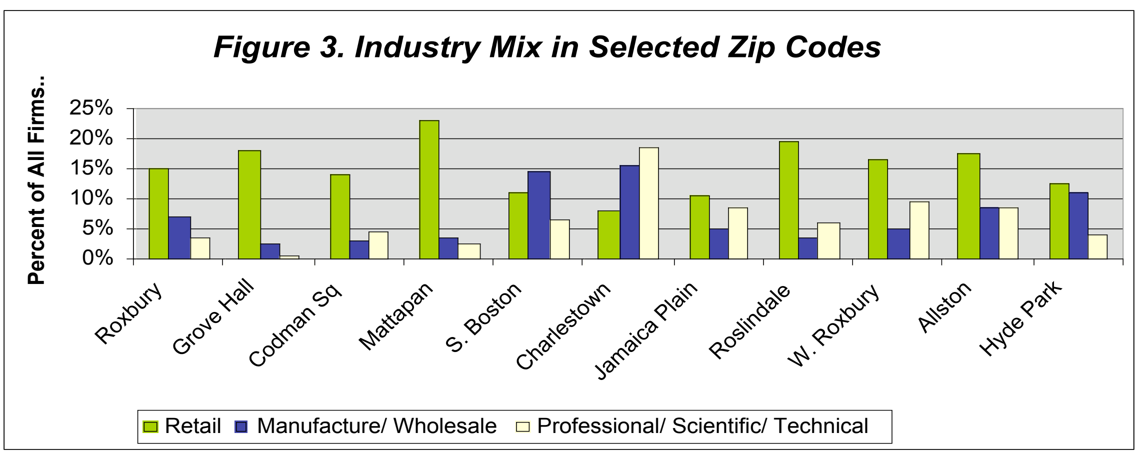
[9] Bitler, Robb and Wolken (2001).



Source: County Business Patterns (employees) and Dun & Bradstreet (revenues)

Industry Mix

Services and retail industries predominate in most Boston neighborhoods. The mix of industries varies considerably, as shown in Figure 3. For example, Mattapan leads in the percentage of retail establishments, while South Boston and Charlestown show the highest levels of manufacturing and wholesale. Grove Hall has the least manufacturing, professional/ scientific/ technical and warehousing (not shown).



Source: County Business Patterns

THE SETTING: COMPOSITION OF BUSINESSES

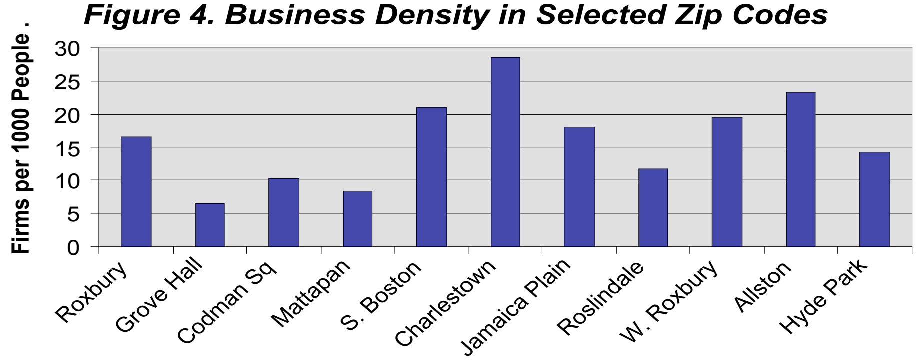
In geographic areas smaller than zip codes, industry mix varies tremendously. Several striking examples suggest the importance of industry mix to lending levels:[10]

- Newmarket (tract 801) shows high lending levels to very small firms (VSF), despite low average family income. Newmarket is a dense industrial area with a concentration of warehousing operations that is spatially disconnected from the residential areas in the tract.
- South Boston near West Broadway and Dorchester Avenue (tract 607) shows low lending rates. The tract consists mostly of public housing with few commercial buildings.
- In Dudley Square east of Warren St (tract 803) a high concentrations of medical, legal and financial firms were encountered. No owners of these types of firms indicated that they wanted bank credit.

Business Density

Neighborhood zip codes with the most business density have three to four times as many businesses per thousand people than the least dense zip codes.[11]

Figure 4. Business Density in Selected Zip Codes



Source: County Business Patterns and Census 2000

[10] Dun & Bradstreet maintains industry mix data at the census tract level, but cost was prohibitive.

[11] *Patterns* (2003) reports number of firms per 1000 people in Table 6 (p. 18). The relative variation is similar, but actual densities vary because the *Patterns* report uses D&B census tract business data aggregated to approximate the Boston Redevelopment Authority's Planning Districts.

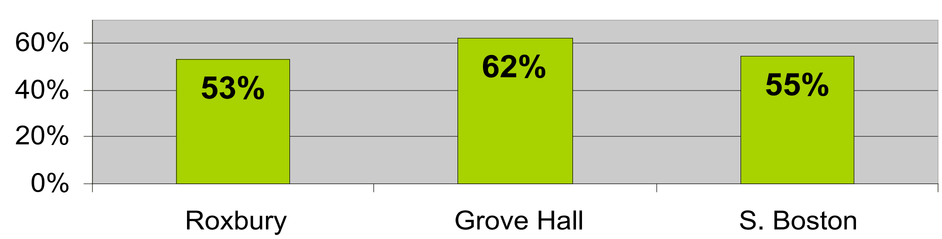
The above comparison reflects variation only in Boston's neighborhoods; downtown areas are likely to be more dense.

Smaller geographic areas show further variation in business density and activity. For example, census tract 920 incorporates two business districts, Bowdoin-Geneva and Field's Corner. Bowdoin and Geneva Avenues have sparse businesses and owners who lived nearby and worked in the shop. In contrast, Field's Corner had densely packed businesses with many non-local owners. In four establishments, employees stated that the owner lived in another part of the city *and* owned additional businesses. Furthermore, new businesses and remodeling activity were evident.

Local and Home-Based Businesses

Approximately half of the businesses in all three zip codes are home-based.[12] This figure excludes corporations, which do not register with the City Clerk.

Figure 5. Percent of Businesses that are Home-Based

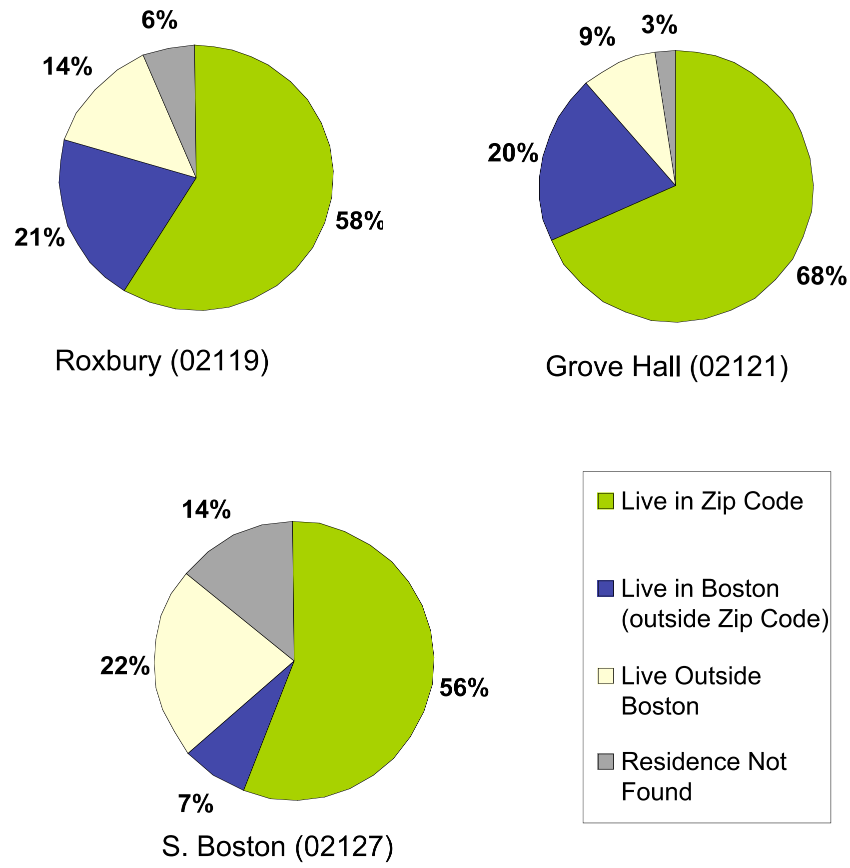


Source: Boston City Clerk and Boston Assessing Department

In addition, many businesses are locally owned. Figure 6 shows residence location.[13] The quantity of home-based and local ownership suggests that neighborhood businesses and residents are closely connected.

[12] Because DBA's rely on owner's reporting of business and residence address, this methodology may overestimate the proportion of businesses that are home-based. See Appendix E.

Figure 6. Residential Locations of Business Owners



Source: Boston City Clerk and Boston Assessing Department

Importance of Very Small Businesses

The foregoing discussion should not be construed to mean that local businesses are stagnant or unimportant. Very small local businesses are crucial to the health of Boston's neighborhoods. Local businesses provide jobs, contribute to safety and are important community stakeholders.[14]

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[13] As noted above, this methodology may overestimate the number of owners who reside in the same zip code. Note that only the difference between Roxbury and Grove Hall achieves statistical significance.

