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An Alternative in Small Business Finance

Community-Based Factoring Companies and Small Business Lending

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The Jerome Levy Economics Institute is publishing this *Public Policy Brief*, without necessarily endorsing its proposals, to make a constructive contribution and advance the debate on this issue.

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Summary

At a time when small businesses are suffering from a credit crunch, "niche" financial institutions increasingly are filling the void left by more traditional sources of financing, such as commercial banks. The authors of this research—Dimitri B. Papadimitriou, Ronnie J. Phillips, and L. Randall Wray—argue that among the most important of these niche players are community-based factor companies, which are rapidly expanding beyond their traditional customer base in the apparel and textile industry to finance a broad range of firms in everything from electronics to health care.

Factors, which trace their roots back to the days of Hammurabi, four thousand years ago, when they made advances to manufacturers and merchants against goods, typically in the United States have been small, independent, and highly specialized firms focusing on providing credit and collection services to a select group of small businesses. However, during the last two decades the factoring industry has experienced widespread consolidation, diversification, and growth. Even as its traditional base of apparel and textile customers has lost ground to foreign competition, factoring volume, since the 1980s, has grown 8.6 percent annually to $50 billion in 1993. Growth has come from expanding into new markets such as health care, electronics, and foreign trade. At the same time the number of firms has shrunk as small factors have merged and in many cases been taken over by banks, which now control 94 percent of factoring in the United States. For example, the number of factors in New York City, the center of the apparel and textile trade, has plunged from 114 in 1935 to only 20 today.

For small businesses there are many advantages to doing business with a factor. The purchase of accounts receivables by factors enhances the balance sheets of their clients because it improves their debt-to-equity and debt-to-asset ratios. Thus, factors can make it easier for small businesses to obtain bank financing. Factors also are willing to take an equity interest in their clients. In addition, full-service factors provide a range of services from bookkeeping and billing to inventory controls and data processing that banks do not offer,

and availing themselves of these services allows small companies to focus on their core businesses.

Because small-scale factors are more "people intensive" and more involved with the day-to-day operations of their clients than banks, they are particularly well suited to monitor the financial condition of their clients and to take on new clients that banks might consider too risky. The credit department of a factor, for example, is in a good position to judge whether work-outs will be cheaper than calling in loans and forcing bankruptcies. And because factors are more interested in the creditworthiness of a client's customers than of the client itself, they often extend loans in excess of collateral to rapidly growing small businesses. Thus, in an extreme case, a factor might take on a start-up business with no equity, no assets, and no credit record; if the factor believes the start-up's customers are creditworthy and the start-up can deliver the goods or services ordered by its customers, then the factor will be willing to make advances to the start-up client once goods are delivered.

The growth of factoring is particularly important now because small businesses—an important engine of economic growth—appear to have less and less access to bank capital. One major reason for this diminished access to funds is that the ranks of the smallest banks (those with less than $25 million in assets), which traditionally have provided the most financing for small firms, are dwindling; the total volume of loans made by these smallest banks fell 37 percent between 1988 and 1993. At the same time the volume of loans by the largest banks (those with over $5 billion in assets), which typically do not lend to small firms, has grown 25 percent.

Because factors are becoming an increasingly important source of financing for small and start-up businesses, the authors of this Levy Institute *Public Policy Brief* propose that factors be encouraged to play a broader role in financing firms in distressed communities. In some cases community-based factors should be eligible for funding and assistance under the administration's new community development financial institutions legislation. In addition, investment by banks in these factors should count toward compliance with the proposed new regulations for the Community Reinvestment Act.

Contents

Preface 7
Dimitri B. Papadimitriou

Community-Based Factoring Compaines
and Small Business Lending................*9*
Dimitri B. Papadimitriou
Ronnie J. Phillips
L. Randall Wray

About the Authors 45

Preface

Among the important developments in the changing financial system is the increasing role of factoring companies as a source of financing for many new ventures and small firms. There is a growing body of empirical literature, as well as a wealth of anecdotal evidence, to support the claim of a "credit crunch" constraining small and midsize businesses. Although skeptics refute this notion by attributing the relatively low level of commercial bank lending to weak demand and slow economic growth, we have observed that in fact demand does exist and that demand has increasingly been met by "niche" factors, which substitute for commercial banks in specific sectors.

Factors, which in this country typically operated in the apparel and textile industry, have recently experienced tremendous growth as a result of diversification into fields as varied as electronics and health care. Firms and industries that are being denied access to the mainstream financial system have little choice but to

rely on unorthodox financing sources for investment and growth. Interestingly, the rapid growth of factoring companies has not gone unnoticed by commercial banks. Indeed, banks are actively involved in the acquisition of and mergers among these factors via the banks' holding companies, and they are now responsible for over 90 percent of the factoring being conducted in the United States.