[14] A longer discussion of the contribution of small businesses is included in Appendix A.

THE SETTING: COMPOSITION OF BUSINESSES

Local businesses provide significant numbers of jobs relative to population. For example, businesses located in the Grove Hall zip code provide a number of jobs equal to one-fifth of Grove Hall's working population, *excluding self-employed individuals.* This is significant, considering that Grove Hall has fewer and less dense businesses relative to other zip codes. The payroll of these employees was $52 million in 2001.[15]

Besides the number of jobs provided, small business ownership often represents a *best-option* for individuals with low formal education or limited English skills.[16]

Table 1. Jobs Provided by Grove Hall Businesses (02121)	
Total Population (02121)	25,057
Population in Labor Force	9,810
Jobs provided by 02121 businesses excluding self-employment	2,034 *(21% of labor force)*
Payroll of 02121 Businesses (2001)	$52.0 (million)

Source: Census 2000 and County Business Patterns

Aggregate Lending Levels and Business Composition

Lending data is shown here for comparison with the business characteristics noted above. Three cautions should be noted. First, the juxtaposition of business composition and lending rates should be considered *suggestive* rather than statistically rigorous.[17] Despite apparent parallels, no statistical associations were found. Second, for this report, census tracts were aggregated to approximate zip codes. They do not correspond to the aggregates used in MCBC's *Patterns* report.[18] Finally, lending levels are averaged over several years to show rough trends. This obscures variation in both

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[15] Based on County Business Patterns data.

[16] Servon (1999).

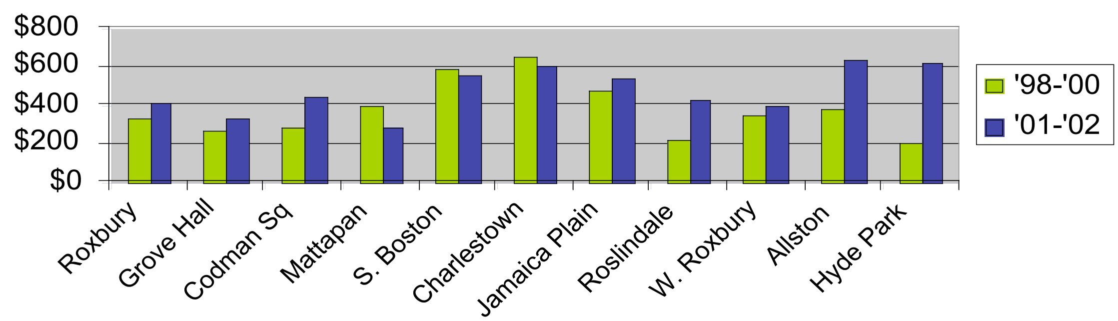
[17] As noted in Appendix E, different geographic units are used for lending rates (census tract) and business composition (zip code), so rigorous statistical analysis is not possible.

[18] Rates for all years are calculated with 2002 D&B data for number of firms.

absolute amounts and relative lending levels between neighborhoods.[19] Readers should refer to the *Patterns* reports for more detailed annual variation.

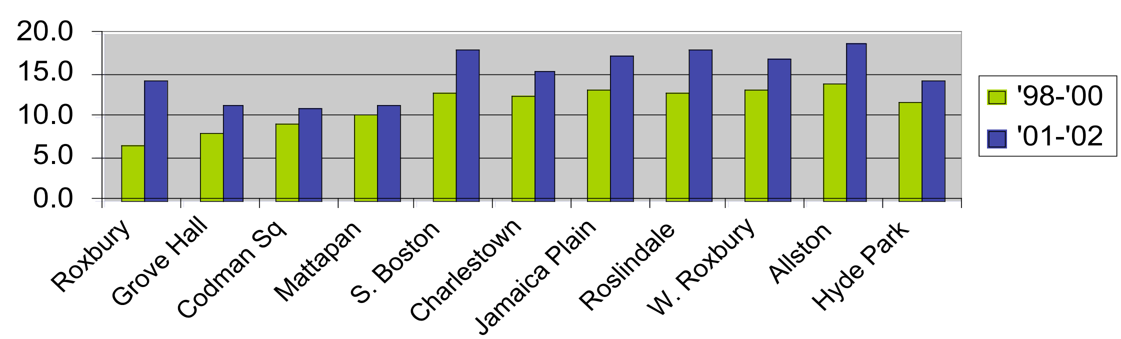
Figures 7 and 8 depict lending rates in terms of dollar amounts and numbers of loans.

Figure 7. Average Annual Dollar Amounts of Loans per 100 Very Small Firms (000's)



Source: FFIEC and Dun & Bradstreet

Figure 8. Average Annual Numbers of Loans per 100 Very Small Firms



Source: FFIEC and Dun & Bradstreet

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[19] See Ryan (2003), p. 14.

THE SETTING: COMPOSITION OF BUSINESSES

Several observations follow from this snapshot of lending patterns in the context of the business composition noted above:

- Some areas that show the lowest numbers of loans (Grove Hall, Codman Square, Mattapan) also have the smallest firms, the least business density and the lowest proportions of scientific and technical firms. Further research could clarify causal relationships.
- Average '98-'00 numbers of loans generally parallel average '01-'02 numbers of loans. However, as noted in *Patterns*, neighborhood lending levels do not show a consistent relationship to average income or minority composition.
- The patterns of numbers and dollar amounts of loans do not match, suggesting that each reflects a different type of lending.[20] For instance, heavily industrialized Charlestown shows the highest dollar amounts of loans, but fewer numbers of loans.

[20] The *Patterns* reports suggest that data on numbers of loans is heavily influenced by credit card lenders.

FINDINGS: LENDING PROCESSES

Local Credit Markets

These findings document perceptions of business owners and intra-institutional processes that affect the functioning of credit markets. The findings are based on interviews with small business owners, staff at financial institutions and practitioners of economic development. The section covers lending processes with some attention to the question of discrimination.

Summary

Most small business owners are not interested in borrowing, and few have current plans to expand their business. However, many owners believe that they are good credit risks and could obtain financing if needed. Many business owners interviewed would approach banks if they needed assistance with their business, partly because loan applications are easy and many bank branches are located in Boston neighborhoods. On the other hand, business owners had low familiarity with alternative assistance and lending programs.

Bank branches generally do not refer loan applicants to external sources of assistance. While business assistance and alternative lending programs have strong relationships with *specialized* banking staff, public and non-profit programs do not work closely with bank *branch* staff. As a result, business owners that approach banks in search of financing are not routinely directed towards outside assistance.

Interest in Borrowing

Most small business owners interviewed for this report preferred not to borrow.[21] Only 19 of 45 businesses were interested in borrowing. Furthermore, 8 of those businesses already had outstanding bank loans. This leaves only one quarter of businesses desiring credit but unable to obtain it.

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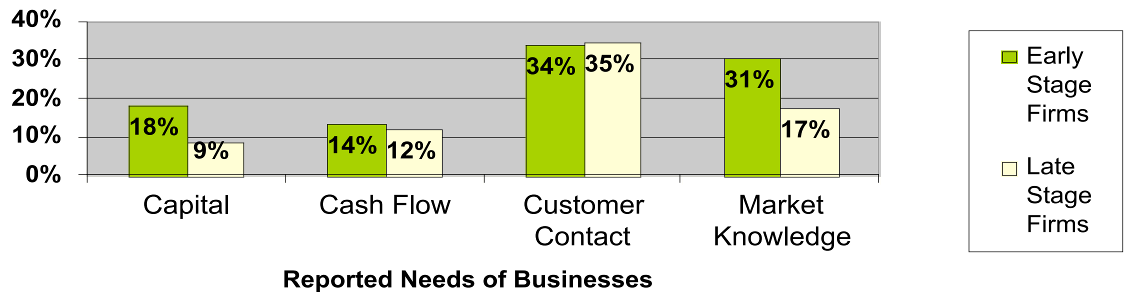
[21]The reader is reminded that proportions of businesses based on interviews should not be construed as having statistical accuracy.

Among the 26 business owners that were not interested in borrowing, primary reasons were reported as:

- no need for credit (18 owners)
- too much risk (5 owners)
- too much hassle (2 owners)
- expectation that the application would be rejected (1 owner)

These findings correspond to the work of other researchers. In one survey of business owners, approximately 18% of owners of young businesses had unmet capital needs, as shown in Figure 8.

Figure 8. Proportion of Businesses Reporting Capital vs. Other Needs*



Source: Dodge et. al. (1994)
** Reflects non-Boston related research*

Other studies suggest that owners of various ethnic and racial backgrounds have different attitudes towards risk. A Chicago study found that minority owners expressed greater aversion to risk than white owners. Caution is required in interpreting this finding. Varying attitudes towards business risk could reflect cultural attitudes or differential fallback opportunities for owners of varying ethnicity.