Assuming that capital development of the economy and fostering a climate that encourages entrepreneurial activity are among the objectives of an efficient and sound financial system, the heightened role of factors and the implications therein about the financial system merit serious attention in the discourse on policy.

This research on factoring companies—in conjunction with the Institute's previous policy research on community development banks, the reform of the Community Reinvestment Act, and evidence of discrimination in access to and delivery of essential financial services—reflects a seriousness of purpose in contributing to the public discussion of our nation's most pressing economic issues.

Dimitri B. Papadimitriou
Executive Director

May 1994

Community-Based Factoring Companies and Small Business Lending

Robert M. Hutchens

I. Introduction

In the past two years bank profits have rebounded and bank net worth is now well in excess of regulatory minimums. However, there is widespread concern that the improvement of financial conditions in the commercial banking sector has not induced additional lending, particularly lending to small business. Although the depressed state of demand in the United States has until recently lowered the demand by small business for loans, trends in commercial banking make it unlikely that commercial banks will be willing and able to meet small business demand for loans even now that the economy is recovering.

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There is widespread recognition that our financial institutions are not providing an adequate level of services to certain identifiable segments of our communities, including low-income and minority households and businesses, especially in depressed neighborhoods. Recent detailed studies have demonstrated that such neighborhoods are systematically denied equal access to home mortgage loans (Munnell et al. 1992; Bradbury, Case, and Dunham 1989; Carr and Megbolugbe 1993). While similar data for commercial lending is not available, anecdotal evidence suggests that firms in these neighborhoods are also underserved. Jerry Jordan, president of the Federal Reserve Bank of Cleveland, recently noted:

> Improving access to credit by minority and low-income communities represents a serious challenge to lenders, community residents, and government officials. . . . The deplorable condition of a lot of our neighborhoods in major cities across this country is clear evidence that something is terribly wrong. The solution to this problem is economic development, an indispensable component of which is an effective banking system. (Jordan 1993 p. 1)

Governor Lawrence Lindsey of the Federal Reserve Board echoed Jordan by saying:

> no single consumer issue is of greater concern than ensuring that the credit-granting process in the institutions that we regulate is free of unfair bias. (Lindsey 1993, p. 10)

In two recent *Public Policy Briefs* published by The Jerome Levy Economics Institute, we proposed the creation of a system of community development banks (CDBs) to increase the provision of financial services to economically distressed communities (Minsky et al. 1993; Papadimitriou, Phillips, and Wray 1993). As part of that proposal, we advocated that the CDBs provide a range of services to small businesses in these communities to provide employment opportunities and to revitalize communities. We also called for strengthening the effect of the Community Reinvestment Act (CRA) by allowing investment by traditional financial institutions such as

commercial banks in community-based lenders such as CDBs to count toward fulfillment of CRA requirements.

Lending to small business can be strengthened even further by encouraging the development of "niche" financial institutions that would supplement the activity of CDBs and commercial banks. This *Public Policy Brief* focuses on the role that can be played by *community-based factor companies* (CBFs). Factors supply credit to firms by purchasing their accounts receivable; in addition, they provide a wide range of other financial services. It is our belief that factors can play an important role in increasing the supply of credit and other financial services to small businesses if they are made a part of a coherent strategy of community reinvestment. In particular, if the CRA is strengthened and if investment by commercial banks in community-based factors is counted toward CRA compliance, then the already significant role (at the small firm and community level) played by community-based factors in providing financial services to small business will be enhanced. In addition, the development of a nationwide system of CDBs should include a role for community-based factors. In some cases, community-based factors could be members of the CDB system; in other cases, some CDBs might include factoring as one of the services that is provided to the community.

The legislation offered by the administration to provide funding and technical assistance to community development financial institutions (CDFIs) has been approved by both the House and the Senate. This proposal will provide $382 million over four years to CDBs, community development credit unions, community development loan funds, microenterprise funds, and community development corporations. In addition, President Clinton has called for reform of the CRA. After a series of public hearings, the agencies in charge of regulating and supervising banks have proposed new CRA regulations. The most important of the proposed changes are the establishment of quantifiable service tests; the requirement to disclose more information on lending to small businesses, small farms, and consumers; and the encouragement of investment in CDFIs. We will argue that, in some cases, community-based factors should be eligible for funding and assistance under the president's plan and that investment by

banks in these factors should count toward fulfillment of the new CRA regulations.

II. Bank Concentration and Small Business Lending

Recent evidence reported by the Federal Reserve Bank of Dallas indicates that small business loans make up 15 percent of total loans at insured commercial banks and 44 percent of all business loans (Klemme 1993). However, the distribution of small business loans across commercial banks is skewed, with small banks the most active lenders to small business. The average asset size of active lenders to small business is only $100 million; in contrast, the average asset size of the least active lenders to small business is $1.2 billion. Furthermore, small banks tend to make smaller loans. The typical bank with assets less than $100 million makes loans of less than $100,000, while the typical bank with assets in excess of $1 billion focuses on loans of at least $1 million.

Small banks in the United States account for a meager portion of total lending. In 1987 less than 200 banks, representing the top 0.9 percent of U.S. commercial banks, held 59.3 percent of all bank assets (Boyd and Graham 1992). The top 10 banks in 1990 held 22 percent of all banking assets, and the top 25 held 38 percent. If a "small" bank is defined as one with $50 million in assets in 1984 and $66.3 million in 1992 (to account for inflation), then there were 9,217 small banks in 1984, accounting for 64 percent of all banks, but they held only 8.6 percent of all bank assets; in 1992 there were 6,692 small banks, 59 percent of the total, holding only 6.3 percent of total assets (Wheelock 1993).

Between 1986 and 1993 nearly 4,250 banks were closed; of these, 1,021 were closed because of insolvency, 2,043 were converted into branches of bank holding companies, and 1,175 were purchased by other banks (DeYoung and Whalen 1994). During the same period almost 1,100 new bank charters were issued, which compensated for those lost to insolvency. The net change in the number of banks over the period represented a large loss due to mergers. Even more impor-

tant than the loss in the *total* number of banks is the loss of independent (and primarily small) banks. More than 6,500 independent banks were lost between 1988 and 1993, many of which were acquired by bank holding companies. The asset share of independent banks fell from 22 percent in 1980 to 6 percent by 1993 (Nolle 1994). This is significant because small, local, independent banks can be an important source of credit to local business.

Table 1 provides the distribution, by size, of insured commercial banks in 1988 and 1993. The dramatic downward trend in banks in the smallest size category (less than $25 million) is evident from the nearly 50 percent drop in their number since 1988. At the same time the number of banks in the largest size category, over $5 billion, has grown by nearly 25 percent.

Table 1
Number of Banks by Asset Size, 1988 and 1993

	Number of Banks	
Asset Size	**December 1988**	**September 1993**
Less than $25 million	4,040	2,314
$25–100 million	6,135	5,544
$100–300 million	1,889	2,122
$300 million–$1 billion	557	631
$1–5 billion	262	251
Over $5 billion	99	115
Total	12,982	10,977

Source: Federal Financial Institutions Examination Council, Uniform Bank Performance Report, September 1993.

The data on numbers of small banks can be somewhat misleading for two reasons. First, loss of small banks is offset to some extent by rising numbers of bank branches; the total number of bank offices (banks plus branches) grew by over 20 percent during the period from 1980 to 1991 (Nolle 1994). Second, many of the losses are attributable to mergers so that loss of a bank does not necessarily mean loss of the bank *office*. However, it is our belief that the acquisition of small, independent banks by larger bank holding companies can, over time, lead to changes in operating procedures that can make it more difficult for small, local businesses to obtain loans (or, at least, to obtain loans on unchanging terms). Indeed, acquisition often occurs on the justification that the acquiring bank will "rationalize" operations and cut costs. Since it is often claimed that a small loan costs as much to administer as a large loan, attempts to cut operating costs can lead to a credit crunch for small firms.

The effect on lending by small banks can be seen in Table 2. Not surprisingly, the total volume of loans by banks with less than $25 million in assets fell 37 percent between 1988 and 1993. At the same time the volume of loans by banks with over $5 billion in assets grew by 18 percent. Admittedly, the data presented do not definitively prove that the number of small loans has declined (we have not been able to obtain data on the size of loans made across bank categories). However, because small banks tend to make small loans, and big banks tend to make big loans, the data do support the presumption that small business loans have decreased in number. To be sure, when a small bank merges into a larger one, the established small firm–small bank relationships are not necessarily destroyed, but the terms, including higher minimum balance requirements and increased fees, most likely will change, becoming more costly for the borrower.

Table 2
Total Bank Loans by Size of Bank, 1988 and 1993, and Percentage Change (dollars in billions)

	December 1988		September 1993		
Asset Size	**Loans**	**% of Total**	**Loans**	**% of Total**	**% Change**
Less than $25 million	$30.20	2%	$18.96	1%	–37
$25–100 million	170.66	9	158.19	8	–7
$100–300 million	178.69	9	192.08	9	7
$300 million–$1 billion	178.09	9	193.16	9	7
$1–5 billion	371.27	19	338.47	16	9
Over $5 billion	996.00	52	1,177.00	57	18
Total	$1,924.91	100%	$2,077.86	100%	8%

Source: Federal Financial Institutions Examination Council, Uniform Bank Performance Report, September 1993.