The majority of businesses encountered were not interested in growth. Policy debates about inner-city businesses often depict dynamic firms constrained by lack of credit. This was not the general character of the businesses interviewed during this study. Most owners wanted a stable business providing an adequate income.[22]

Only four owners articulated a current plan to expand their businesses, although several others shared vague interests in growth. For many, expansion would require a serious threshold investment, such as a second location or hiring a manager. Most owners did not want to make such a commitment.

Many owners would approach a bank if they needed help with their business. While most owners were not interested in borrowing, many indicated that they would approach a bank if they needed help with their business.[23] By implication, these owners would approach a bank during *weak* rather than *strong* performance. This orientation could be stated as follows: If the business is profitable, then assistance is unnecessary. If the business is having financial difficulty, then financing is the obvious solution.

Expectations of Owners

Business owners perceived their businesses to be credit worthy. This perception emerged in two ways. First, owners who were not seeking credit expected that they could obtain it if a need arose. Second, owners who had been denied loans usually argued that they should be considered a good credit risk.

Business owners who foresaw a need for credit expected that they could obtain it when the need arose. Numerous owners who reported no previous borrowing experiences with banks expected that they could obtain credit. Typical reasons offered included holding a business checking account or having good supplier and landlord relationships. One owner suggested that if he needed credit, he could threaten to move his business bank account elsewhere. Only one owner had attempted to borrow incrementally in order to establish a business credit history.

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[22] Similar insights are offered by Servon (1999) and Carland *et. al.* (1984).

[23] It is difficult to quantify how many owners responded this way. Owners often mentioned multiple sources or interpreted the question to mean financial difficulty.

FINDINGS: LENDING PROCESSES

Business owner expectations contrast with the perspectives of lenders and business assistance providers. Bank staff emphasized the tremendous importance of personal and business credit history, especially for small loan amounts.[24] Lenders also emphasized the need to build credit history early during strong financial performance, rather than waiting until the need is dire.

Some owners believed that they were a good credit risk but that narrow lending criteria ignored factors in their favor. Most business owners could articulate the basis for past denials, including business debt or spotty credit records. However, these owners argued against narrow lending policies that ignored other positive factors, such as punctual payments to suppliers. One owner stated that lenders demand information in a form that requires unaffordable business accounting services.

A more fundamental question is whether strict lending criteria screens out viable businesses or overly optimistic applicants.[25] As noted by several assistance providers, business owners walk through the door thinking that a loan is the answer to their business troubles. Often, the solution lies elsewhere.[26]

A few owners expected assistance from banks regardless of the creditworthiness of their business. Some business owners expect unsupportable loans or negotiability of repayment.[27] Furthermore, a few business owners conflated banks, city government and non-profits as sources for assistance. This idea is typified by the following example.

- A struggling business owner of twenty years variously expressed his needs as a loan, rent control, cessation of street repair and a temporary grant. He argued that "they" should help him on the basis of the length of his tenure

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[24] Loan applications for under $100,000 are routinely processed via credit score. Even loan applications up to $500,000 are highly affected by personal and business credit scores.

[25] See the text box on credit market theories in Appendix A.

[26] Margaret Somer noted that many owners should first examine business processes, including collections, inventory control and marketing, January 30, 2004. Similar comments were made by Kevin Winn and Pierre Fils-Aime.

[27] Lou Corapi noted that some borrowers expect loan forgiveness, March 5, 2004. The attitude is reflected in statements by several owners.

> rather than on the basis of his business prospects. He complained that public programs and banks were unresponsive.

Assisting individual distressed businesses may be an important policy goal. However, the intervention probably lies beyond the scope of the bank-community relationship.

Loan Processing at the Branch Level

Small business loan applications are quick and easy. Applications for the smallest loans have no fee and require no documentation of business financials. Most lenders can respond within a couple of business days. For small loan amounts, this is often the extent of the application process; most lenders do not assign costly relationship management to small loans.[28]

In addition to a quick process, branch managers are eager to solicit loan applications. Branch managers have incentives to meet per-period loan goals. Furthermore, branches are attentive to customer service. Branch staff generally do not make lending decisions but are eager to help loan applicants. Finally, lending institutions are prohibited by law from dissuading any applicant from applying for credit.

These factors make small business loan applications simple and non-threatening, at least in terms of the initial encounter. Furthermore, bank branches perfuse Boston's neighborhoods and branch staff are diverse. This provides good access to the loan application process for small business owners.

Ease of loan applications contributes to business owners' expectations that they will obtain credit. The ease of loan application is a positive feature of banking in Boston that can be credited to financial services innovation and to bank-community agreements such as the Community Investment Program (CIP). At the same time, the ease of application contributes to overly high expectations on the part of some business owners. When lenders respond to applications with requests for additional information or denial letters, business owners are unprepared based on their experiences with the

[28]Based on interviews with lending staff and examination of loan application materials.

initial application.[29] In response, multiple business owners who were interviewed for this report theorized other reasons (besides business credit-worthiness) for which lenders might have denied their application. In an extreme formulation, one owner stated that banks will "give any reason just to say no."

Pathways to Assistance: Alternatives and Referrals

Boston has a rich array of training, assistance and alternative loan programs. Many of these programs are referenced in two documents available on the website of the Boston Office of Business Development (OBD).[30] However, business owners are insufficiently aware of the extent of programs available, and referrals from bank branches to such programs are inconsistent.

Less than half of the owners interviewed expressed familiarity with public or non-profit technical assistance or alternative lending programs.[31] When asked where they would seek business assistance, fewer than half of the business owners interviewed stated that they would seek help from a public or non-profit program.

Proximity seemed to matter a great deal. Owners of businesses located near supportive programs typically knew of their existence. For instance, owners located near Dudley Square were aware of the Boston Business Assistance Center (BBAC) or Nuestra Comunidad Development Corporation (Nuestra), while owners in Codman Square knew of the Codman Square Neighborhood Development Corporation (CSNDC). Others knew of ReStore Boston or the Small Business Administration (SBA).

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[29]Several owners made comments to the effect that bank branches were helpful initially, but the relationship degenerated into hassle and eventual denial of credit.

[30]Due in part to MCBC's initiative, the Boston OBD has placed two resources online:

the *Small Business Finance Resource Guide* (http://www.cityofboston.gov/dnd/OBD/PDFs/G_Small_Business_Financial_Resource_Guide.pdf) and the *Small Business Technical Assistance Resource Guide* (http://www.cityofboston.gov/dnd/OBD/PDFS/G_Technical_Resource_Guide.pdf).

[31]Some caution should be exercised in interpreting this response. Here, "familiarity" means that the owner either stated that they would approach a program or that the owner was able to articulate the basic services of one or more providers. Furthermore, some owners interpreted the question to mean financial difficulties. Other owners mentioned multiple sources or expressed bewilderment about the concept of approaching someone for help.

FINDINGS: LENDING PROCESSES

Owners' interest in alternative programs was mixed. Some owners were actively interested but lacked information. Other owners knew of programs but had little desire to seek non-financial assistance from them. For example, Pierre Fils-Aime noted that many business owners lose interest in technical assistance when they realize that it will require significant effort or increased financial reporting.[32]

Most small business owners seeking credit had approached only a few banks. In general, business owners had not "shopped around" for credit. Several business owners had been rejected by one or two banks and had stopped seeking credit. Two well-established business owners were notable exceptions. Both regularly approached multiple banks as well as suppliers to seek competitive rates and credit availability.

Public and non-profit programs network well with each other and with *specialized* lending staff at banks. *Every* practitioner cited referrals to and from multiple other programs and specialized small business lending staff at banks.[33] In addition, practitioners tailor referrals based on subtle differences between programs. Specialized lending staff also cited referrals to technical assistance providers and alternative sources of credit. In some cases, bank staff sit on loan committees for public and non-profit lenders. These interactions persist through positive and mutual personal connections between staff across institutions. For instance, MCBC's Economic Development Committee meetings typify and reinforce such connections.

Non-profit and public programs collaborate minimally with staff at bank branches for referral or marketing. Unlike specialized staff, *branch* level staff generally refer customers to internal sources of assistance or to none at all.[34] Furthermore, business owners applying for the smallest loans often don't receive internal referrals. Some referral does happen through the denial letter.[35] In other cases, branch staff are not

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[32] Pierre Fils-Aime, March 2, 2004.

[33] See Seidman (2003).

[34] For instance, Fleet branch staff may refer applicants to the Upham's Corner loan office of Fleet's first community bank.

[35] For example, Citizens' Bank refers clients to Accion in its denial letter.

attuned to very small businesses and to supportive programs, due in part to scarcity of specialized staff. The lack of familiarity was occasionally striking. For example, an assistant branch manager was asked to suggest sources of help for loan applicants needing to produce additional information such as income statements or financial projections. The manager's response was that it was "just something that [business owners] need to do."

Few non-profit or public program staff indicated that they work closely with bank branch staff. City-wide programs, such as the SBDC or Accion, have logistical barriers to working with individual branches. Staff at locally-based programs tend to do intensive outreach to area businesses through mailings and in-person visits. Little public or non-profit program literature was found at bank branches.[36]

Discrimination

This discussion attempts to deal squarely with owners' perceptions of discrimination encountered during research. The effects of *historical* discrimination on the prospects of present businesses is a more complex issue that is beyond the scope of this report.[37]

This research has not found direct evidence substantiating (or disproving) discrimination against minority-owned firms by financial institutions. While this research was not designed to compile statistical evidence on discrimination, circumstantial evidence might have been generated if minority owners consistently reported unfair treatment while white owners reported none. Instead, both white and minority owners reported difficulty accessing credit. Owners variously blamed banks or cited business difficulties.

[36] An exception was the small business lending office in Fleet's Upham's Corner branch. This literature was available as a result of bank staff initiative, rather than non-profit outreach.

[37] See Appendix A for a discussion of academic debates on discrimination in small business lending.

FINDINGS: LENDING PROCESSES

Self-reported business liabilities cut across racial and ethnic categories:

- A Hispanic owner operating a repair business desires credit to cover a slowdown in business, yet his rent is two months in arrears and he has no collateral.
- A white owner of an auto-related business would like to upgrade its physical appearance, but his cash flow is marginal and the property cannot be used as collateral unless an environmental assessment is performed.
- An African American owner of a restaurant needs more credit to replace stoves. However, the business has borrowed to the maximum on its line of credit, and the business needs to deal with "money management issues" resulting from a current business slowdown.
- A white owner of a home improvement supply store was rejected for refinancing an existing line of credit and commercial mortgage due to insufficient cash flow. Despite similar cash flows for three years, he has never missed a payment on either loan.

The bank branches examined for this study maintained ethnically and racially diverse staff. Furthermore, applications are seldom processed at the branch in which they are received. The applications, which contain no racial or ethnic information, are sent to remote processing centers for approval or denial. Finally, under CRA regulations, lenders have considerable incentive to process loans in LMI and minority neighborhoods. The combination of these factors makes it seem unlikely that intentional discrimination is occurring for small loan size applications at the branch level.[38]

Small business owners are exacting and unforgiving customers. Bank handling of loan applications has consequences for small business owners' perceptions. Quite a few owners had strong opinions about particular banks. These opinions were not consistent; for every supporter of a particular bank, a detractor could also be found.

[38] The foregoing discussion does not rule out unintentional discrimination for larger loan sizes that are managed with greater discretion by lending staff. However, this study is inconclusive on that topic.

Furthermore, a single incident or recommendation from a peer was enough to resolve a business owner to avoid an individual bank.

When such incidents were related by minority owners, they were sometimes cast in terms of discrimination. The three incidents listed below appear unrelated to the creditworthiness of the individual businesses. In each case, the response of the owner was to *disengage from any business relationship with the particular bank.* These incidents underscore the risk that mistakes in operations will be perceived as discrimination or as a lack of concern for small businesses.

- A white owner of a physical therapy business was rejected for a line of credit from a major bank. Upon further inquiry, she was told that not all of her paperwork had been sent for approval. She subsequently obtained the line of credit from a local bank in Quincy.
- A Cape Verdean owner of a barber shop was approved for a small loan for storefront renovation. The loan was never disbursed, yet he received repayment notices from the lender. The repayments were cleared, but the owner has neither received the loan nor attempted to reapply .
- With several partners, the African-American owner of an upholstery business was initially approved for a commercial mortgage over ten years ago. Several neighborhood events prompted the lender to deny the loan.

Finally, public and non-profit programs were not exempt from assertions about discrimination. One owner suggested that he was directed to programs that he did not need before he could obtain financing. He believed this to be racially motivated. In addition, diversity of staff affects perceptions of discrimination. Most bank branch staff encountered were people of color, yet many public and non-profit staff were white.

FINDINGS: LENDING PROCESSES

Implications of Credit Market Processes and Owner Perceptions

The difficulties noted above are persistent and great strides have been made in Boston. However, improvement can still be made. The foregoing discussion suggests that small business owners have unrealistic expectations about lending processes and insufficient information about supportive programs. While specialized bank staff recognize community needs, branch level processes do not meet the needs of the smallest neighborhood businesses. Furthermore, branches generally do not direct clients towards outside sources of support even though such referrals could improve owners' perceptions of banks.

Improved collaboration between bank branches and public and non-profit programs could offer better public relations and future customers to banks, while affording better visibility to alternative programs.

FINDINGS: COMMERCIAL REAL ESTATE NEEDS

Community Economic Development

Community Economic Development encompasses broad goals that cannot be addressed by private market mechanisms alone. Many such issues are beyond the scope of this report. This section examines one key issue that is germane to the intersection between community reinvestment and banking practice, namely escalating commercial rents.

Many Boston businesses face a double irony. After establishing a foothold in a historically difficult business environment, these businesses may be driven out by rising rents just when neighborhood markets are on the upswing. This issue is larger than any specific institutional actor and will require dialog between financial institutions, communities and non-profit and public programs.

Open-ended questions were used as part of the interview process with small business owners in order to understand critical needs from the owners' perspectives. The two most prevalent issues that emerged were general *downturns in business activity* and *rising commercial rents*. This section focuses on commercial real estate needs as an issue that can benefit from collaborative focus from the public and private sectors.

Rising commercial rents

Most business owners complained of escalating commercial rents. Nearly all tenant businesses complained that rising rents hindered their profitability. Several businesses had moved recently to find cheaper rent. A few business owners noted that if they had purchased their building a few years ago, they would be paying less for a mortgage than they currently pay for rent.

These comments are not surprising given the explosion in commercial rents and sales prices in Boston neighborhoods. Too often, rent separates a viable business from a failing one. Table 2 shows retail and office lease rates for selected Boston Mainstreets Districts.

Table 2. Increases in Lease Rates in Selected Boston MainStreets Districts ($/sq. ft.)			
MainStreets District	**Retail (2000)**	**Retail (2003)**	**Office (2003)**
Bowdoin/Geneva	$7 to $12	$11 to $14	$11 to $14
Dudley Square	$15 to $25	$17 to $27	$15 to $31
Fields Corner	-	$14 to $18	$12 to $14
Four Corners	$5 to $15	$12 to $25	$11 to $20
Grove Hall	$9 to $16	$15 to $25	$22
St. Mark's	$12 to $17	$12 to $15	$14 to $16
Upham's Corner	$8 to $15	$15 to $19	$5 to $15

Source: Boston Department of Neighborhood Development

Commercial building ownership affords flexibility for business owners. Business owners who owned their commercial building articulated a greater ability to weather business slowdowns. One owner's sales had dipped severely, prompting him to put the business on a four-day work week. Another needed to find an extra commercial tenant in order to boost cash flow. The owner was consolidating his use of building space to accommodate another tenant.

Rent levels also affect the ability of businesses to support other borrowing. Table 3 shows the differing borrowing preferences reported for owners vs. non-owners of commercial buildings.

Table 3. Differences in Financing Needs Reported by Owners and Non-Owners of Commercial Buildings

Among the 12 businesses that owned their buildings:	**Among the 33 businesses that did not own their buildings:**
▪ 7 stated that they had no business needs for credit ▪ 3 would borrow to expand their business ▪ 1 would borrow to improve the appearance of the business ▪ 1 would attempt to pay off liens and retire	▪ 9 businesses (mostly professional services) stated that they had no needs ▪ 5 businesses expressed critical operational needs, including seasonal inventory, primary equipment and outstanding bills ▪ 6 expressed ongoing financing needs ▪ 1 would expand

FINDINGS: COMMERCIAL REAL ESTATE NEEDS

With commercial building prices skyrocketing, building ownership is out of reach of many owners. In hot real estate areas such as Dudley Square, median commercial building sales prices have doubled in five or fewer years, rising from approximately $200,000 to $400,000.[39]

Building ownership is not the only means by which owners can safeguard against skyrocketing rents. One auto repair owner noted that the City of Boston owns his building. Another retail business owner has a decision-making role in the property management company that operates his building.

Zip-Code level differences in Commercial Building Ownership

Rising rents impact all tenant business. At the same time, the overall level of commercial building ownership by local businesses affects the stability of the district as a whole. Commercial building ownership also has profound implications for the wealth-building potential of small businesses and their ability to generate cash flow. This study sampled commercial building ownership.[40] Three zip codes were examined, South Boston (02127), Grove Hall (02121) and Roxbury (02119).[41]

Grove Hall and Roxbury showed lower rates of commercial building ownership than South Boston. In all three of the zip codes examined, most non-home based business owners rent their commercial space. However, the proportion varies by zip code.[42]

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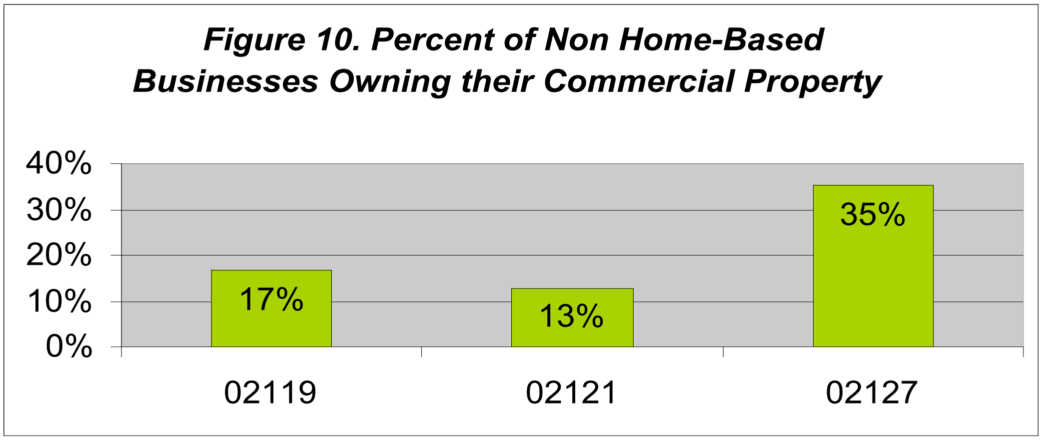
[39] Boston Department of Neighborhood Development, *Commercial Trends.*

[40] Businesses were sampled using every third entry in the City Clerk's listing of business certificates. These listings were cross-checked with City Assessor data to determine building ownership. See Appendix E for a more detailed methodology.