Thus, the rising concentration in the commercial banking sector would suggest that small businesses are finding it increasingly difficult to maintain a relationship with a small bank that would be interested in making loans that suit their needs. Hard data on this credit crunch are difficult to obtain. There are no convenient data that categorize business firms according to access to capital markets, although the Federal Reserve Board's flow of funds data provide some evidence on small firm finance. (The limited data available indicate that while bank lending to small business has increased since the 1980s, this growth is largely due to a rise of commercial mortgage lending by banks (French 1994, p. 20).) The financial and popular presses, however, provide substantial anecdotal evidence. "For many small businesses, obtaining traditional credit based on their balance sheets or anticipated cash flow has been more difficult. Factoring has become a convenient method to satisfy their working capital requirements" (Slater 1993, p. 38). It is easy to find other, similar statements.

Somewhat surprisingly, there appears to be no evidence that specialization in small business loans is less profitable; it is other considerations that are driving the trend to consolidation in commercial banking, which increases bank size beyond the scale that makes small loans attractive. Small firms rely to a much greater extent on commercial banks than do large firms, which have at their disposal many alternative forms of financing that are generally not available to small firms, including commercial paper. In October 1993 total commercial paper outstanding was $550 billion, while total commercial and industrial lending of all commercial banks was $586 billion (*Federal Reserve Bulletin, 1994*). The commercial bank share of U.S. financial assets held by all financial service firms was 51.2 percent in 1950, but only 26.6 percent in the third quarter of 1992. Similarly, Simonson (1994) reports that the ratio of finance company business credit to bank commercial and industrial loans rose from 20 percent in 1982 to 55 percent in 1992. This declining share of the financial services market held by commercial banks affects smaller business to a greater extent because it has fewer noncommercial bank options.

There are other causes of the reduction of the supply of credit to small business in the near term. Small firms rely to a greater extent than do large firms on collateral and asset-based lending. Small firm borrowing is frequently based on real estate values; the short-term financing of inventories is another important collateralized loan for small firms, especially single family proprietorships. Deregulation, fear of litigation (product safety, environmental problems), concern over interest rate fluctuations, and unstable exchange rates have all eroded banker faith in long-established rules of thumb regarding debt–to–equity ratios and cash flow–to–debt coverage ratios (Schlegel 1990). This, in turn, has caused banks to raise the standards and costs of asset-based lending in which collateral must be pledged. Further, problems experienced during the 1980s have caused banks to be cautious and conservative when lending against assets.

Of even greater concern is that while the credit crunch affects all firms, it has a greater effect on growing firms. Traditional, asset-based lending works against small but expanding firms that have large orders to fill, but lack the financial means to expand production.

These firms typically find that potential revenues are growing faster than actual productive capacity. A tightening of conditions on collateral-based lending exacerbates this situation and the growth of these firms is constrained (Schlegel 1990).

The credit crunch small firms are facing may be hindering economic recovery. The conventional wisdom is that small business will be the driving force that leads the nation along the path of economic growth, because nearly half of the nation's output is produced by small firms (Samolyk and Humes 1993) and because many economists believe that employment growth will occur first among small firms (Birch and Medoff 1993). There is some controversy, however, about whether small business is normally the driving force (Davis, Haltiwanger, and Schoh , forthcoming). While we cannot rely solely on small business to lead the economy out of stagnation, we do recognize that it can play an important national role and, in many cases, a decisive regional and local role. If, as the anecdotal evidence appears to indicate, the credit crunch is preventing small firms from undertaking potentially profitable projects, then efforts must be made to increase the supply of credit to small business. However, we do not want to overemphasize the importance of small business lending; depressed neighborhoods will require a variety of programs to restore vitality, including programs to increase mortgage and home rehabilitation lending, to provide more training and more jobs, to increase the supply of payment and savings facilities, and to promote entrepreneurship.

III. The Role of Factoring Companies in Alleviating the Credit Crunch

A factor raises funds by issuing commercial paper, notes, and debentures; it purchases accounts receivable a client, advancing about 80 percent of the value of the receivables; and it takes over billing and collection of the client's accounts. Once the client's customers have paid their bills, the factor pays the remaining value of the invoices to the client, after deducting a discount fee that ranges from 1 percent to 5 percent and interest charges on the advance. In addition, a factor may offer many financial services to the client.

Factor companies have traditionally served small to medium—size firms engaged primiarily in textiles and apparel. Until the 1960s factors were usually independent and closely linked to the clients they serviced. In recent decades a trend toward consolidation has led to a two-tier factor sector composed of a few dominant, typically bank-owned, large factors and a declining number of small, independent factors. At the same time factors have moved into new areas (such as health care, footwear, furniture, housewares, electronics, and foreign trade) and into new financing arrangements. In general, the smaller, independent factors have been more creative in developing new products, although their client base has been eroded by a decline in their traditional clients, the textile and apparel industries. This is particularly true for those small factors that specialized in providing finance for small retail stores. In the aggregate, the majority, in terms of *numbers* of customers of clients of factors, are retailers. As retailers consolidate, independent factors find their business shrinking. Thus, even while the *volume* of factor business grows quickly, the *number* of factors and the number of customers serviced by factors is likely to decline (Stuchin 1991). This is countered to some extent by the expansion of factoring beyond its traditional apparel industry base.

Smaller, independent factors, have found a niche market in which they can compete by providing to smaller, growth-oriented firms outside textiles and apparel specialized services that these firms cannot obtain from commercial banks and other competitors (Remolona and Wulfekuhler 1992; Doherty 1993). These factors are willing to take equity interests in their clients, and they will make secured and unsecured loans in excess of collateral offered. They are able to offer management advice and costly bookkeeping, credit, and collection services, thus taking over tasks that small businesses are frequently happy to unload so they may focus on what they do best. In short, factors are able to fill a gap and to alleviate the credit crunch in some cases.

Factoring has advantages and disadvantages compared to commercial banking. Factors are not subject to the supervision and regulation imposed on commercial banks unless they are part of a bank holding company. For example, factors can avoid writing off loans and absorbing losses that banks would be required to recognize. While

this is a potential source of risk—and, in the bankruptcy of United Factors, a large factoring concern, unrecognized losses played a major role (Rutberg 1989)—it also makes it possible for a factor to work closely with a client to work out of problems. Given the "people-intensive" nature of small-scale factoring, the credit department of a factor is in a good position to monitor the financial condition of a client and to judge whether work-outs would be cheaper than calling in loans and forcing bankruptcies.

Factors enhance the balance sheets of their clients in a way that cannot be duplicated by commercial banks. When a client sells its accounts receivables to a factor, its debt-to-equity and debt-to-asset ratios are improved, increasing its creditworthiness. Thus, the use of a factor can make it easier for the small business to obtain bank finance. Furthermore, the factor's balance sheet is more favorably affected when it purchases accounts receivable than a bank's balance sheet is affected when it accepts accounts receivable as collateral against a loan. (We will return to these points later.)

Factors are also in a unique position to engage in "pipeline finance," that is, to finance a series of borrowers as a product moves through the entire production and marketing process, beginning with raw materials and ending with retail sales.

Finally, factors apparently did not engage in the "fad lending"—LDC lending, commercial real estate, energy loans, and residential housing—that commercial banks succumbed to during the 1980s (Andersen Consulting 1990b). Even bank-owned factors did not experiment with the types of loans that proved later to have high default rates. The only important exception was in the area of LBOs, where factors played a role in providing some of the finance.

IV. Overview of the Factoring Business

A. *Historical Background*

Factoring is an old business, indeed. Factors were common by the time of Hammurabi, 4,000 years ago, making advances to manufac-

turers and merchants against goods. Early factors may have sold clients' goods in addition to providing credit and collection services. Factoring was the dominant form of finance used in the American colonies before the Revolution. In colonial America New York factors acted as sales agents for British and European textile mills, "selling the goods on a commission basis, perform[ing] the credit and collection function for their clients, guaranteeing the credits extended to their customers in this country, and advanc[ing] funds to the mills against these receivables and also against the goods received on consignment" (Phelps 1956, p. 65). Eventually, factors stopped acting as sales agents and specialized in credit and collection services. As the U.S. textile industry developed, it followed the British and European practice of relying on factors for these services, and until this century U.S. factors focused almost exclusively on firms in the textile industry (including manufacturers, wholesalers, and retailers). It was not until the 1930s, partially due to the effects of the Great Depression, that factors expanded their business beyond textiles to wholesalers and retailers of other "dry goods." By the 1950s factoring had spread to "bedding, chemicals, cosmetics, dry goods, electrical appliances and supplies, fertilizer, furniture, garden hoses, gloves, hardware, hats, hosiery, household furnishings, housewares, infants' and children's wear, knit specialties, leather goods, linens, men's, women's, and children's apparel, metallic yarns, nylon fishing lines, paint, paper, piece goods, plastics, portable organs, radios, rubber goods, screening, shoes, sporting goods, thread, toys, and underwear" (Phelps 1956, pp. 67–68).

Until quite recently more than half of the worldwide volume of factoring business was in the United States. During the 1980s, however, factoring experienced much faster growth abroad, and the United States no longer dominates the business. By the mid-1980s the U.S. share fell to less than half; by 1990 it was not much more than one-sixth. During the last half of the 1980s factoring grew at a rate of 22 percent per year worldwide, but at a national rate of only 8.4 percent per year. Relatively slower growth in the United States might be the result of greater penetration by U.S. factors into domestic markets rather than those in the rest of the world, but may also be attributed to loss of U.S. textile manufacturing, the traditional factor business.

Factoring business totaled $260 billion worldwide in 1991. In the United States the volume of factoring in 1993 was over $50 billion. As shown in Table 3, factoring volume among the top 16 companies in the United States grew 6.9 percent in the first six months of 1993. The top 10 companies have over 90 percent of the volume.