[41] A study of more zip codes was logistically unfeasible for this report.

[42] Difference between Roxbury and South Boston and between Grove Hall and South Boston were statistically significant.



Source: Boston City Clerk and Boston Assessing Department

The implication of the foregoing comparison is that business owners are more vulnerable in some geographic areas an. Further study could illuminate patterns across a greater number of zip codes as well as a finer-grained geographical analysis.[43]

[43] Geo-coding the building ownership data through the use of a Geographic Information System (GIS) would enable finer attention to business districts with low rates of commercial ownership.

RECOMMENDATIONS

Overview of Recommendations

The findings above suggest two main directions for community advocates and lenders to better address the needs of Boston's small businesses. First, collaboration of non-profit and public programs with bank branches needs improvement. Second, escalating commercial rents are a high priority item, and some business districts merit particular attention.

This report offers two recommendations to improve referrals in neighborhood small business credit markets:

- ***Direct small business owners to assistance through denial letters.***
- ***Market alternative programs at bank branches.***

The report also offers two possible action steps regarding commercial rents that merit discussion between lenders and community organizations:

- ***Target "affordable commercial mortgages" to stable local businesses.***
- ***Offer "affordable commercial rents" as part of commercial revitalization.***

These recommendations are not simply action steps that can be implemented by MCBC or any single organization. Rather, they are intended as conversation starters. Addressing the two issues highlighted here will require dialog, joint learning and shared commitment between organizations and sectors. To help move that dialog, this section also addresses the resources and constraints of the institutional actors involved.

Forums such as that provided by the Massachusetts Community & Banking Council are indispensable for forming the relationships and understanding required to make headway on these difficult issues. *Perhaps the most important general recommendation that this report can make is for area banks and community development advocates to make greater use of opportunities to dialog and collaborate.*

Credit Markets: Referral and Marketing

The recommendations concerning lending processes address two problems. First, a rich network of lenders and technical assistance providers serves Boston neighborhoods, but *referral pathways are not adequate* to direct small business owners to assistance. Second, business owners who lack information often develop negative perceptions about lenders and public programs. These perceptions result in a *reputational risk for individual institutions and programs*.

Constraints of Participants in Credit Markets

As noted above, small business owners:

- Have limited familiarity with public and non-profit lending and technical assistance programs,
- Are likely to approach a bank if they encounter financial constraints,
- Expect to obtain credit if they have not had experiences with bank financing,
- Are unprepared for loan denials, and
- Usually do not receive information about alternative programs from bank branches upon application or denial of small-size business loans.

Some of these business owners would benefit from alternative lending programs such as Accion or the Boston Local Development Corporation (BLDC). Other owners could be equally or better served through technical assistance.

At the same time, wholesale referral of all bank denials to public and non-profit providers would swamp the capacity of these programs. The specific mechanisms of referral must fit within the constraints faced by bank branches and alternative programs.

As noted in the findings section, bank branches:

- Are prohibited by law from dissuading anyone from applying for credit,
- Have incentives to meet per-period loan goals,
- Compete with other banks on the basis of credit availability and customer service, and
- Have limited numbers of specialized small business lending staff.

RECOMMENDATIONS

Constraints faced by public and non-profit technical assistance providers and lenders include:

- Limited resources and staff capacity,
- Limited ability to do outreach to neighborhoods city-wide,
- Mandates to assist all clients who approach (especially public programs).

Specific Strategies for Referral and Marketing

Several strategies for referrals fit within these financial and legal constraints:

Direct small business owners to assistance through denial letters. Banks are required by law to mail denial letters for rejected applications of less than $100,000. The letter provides a contact opportunity that can be used for referral and to demonstrate the bank's commitment. *A few examples of this referral mechanism already exist.* Citizen's Bank's denial letter refers small business owners to Accion.

Three caveats need to be stressed:

- First, small business owners can benefit from training and technical assistance in addition to alternative financing. Denial letter referrals can best help small businesses by referencing both types of assistance.
- Second, small business owners receiving a denial letter may not absorb all of the information. Referrals could be made towards the beginning of the letter or included as an additional flyer.
- Third, individual public and non-profit programs cannot handle the numbers of clients seen by local banks. Referrals could direct business owners to a coordinated information resource, such as the guides available on the website of the Office of Business Development.

Market alternative programs at bank branches. Both printed materials and personal recommendations from bank staff can serve as unobtrusive means to better inform consumers. Business owners have a variety of needs when they approach banks.

Making brochures for public and non-profit programs available at bank branches would direct businesses to needed support and could improve perceptions of customer service.

Four points should be stressed about marketing alternative programs:

- First, marketing must fit within bank objectives of improving customers' perceptions and attracting business. Marketing materials emphasizing alternative programs as complements or precursors to bank financing may prove more adaptable to the bank branch setting.
- Second, the onus for developing marketing materials lies on public and non-profit programs. Materials need to distill the array of programs into specific options for business owners. Also, banks cannot be expected to display extensive materials for multiple programs.
- Third, key bank branch staff need basic familiarity with programs available in order to provide relevant referrals. Small business customers can ignore brochures. Personal suggestions from bank staff can forge the link between alternative programs and future financing at that bank.
- Fourth, assisting small businesses through referrals requires *relationships* between bank branch staff and alternative providers. Devoting some effort to relationships can provide important returns for public and non-profit programs as well as bank branches.

Community Economic Development: Commercial Property

Commercial rents and building ownership is a more complex topic than lending processes. The focus here is not on detailed technical solutions. Rather, this section highlights the issue and suggest a few directions. The fundamental community economic development concern posed here is the risk that neighborhood businesses will be displaced by rising rents at a time when much-needed investment is improving local market conditions.

Other strategies to assist small businesses are important, such as adjusting to changing clientele and reaching broader geographic markets. However, many such strategies are beyond the scope of bank-community relationships. For that reason, the recommendations below emphasize commercial real estate as a topic that can benefit from dialog between lenders and community development groups.

Resources of Institutional Actors

As noted in the findings section, commercial rent is a critical issue for Boston's small businesses:

- Commercial rents have risen sharply in nearly all business districts
- Commercial sales prices have doubled in a few years
- Small business owners who own their building or have alternative means to control their rent are better able to weather business slowdowns
- Some areas of Boston show particularly low levels of commercial building ownership among local businesses

Lenders, non-profit developers and various agencies of the City of Boston have roles to play in addressing these issues. Lenders are equipped with:

- Specialized staff in commercial real estate lending
- The ability to work statistically with risk
- Knowledge of costs associated with default
- Geographic reach across neighborhoods

Non-profit developers and economic development staff can contribute:

- Knowledge of local business communities and local real estate
- Ability to tap public subsidies
- Knowledge of non-financial indicators and program supports that complement financial products

Specific Suggestions to Address Commercial Rents

Target "affordable commercial mortgages" to stable local businesses. Most Boston area community development corporations actively work on commercial real estate development. However, non-profit (and private) developers attempting to attract business activity with limited subsidy sources often develop commercial property in a way that *increases rents* for existing businesses. Furthermore, neighborhood commercial real estate development rarely results in increased *ownership* opportunities for businesses.

Both the Massachusetts Housing Investment Corporation (MHIC) and Nuestra Comunidad Development Corporation (Nuestra) currently offer an affordable commercial mortgage through the use of New Markets Tax Credits (NMTC). These mortgages are available to commercial tenants seeking to buy the building in which their business operates. Furthermore, these programs geographically target underinvested areas. For instance, MHIC has committed 60 percent of its investments to areas with a 30 percent or greater poverty rate.[44] These innovative uses of the NMTC subsidy has the potential to assist business owners to make purchases that would not otherwise be possible.

Three points can plant further seeds for dialog:

- First, commercial development of neighborhood business districts does not necessarily equate to better opportunities for *existing* businesses. Affordable commercial mortgages could target wealth building opportunities to specific, established local businesses.
- Second, commercial mortgages place considerable risk on lenders, since property management no longer mitigates risks of business failure and turnover. Accordingly, affordable commercial mortgage products need to address the back-end risks and costs of default.
- Third, subsidy sources for commercial mortgages are scarce. Meeting the needs in disadvantaged business districts will require creative debt and equity from public or owner sources.