Until the 1960s most factoring was in the wholesale trade markets, primarily in textiles and apparel. During the 1960s, however, retail trade factoring surpassed wholesale factoring and now has the dominant share of the market. Also occurring during the 1960s was the movement by commercial banks into the factoring sector via purchases of many of the leading factors. For example, in New York (the center of the textile and apparel trades and, thus, of factoring) there were 114 factors in 1935; there are now only 20 (Rutberg 1993). As a result, a handful of top banks now control most of the factoring in the United States; about 94 percent of factoring nationwide is undertaken by bank-related factors. Concentration continues at a rapid pace, with estimates that half of the existing factors will disappear or merge by the year 2000. Part of the reason for this concentration is the consolidation of many of the clients of factors, particularly consumer goods retailers. It is estimated, for example, that half of retailers will be gone by the year 2000 (Rutberg 1993). A second explanation is that commercial banks find it easier to buy factors than to set up their own operations. The United States does not seem to be unusual on this score: the major clearing banks in the United Kingdom also own the major factors. However, part of the reason for the recent increase of consolidation is that the Justice Department has ignored mergers and concentration within the factoring industry.

Table 3
Factoring Volume in the United States, 1992–1993
(for the six months ending June 30, 1993; dollars in millions)

Company	1992	1993	% Change
CIT Group/ Commercial Services	$3,473	$3,738	7.6%
BNY Financial	3,350	3,650	9.0
NationsBanc Commercial	3,100	3,400	9.7
Heller Financial	2,967	2,919	–1.6
Barclays Commercial	2,280	2,243	2.8
Republic Factors	2,080	2,325	11.8
Congress Talcott	1,735	1,915	10.4
BancBoston Financial	1,690	1,800	6.5
Trust Co. Bank	1,546	1,590	2.8
Rosenthal & Rosenthal	620	620	0.0
Capital Factors	466	616	32.2
Milberg Factors	455	550	20.9
Midatlantic Commercial	474	455	–4.0
Ambassador Factors	390	410	5.1
Merchant Factors	95	93	–2.1
Standard Factors (Sterling National)	76	83	9.2
Total	$24,797	$26,507	6.9%

Source: Daily News Record, September 15, 1993, p. 8.

Factoring has spread beyond textiles and apparel; clients of BNY Financial (the second largest U.S. factor in terms of volume) now include metals manufacturers, glassware companies, and computer manufacturers. Newer clients of CIT Group/Commercial Services (the largest U.S. factoring company) include footwear, furniture,

housewares, luggage, and electronics. It was projected that in 1993 the volume of factoring of these newer businesses would be up 18 percent over the previous year, compared to almost no change in volume for the apparel business. A large factor may have a variety of clients who are suppliers to a large retailer (such as Kmart), and the factor's bank affiliate may have a banking relationship with the retailer (Kmart). This means that the customer (Kmart) of the factor's clients (the various suppliers) is also a customer of the factor's associated bank; this gives the factor control over the customer that it would not normally have in the case of a large retailer.

Still, factoring has made relatively small inroads into the overall financial services market. For example, it is estimated that factors in the United Kingdom (a £200 billion business annually) have captured only 6 percent of the potential factoring market; only 12,000 firms (2 percent of the total) use factors. In the United States total factoring business is equal to about 2.7 percent of total bank loans or to nearly 10 percent of commercial and industrial loans. According to data from 1986, accounts receivable were 21 percent of total U.S. manufacturing corporate assets, which would seem to indicate that the growth potential of factoring is large (Mian and Smith 1992).

B. What Is Factoring?

To explain what factoring is all about, let us begin with a "plain vanilla" factor. A factor raises its funds through notes and debentures and by issuing commercial paper or other short-term borrowings. An established firm with an established customer base uses its credit line to meet a wage bill in order to produce goods ordered by customers who typically pay for the goods 30 days after delivery. It is not unusual for the firm to obtain a new customer that places an order too large to be filled with the existing credit line. A bank will not expand the firm's line of credit because the firm has not yet experienced greater sales revenue, profit flows, or net worth position. The firm, therefore, turns to a factor and sells the accounts receivable (the invoices for delivered goods that customers will pay in 30 days) of its *established* customers to the factor. (Factors will not normally purchase accounts receivable until goods are shipped; thus, the firm

cannot sell the *new* invoices for goods to be produced.) The factor immediately advances the firm (its client) 70 to 80 percent of the value of the invoices, which the firm can use to produce the goods to fill the new order. The new customer then pays (30 days after delivery) the factor. When established customers pay their invoices, the factor pays the remaining value of the invoices to the client, after subtracting a discount fee (ranging from less than 1 percent to as high as 5 percent) plus interest for the period between the advance and the final payment by the customers (usually prime plus two percentage points). If the customers are late in remitting payment, the discount fee can be raised and the interest cost is higher (since the finance period is longer).