[44] Based on draft: Massachusetts Housing Investment Corporation: *New Markets Tax Credits Investment Plan*, November 2003.

Offer "affordable commercial rents" as part of commercial revitalization. Commercial building ownership will serve only a fraction of existing businesses. Boston's neighborhoods need affordable commercial spaces in order to sustain existing businesses. At the same time, monitoring income-limits for occupancy poses considerable challenges. Furthermore, rents charged to businesses by non-profit (or public) property owners are constrained by past acquisition and development costs. Where these have been low, for instance in the brewery complex owned by the Jamaica Plain Neighborhood Development Corporation (JPNDC), low rents can be maintained for business tenants. Developing new affordable commercial property in Boston's high cost development environment will require considerable ingenuity.

Two additional points should be recognized with regards to affordable commercial rental properties:

- First, reporting requirements for tenants built into affordable leases could help to address well-known informational and regulatory problems such as poor business accounting systems and underreporting of sales for tax purposes.
- Second, business income limits would need to address variable income and to avoid contrary incentives, perhaps through sliding scales. It makes little sense to penalize or evict businesses for thriving.

Conclusion

This report is only as good as the dialog and collaboration that it stimulates. The issues profiled herein are difficult issues that fall outside the domain of any single organization. Thus, the adoption of new operating procedures by individual organizations is a necessary but insufficient step towards assisting small businesses with these needs. Instead, improving credit markets and finding solutions to escalating rents will require negotiation between institutions in order to create action steps that match the resources and constraints of all parties.

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Lenses

Researchers, lenders, community advocates and small businesses interpret low lending levels to LMI and minority communities through differing lenses. Thus, these stakeholders may discuss the same phenomenon but perceive differing underlying causes and solutions. This appendix highlights three lenses – credit market improvement, discrimination and community economic development – that have framed public debate on lending issues in low-income and minority communities.

Credit Market Improvement

One policy and research direction in small business lending has addressed non-optimal lending levels. Small business credit markets have been shown to suffer from at least two flaws: asymmetric information between parties to the lending contract and differences in culture between small business owners and lenders.

Theories of Asymmetric Information in Credit Markets

One economic theory of private credit markets assumes that lenders receive limited information about potential borrowers. Perfect information is either impossible to obtain or too costly. As a result, lenders ration credit to businesses when information is hardest to obtain (Stiglitz and Weiss 1981, 1983).

An alternate theory posits that small business owners are overly optimistic about their business prospects and consequently their credit worthiness. Thus, small business owners expect more credit to be disbursed than the strength of their business merits (Meza and Southey 1996).

In practice, both of these mechanisms are at work. Lenders currently proxy for credit-worthiness through the use of scoring or other means. This necessarily screens out some viable businesses. At the same time, business owners may believe that they will repay loans even when their optimism is not fully warranted.

In addition to problems of information, researchers have ascribed non-optimal levels of borrowing to the differing attitudes towards business ownership, borrowing and risk across gender and ethnicity.

- Often, small business owners do not want to expand beyond a manageable scale. Growth potential is superceded by non-economic considerations, such as flexible scheduling, supervisory requirements and proximity to home.[1]

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[1] Servon (1999) suggests that the owner's preference for the size of the business is the most important

- Female-, Hispanic- and Black-owners use less debt than male- and non-Hispanic-owners with similar businesses.[2]

- Individuals in various gender and racial/ethnic categories have varying attitudes towards risk (Table 1).

Table 4. Differences in Entrepreneurial Disposition (percent) [3]

	All	Hispanic	Black	White	Asian	Other
Willing to risk all on business	56.6	60.5	49.4	69.3	37.9	69.6

Source: Huck et. al. *(2001).*

Historically, lenders have used relationships to improve their information about business borrowers. As a result, businesses that have standing relationships with lenders are more likely to gain access to credit, though not necessarily lower interest rates.[4]

Increasingly, lenders use credit scoring to proxy for the risk of default, especially for small loans.[5] According to credit market theories, credit scoring should decrease the costs of information thereby decreasing credit rationing. Credit scoring is *certainly* more preferable than ethnic or geographic proxies for risk that were once used, but it probably screens out some viable businesses.

Discrimination

A second thrust of debate has aimed to prove or disprove discrimination. Some researchers have charged financial institutions (in the aggregate) with racial discrimination on the basis of national-level data sets.[6] Findings reported include:

- Black-owned firms (but not Hispanic- or Asian- owned firms) are rejected for

factor in whether the owner seeks credit.

[2] Bitler, Robb and Wolken (2001); Cole and Wolken (1995).

[3] Huck *et. al.* (2001) posed the question, “How willing would you be to risk your house and all of your possessions in borrowing money to start a new business?”

[4] Petersen and Rajan (1994).

[5] Lou Corapi, March 5, 2004; Emma Montague, March 25, 2004.

[6] National data sets include Small Business Lending Data reported since 1996 under the Community Reinvestment Act (CRA), the 1992 Characteristics of Business Owners (CBO) Survey, the 1997 and 1992 Surveys of Minority-Owned Business Enterprises (SMOBE) and the 1998, 1993 and 1987 (National) Surveys of Small Business Finance (NSSBF / SSBF).

loans at higher rates than comparable firms owned by white males.[7]

- Black-owned firms are charged higher interest rates compared to similar white-owned firms.[8]
- White-owned start-ups begin with more equity than minority-owned start-ups. In addition, white-owned start-ups leverage more debt per dollar of equity than black-owned start-ups.[9]
- Minority census tracts have lower small business lending rates than majority white tracts with similar industry and income characteristics.[10]

Other researchers have contested these findings on the basis that the national data sets leave out too many variables.[11] Finally, even researchers who find discrimination admit that disparities in human and financial capital (partly due to historical discrimination) are more severe than differential practices by lenders.[12]

Community Economic Development

A third thrust of research on small businesses has sought to explain the benefits of neighborhood business districts and to identify critical needs unmet by credit markets.

A variety of benefits of strong business districts have been articulated:

- Business owners are stakeholders who can advocate for the interests of neighborhoods. Also, small businesses are more likely than large firms to be owned or managed by nearby residents.[13]
- Retail and service districts can increase pedestrian traffic, resulting in safer public spaces.[14]
- Job creation in neighborhoods may promote labor force attachment and

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[7] Blanchflower, Levine and Zimmerman (1998); Cavalluzzo, Cavalluzzo and Wolken (1999). Studies controlled for firm and owner characteristics, including credit scores.

[8] *ibid.* The Blanchflower study found higher rates charged to minorities, while the Cavalluzzo study found that rates were explained by non-racial/ethnic factors.

[9] Bates (1997). Based on 1992 CBO Survey.

[10] Immergluck (2002). Based on CRA, D&B and Census data. This Philadelphia study controlled for industry mix, firm size and density, neighborhood income and average business credit score by tract.

[11] Comments attributed to Glenn Canner and Anthony Yezer in Lang (1999).

[12] Bates (1997).

[13] Gittell and Thompson (1999).

[14] Wheeler (2002); Jacobs (1969).

transition to work among previously unemployed individuals.[15]

Characterizations of inner-city businesses differ. Some accounts emphasize the inner-city businesses as engines of growth:

- Porter and others have argued that inner-cities have vast untapped potential in the form of distinct competitive advantages. Growth is hampered by over-regulation and anti-business attitudes.[16]
- The U.S. Small Business Administration (SBA) champions small business as the engine of the U.S. economy. Small businesses produce three quarters of all new jobs, employ half the private sector labor force and produce many more patents per employee than large firms.[17]

Other researchers emphasize a distinction between growth-focused firms and other small businesses that provide a family income:

- Most of the job growth associated with small businesses can be traced to a few "gazelles," or rapidly growing firms. Other small businesses are managed for stable income generation, rather than for growth.[18]
- Small business owners can be divided conceptually into two categories: those who choose small business ownership as a "luxury" over higher-return prospects and those for whom ownership is a best option strategy.[19]

Implications

This discussion has been presented to provide some common language for dialog between various institutions and small businesses. By agreeing on interpretation of the problem of low lending levels, diverse organizations can work towards collaborative solutions.

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[15]Gittell and Thompson (1999).

[16] Porter (1995).

[17]U.S. Small Business Administration, Office of Advocacy, http://www.sba.gov/advo/stats/sbfaq.pdf.

[18]For example, Carland *et. al.* (1984) proposes a conceptual distinction between entrepreneurs and small business owners.

[19]Servon (1999), pp. 48-49, 79.

Survey Questions

Both open-ended and informational questions were asked of small business owners.