The basic factoring agreement also includes provision for a customer's refusal to pay the invoice. The refusal might be the fault of the client firm; perhaps the good or service was never delivered or was of inferior quality. The agreement protects the factor from this eventuality by making the client liable for payment of the advance (plus the fee and interest). On the other hand, the customer might simply default. Most factoring agreements include credit insurance so that the client is not liable for default; indeed, this is one of the principal attractions of factoring over bank-supplied credit.

The "minimal" factoring service, then, is one of purchasing accounts receivable on a "nonrecourse, notification basis." This means that the client is not liable for credit risk (nonrecourse) and that customers are notified that they are to pay the factor directly. This is much different from bank lending against accounts receivable, in which (1) the bank will usually lend only 50 percent of the value of the collateralized accounts receivable, (2) the bank does not assume credit risk, and (3) the firm continues to collect invoice payments.

In an extreme case the factor assumes that a client has no credit and that the factor will not be able to collect anything from that client should a customer default. The factor, therefore, closely examines a firm's potential customers and decides which ones are creditworthy; it then is willing to purchase the invoices of only these customers. It will not make advances against the invoices of customers whose creditworthiness is not established, which means that the firm cannot

ship merchandise to those customers unless the firm is willing to assume the credit risk and can wait the normal 30 days for payment. Factors traditionally will not finance orders and will provide finance only after the merchandise has been shipped. Factors (like banks) set a minimum size for client firms, depending on the factors' own cost structure. The minimum-size firm that average-size factors seem to be willing to service is on the order of $500,000 in annual sales revenue. Larger factors would presumably set a higher minimum. In foreign trade the minimum volume that would interest factors appears to be $2 million in annual sales.

Factors rely primarily on commercial paper, short-term borrowings, notes, debentures, and subordinated notes to finance their position in receivables. As an example, consider the following 1992 balance sheet data for one of the largest factor companies: commercial paper accounted for 39 percent of liabilities, notes and debentures equaled 57 percent of liabilities, the equity-to-asset ratio was 14 percent, and its allowance for losses on receivables was 3 percent of assets. More than 90 percent of the firm's equity was in the form of common stock, with less than 10 percent in the form of preferred stock. Of course, these figures would not be strictly applicable to all factors and would deviate considerably from those of smaller factors that might be closely held and have restricted access to the commercial paper market.

A firm that sells its accounts receivable to a factor immediately improves its balance sheet position because approximately 80 percent of the receivables are transformed into cash; on the balance sheet of the firm, the sold receivables are "netted" against the "loan" made by the factor when it discounts the receivables. If the firm had instead chosen to use accounts receivable as collateral against a loan advanced by a commercial bank, its balance sheet would not look nearly so favorable, as illustrated by the example in Tables 4 and 5.

Table 4 illustrates a typical balance sheet of a firm that has pledged accounts receivable against a commercial bank loan. (Banks normally advance only 50 percent of the value of accounts receivable; however, in our example, we have assumed the bank advances 80 percent of the value in order to make this example consistent with

the example using factor financing.) The firm has pledged $200,000 of its accounts receivable against a loan of $160,000; the firm's total liabilities are $470,000, its current assets total $620,000, and its net worth is $200,000. This results in a working capital ratio (current assets over current liabilities) of 1.32 and a debt–to–net-worth ratio of 2.35.

Table 4

Balance Sheet with Financing Through a Commercial Bank

Assets		**Liabilities + Net Worth**	
Cash	$20,000	Accounts payable	$300,000
Accounts receivable (pledged to secure bank loan)	200,000	Due to bank (secured by receivables)	160,000
Inventory	400,000	Accrued expenses	10,000
Current assets	$620,000	Current liabilities	$470,000
Fixed assets (net)	50,000	Net worth	200,000
Total	$670,000	**Total**	$670,000

Working capital ratio: 620,000/470,000 = 1.32
Debt–to–net–worth ratio: 470,000/200,000 = 2.35

Source: Joseph F. Lux, "The Factoring Advantage," *The Secured Lender*, November/December 1988, pp. 86–89.

Table 5
Balance Sheet with Financing Through a Factor

Assets		**Liabilities + Net Worth**	
Cash	$20,000	Accounts payable	$300,000
Accounts receivable (due from factor)	40,000		
Inventory	400,000	Accrued expenses	10,000
Current assets	460,000	Current liabilities	$310,000
Fixed assets (net)	50,000	Net worth	200,000
Total	$510,000	**Total**	$510,000

Working capital ratio: 460,000/3100,000 = 1.48
Debt–to–net–worth ratio: 310,000/200,000 = 1.55

Source: Joseph F. Lux, "The Factoring Advantage," *The Secured Lender*, November/December 1988, pp. 86–89.

In the case of financing through a factor (Table 5), the firm does not carry either the accounts receivable or the advance on these accounts on its balance sheet because it has sold these accounts rather than pledged them as collateral. The firm carries only the amount due from the factor ($40,000) as an asset. The firm's working capital ratio is 1.48 and its debt–to–net-worth ratio is 1.55.