Contact Information

1. Name and Address of Business
2. Name(s) of Owner(s)

Questions About Business

1. OPEN QUESTION: How is your business going? What is your chief complaint?
2. Type of Business
3. Number employees (excluding owner)
4. Years in operation
5. Years under current owner
6. Does the business own the building?
7. Approximate revenue of business: < $1M > $1M

Questions About Ownership

1. OPEN QUESTION: How did you get into this business?
2. Number of owners
3. Race/ethnicity of owners
4. Sex of owners
5. Does owner live in same zip code as business?
6. Is the business owner a homeowner?
7. Does the business owner have any history of bills to collection? Bankruptcy?*

Questions About Financing

OPEN QUESTION: What has been your experience financing your business?

1. Are you interested in borrowing for the business? Why or why not?
2. Does the business currently have loans outstanding?
3. Have you (the owner) used any of the following types of credit for the business in the last 2-3 years?*
    - Term loan
    - Small Business line of credit
    - Credit card
    - Home equity loan/line of credit
    - Loan/equity from personal finances
    - Loan/equity from friends/family
    - Trade credit from suppliers
    - Other
4. Has the business been rejected for a loan in the past 2 years? Ever?
5. If you (the owner) had a windfall (perhaps $20,000), what would you use it for?

Questions About Business Services

OPEN QUESTION: If you (the owner) needed help with some part of your business, who would you approach?

1. Are you familiar with any programs that could help you?

* Indicates question that was not answered reliably.

Surveyed Census Tracts

Several census tracts were chosen for neighborhood level study based on lending rates relative to neighboring tracts, demographic characteristics and particular interest of MCBC Economic Development Committee members.

Table 5. Census Tracts Chosen for Interviews or Observation

Tract[20]	Neighborhood	Average MFI as % of average for MSA[21]	Percent Non-white Non-Hispanic[22]	Number Businesses Sampled	Relative Lending Rates
607	South Boston	31%	13%	0[23]	Lending comparable to Dudley/Codman
608	South Boston	55%	2%	2	Very high relative to neighboring tract (607)
801	Newmarket (Roxbury)	35%	72%	0[24]	Consistently high relative to adjacent Dudley tract (803)
803	Dudley Sq. (Roxbury)	38%	99%	8	Low / inconsistent lending
804	Dudley Sq. (Roxbury)	19%	96%	11	Lending comparable to 803 despite lower MFI
920	Bowdoin-Geneva (Dorchester)	58%	86%	8	Higher lending rates than tracts 922, 923
922	Codman Sq. (Dorchester)	97%	53%	6	Lower lending rates than 920 despite higher MFI
923	Codman Sq. (Dorchester)	71%	96%	10	Lower lending rates than 920 despite higher MFI

[20] 1990 Census Tract.

[21] Based on 2002 Estimated Census Tract Median Family Income (MFI) as a percentage of 2002 Metropolitan Statistical Area (MSA) Median Family Income (MFI). Both figures are available at http://www.ffiec.gov/webcensus/ffieccensus.htm.

[22] Based on 1990 census tracts and data. Reflects total tract population minus white non-Hispanic population.

[23] Tract 607 was observed only.

[24] Newmarket was observed only.

Owner and Business Characteristics

A breakdown of business owner characteristics is shown below. Table 2 shows race and Hispanic origin of business owners by census tract.

Race / Ethnicity

6 owners interviewed identified as having Hispanic origin
15 owners identified as African-American
6 owners identified as Asian
13 owners identified as Caucasian
1 owner did not identify race or ethnicity

Gender

6 businesses were owned by females
31 businesses were owned by males
14 businesses had both a male and female owner

Gross Revenue

37 businesses grossed less than $1 million in annual revenue
3 businesses grossed more than $1 million in annual revenue
6 businesses did not report their gross annual revenue

Employees[25]

6 businesses employed only the owner(s)
25 businesses employed between one and four employees
7 businesses employed between five and nine employees
1 business employed between ten and twenty employees
6 businesses did not report their number of employees

Types of Businesses

18 businesses were engaged in retail sales
5 businesses were restaurant establishments
14 businesses provided repair and personal services (excluding auto and medical/legal)
4 businesses provided auto repair
3 businesses provided medical or legal services
1 business engaged in commercial construction

[25] Full or part time. Initially, the survey attempted to distinguish between full- and part- time employees, but owners responses were often qualified or unreliable.

APPENDIX C: SURVEYED TRACTS AND OWNERS

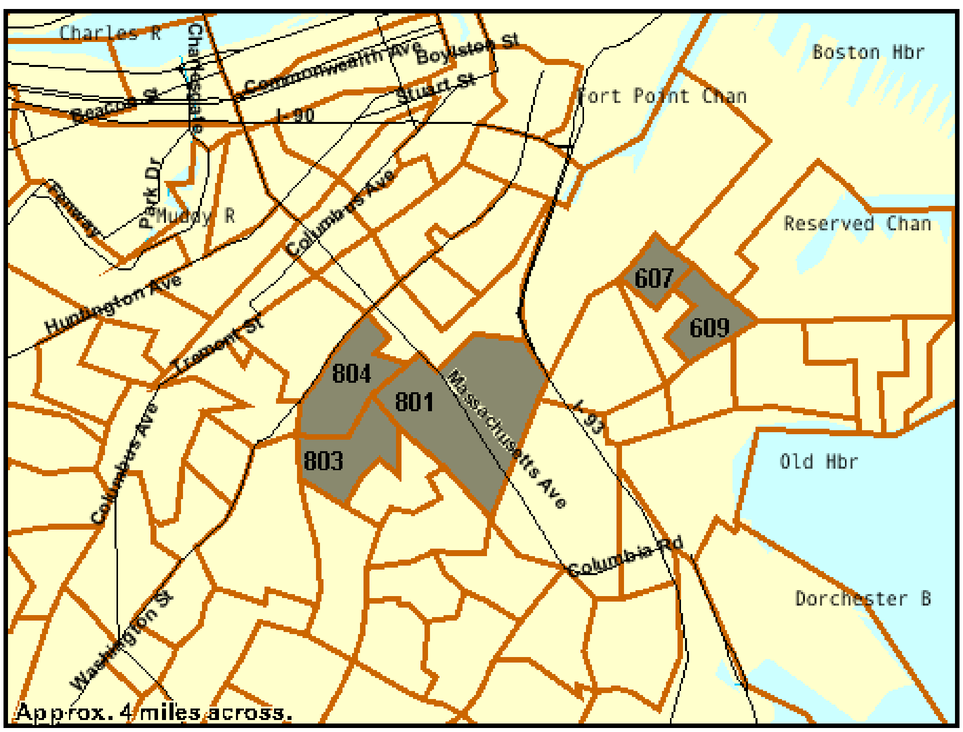
Table 6. Number of Businesses Surveyed by Census Tract and Race/Ethnicity of Owner.

Census Tract	Businesses Surveyed	Minority or Hispanic Owners	Caucasian non-Hispanic Owners	Neighborhood
608	2	0	2	West Broadway (South Boston)
803	8	6	2	Dudley Square (Roxbury)
804	11	7	3	Dudley Square (Roxbury)
920	8	8	0	Bowdoin-Geneva / Field's Corner (Dorchester)
922	6	3	3	Codman Square (Dorchester)
923	10	7	3	Codman Square (Dorchester)
Total	45	31	13	

Location

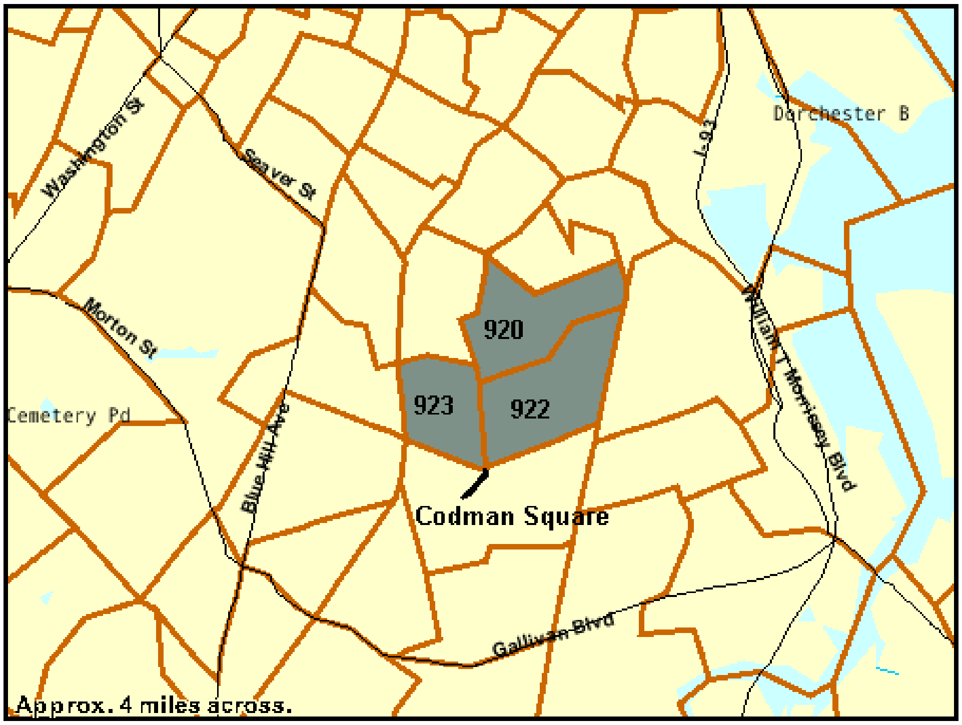
Locations and boundaries of the tracts are shown below:

Figure 11. Location of Roxbury and South Boston Census Tracts



APPENDIX C: SURVEYED TRACTS AND OWNERS

Figure 12. Location of Dorchester Census Tracts



Expert Interviews

The following individuals were interviewed between October 10, 2003 and March 25, 2004.

Lou Corapi (10/10/03; 3/5/04)
Director, Upham's Corner Loan Center
Fleet Bank

Erika Eurkis (1/8/04)
Program Director, Boston Office
Accion U.S.A.

Pierre Fils-Aime (3/2/04)
Small Business Counselor
Codman Square Neighborhood Development Corporation

Mike Grace (11/14/03)
Assistant Deputy Director, Boston Business Assistance Center
Boston Office of Business Development

DeAnna Green (10/16/03)
Director, Small Business Programs
Massachusetts Association of CDC's

Jessica Gustin (11/13/03)
Program Director
This Neighborhood Means Business

Emily Haber (10/17/03)
Program Director, Boston MainStreets
Boston Office of Business Development

Keith Hunt (10/17/03)
Assistant Director
Boston Office of Business Development

Kathy Kottaridis (3/01/04)
Director, Office of Small Business and Entrepreneurship
Massachusetts Department of Business and Technology

Deidre Macleod (12/17/03)
Small Business Technical Assistant
Dorchester Bay EDC

Emma Montague (3/25/04)
Citizen's Bank

Esther Schlorholtz (11/5/03)
Senior Vice President and Community Reinvestment Act Officer
Boston Private Bank & Trust Company

Karl Seidman (11/3/03)
Professor
Massachusetts Institute of Technology

Margaret Somer (1/30/04)
Director, Small Business Development Center
University of Massachusetts, Boston

Kevin Winn (2/25/04)
Director, Lending and Technical Assistance
Nuestra Comunidad Neighborhood Development Corporation

Tom Young (11/5/03)
Senior Vice President, Small Business Lending
Boston Private Bank & Trust Company

Use of Methods and Data

This appendix describes methodology and data used for business composition, lending levels, home-based businesses, residential location and commercial building ownership.

Methods

Zip Code Business Composition

Size, Mix and Density of Businesses in zip codes were calculated using 2001 County Business Patterns (CBP) and 2000 Census data. Eleven zip codes are profiled to present a manageable snapshot of Boston neighborhoods. These zip codes were chosen based on three criteria. First, downtown, South End and Fenway zip codes were not considered because they are less reflective of the types and densities of businesses in Boston neighborhoods. Second, zip codes were chosen to highlight the extremes of the data presented. Neighborhood zip codes that are not included (such as South Dorchester or Brighton) generally fall within the ranges of data presented. Finally, zip codes that contain geographically discrete neighborhoods (such as South Boston or Roslindale) were prioritized so that the depiction of business composition would make intuitive sense to readers familiar with Boston. The eleven zip codes are named using U.S. Postal Service designations:[26]

Roxbury	(02119)
Grove Hall	(02121)
Codman Square	(02124)
Mattapan	(02126)
South Boston	(02127)
Charlestown	(02129)
Jamaica Plain	(02130)
Roslindale	(02131)
West Roxbury	(02132)
Allston	(02134)
Hyde Park	(02136)

Aggregate Lending Levels

Numbers and dollar amounts of loans for figures 7 and 8 were calculated using 2002 D&B data for number of firms per (1990) census tract and CRA data on numbers and dollar amounts of loans. Lending levels were averaged over 1998-2000 and over 2001-

[26] Codman Square is the exception. The Postal Service designation for 02124 is Dorchester Center.

2002 in order to present rough lending trends without the large annual variation documented in *Patterns.* Census tracts were aggregated to approximate the eleven zip codes chosen (see above). Aggregated census tracts are as follows:

Roxbury:	802 – 804; 813 – 818
Grove Hall:	819 – 821; 901 – 903; 919
Codman Square:	920; 922 – 924; 1001; 1003 – 1006; 1008
Mattapan:	1002; 1009 – 1011.02
South Boston:	601 – 614
Charlestown:	401; 403 – 408
Jamaica Plain:	811 – 812; 1101; 1201 – 1207
Roslindale:	1102 – 1106.02
West Roxbury:	1301 – 1304.02
Allston:	7.01 – 8.02
Hyde Park:	1401.01 - 1404

Home-Based Businesses

The proportion of home-based businesses were calculated from a sample of every third entry in the Boston City Clerk's database of "Doing Business As" (DBA) certificates, excluding withdrawals, multiple entries for the same business and businesses organized for the purpose of renting residential real estate. These entries were cross-checked with Assessor data to determine business and residential addresses and ownership of buildings. Four basic data situations were encountered:

- *DBA entry lists separate business and residential addresses.* In this case, businesses were assumed to be non home-based. Assessor data was searched to determine building ownership.
- *DBA entry lists business address only and property is commercial/ industrial.* These businesses were assumed to be non home-based. Residential address of the business owner was sometimes unobtainable.
- *DBA entry lists business address only and property is residential.* These businesses were generally assumed to be home-based. Some exceptions were made when a separate address with a residential exemption was discovered for the owner.
- *DBA entry lists business address only and property is mixed use.* These businesses were determined to be home-based or not based on 1) the type of business, 2) whether the business owner also owned the building, 3) whether an alternate residential address could be located and 4) occasional cross-checks using online yellow pages. In the few cases that none of these methods yielded conclusive evidence, businesses were assumed to be home-based.

Residential Location and Commercial Building Ownership

Residential address is listed in DBA entries for business owners and Assessor entries for building owners. In some cases, the business owner was listed as an incorporated entity with no residence provided. In a few cases, a business was determined to be non home-based (see above), but no residential address was found. As a result, a portion of residential locations are reported as "not found."

Residential location is used in this report as a means to understand the extent of local ownership of small businesses. Therefore, when multiple owners were listed on the DBA entry, the residential location of the most proximate owner was recorded.

Commercial building ownership for non home-based businesses was determined by matching the last name of the business owner with the name of the building owner. Last name matches were interpreted as ownership of the building.

Sources of Error

Calculations of home-based business composition, residential location and building ownership are subject to three main sources of error.

- *Business owners can make entry errors.* In particular, owners may not list their home address. This error would tend to work in one direction; estimates of home-based and local businesses would be biased upwards.
- *Last name is an imperfect proxy for building ownership.* Some business owners who own their building may list another relative or incorporated entity as the building owner. This error would also tend to work in one direction; estimates of building ownership would be biased downwards when no last name match was found.
- *Sampling error.* These estimates are based on samples of one-third of the entries in each zip code. Significance was tested for differences in zip code proportions of home-based businesses, owners residing in the zip code and non home-based owners owning commercial property. Levels of significance are shown below.

Table 7. Statistical Significance of Zip Code Comparisons

Zip Code Comparison	Percent Home-Based	Percent Residing in Same Zip Code	Percent of Non Home-Based Owning Commercial
Roxbury – Grove Hall	0.05	0.01	*
Roxbury – S. Boston	*	*	0.01
Grove Hall – S. Boston	*	0.01	0.01

* No statistical significance.

APPENDIX E: METHODS AND DATA

Data

Business Certificate Data

The Boston City Clerk maintains a database of "Doing Business As" (DBA) certificates. All businesses other than corporations that do business in the City of Boston are required by law to register with the City Clerk and to renew every four years. Corporations file at the state level. Thus, the City Clerk's database includes many of Boston's small and local businesses. The database includes registrations, renewal registrations, changes of location and withdrawals.

The database contains self-reported information from business owners, including:

- Name of business
- Type of business (as entered by owner)
- Address of business
- Owner's name (or name of corporation and signatory)
- "Residence of owner or corporate address"

DBA Database Limitations

In the format available to the public, the DBA database cannot be searched to exclude multiple entries for a single business. The database can be searched by zip code, by owner's address or name and by type of entry or business. Type of business searches did not prove reliable, since owners can enter anything for business type or leave the entry blank. For instance, clothing retailers variously entered "clothing," "retail," menswear," "shoes" or "discount."

In addition, the business certificate form asks for both business address and "corporation or residence address." This wording probably contributes to some owners listing their business address instead of residential address.

Assessor Data

The Assessing Department of the City of Boston maintains a searchable web-based database of properties in the City. Entries contain the following information:

- Owner's name
- Owner's address
- Property Address

- Parcel Number
- Assessed Value
- Type of property (residential, commercial, etc.)
- Residential exemption

In addition, the Assessor website allows online mapping of parcels.

Assessor Data Limitations

While street addresses typically match database addresses for residential property, the same is not true for commercial and industrial buildings. This circumstance was mitigated by using the online mapping function and by searching for the owner's name by street, rather than by single address. Also, the owner's address was sometimes listed as the property address despite no residential exemption for the property. Staff in the Assessing Department suggested that the residential exemption should be trusted over the owner's listed address when the two conflict.