It is clearly more advantageous to the firm to use the factor. (Our example has understated the advantage of factoring because in most cases the bank will advance only 50 percent of the value of the receivables, not the 80 percent in the case of factoring). Furthermore, the accounts receivables pledged against the bank loan are carried on the books as an offset to the amount due to the bank. In other words, there is no "netting" in the case of pledged receivables as there is in the case of receivables sold to a factor. The debt–to–net-worth ratio of the firm relying on the bank loan is much worse than that of the firm using factoring. Furthermore, the factored

firm appears more liquid in terms of its working capital ratio. In addition, bank loans usually require compensating balances, thereby tying up a firm's liquid resources, while factoring does not (Lux 1988).

When entering the market, niche factors may offer fewer services than even those of plain vanilla factors. Because the factor is usually liable for the credit risk of the customers of its client, it may use "refactoring" to limit its services to only the marketing end of the business. In such a case a factor might market various services to local businesses and sell its accounts receivable business to another factor, which then would be responsible for billing and collection. In these refactoring arrangements a small factor typically develops close relationships with local businesses as it markets the services that are ultimately provided by a larger factor (often one of the megafactors discussed below). In some cases smaller factors become niche factors by specializing in providing a narrow range of services. The refactoring business is particularly suited to international trade, where the local factor can determine the creditworthiness of domestic customers and agents for a foreign client serviced by a foreign factor.

Offering even more services than plain vanilla factors are full-service factors whose services typically includes the purchase of accounts receivable and the provision of bookkeeping, billing, and collection services, payment for which are included in the discount fee paid by the client to the factor. In addition, a factor might offer data processing and counseling, take over the sales ledger, conduct sales and cost analyses, handle customer orders, provide inventory records and control, and even bring new customers to the client. This makes the factor a legitimate financial services center.

The potential for growth among factoring firms appears to be large for a number of reasons. Many factors are moving out of traditional sectors. Unlike providers of a traditional credit line, a factoring facility grows automatically with a firm's business, making it attractive to rapidly growing firms. Banks appear to be restricting credit to smaller businesses, thereby creating a niche for factors. Factors can provide services not normally offered by banks. The recent recession (and

consolidation) has reduced the creditworthiness of many retailers, both small and large; their suppliers may wish to avoid credit risk and can do so by turning to factors. Firms that were the subject of LBOs during the 1980s are finding it difficult to obtain bank financing and, therefore, are more likely to turn to factors. Factors can help in workouts of heavily indebted firms. Because factoring is often used in international trade (particularly in trade that banks feel is too risky), there is a great opportunity for factors to finance trade with Eastern Europe and the former Soviet Union. U.S. factors can also arrange partnerships with foreign factors that know the credit risk of overseas customers of U.S. manufacturers. Exporters who use factors can ship goods without a letter of credit because the factor assumes the credit risk of the foreign customers. Factoring makes it easier for an inexperienced company to engage in exports since the factor will collect payment and may even offer currency exchange contracts to eliminate exchange rate risk (Hill 1992).

The niche market for factors appears to be newer, well-managed, highly profitable, fast-growing firms (particularly those with a rapidly growing working capital requirement). Niche factors have also provided capital to start-up businesses. There is a fundamental difference between normal bank lending and factoring: The bank focuses on the creditworthiness of the client to which it is lending, while the factor is less concerned with the creditworthiness of its client than it is with that of its client's customers. *At the extreme, the factor's client may have no equity, no assets, and no credit record, as in the case of start-up businesses. However, if the client's customers are creditworthy and the factor believes the client can deliver the goods or services ordered by the customers, then the factor will make advances to the client once goods are delivered.* One can imagine many cases in which the factor can fill a niche that could not be filled by a bank, given this difference in operating procedure. The relative success of factors and other "nonbank banks" does not appear to be due to the onerous regulation of commercial banks. Remolona and Wulfekuhler (1992) argue that if this were true, factors and nonbank institutions would have done better than banks in all sectors of the financial services industry, but this has not been the case. Rather, nonbank banks (including factors) have been more successful than banks only in niche markets.

Factoring, however, is not suitable for all lines of business. Factoring may be most appropriate in industries that have large markups, as in the apparel business. This is because, first, factoring is advantageous where there is a temporal gap between the provision of a good or service and the receipt of payment. Second, the desirability of factoring increases as the unit markup (the difference between the cost of providing a good or service and the price charged to the customer) rises because finance obtained through a factor is more expensive, in part because factors themselves rely on more expensive sources of funds (usually on commercial paper) than do banks. Obviously, the desirability of factoring will decline as the discount fee charged rises, as the percent of the value of accounts receivable advanced declines, and as the interest rate charged on advances (a function of the factor's cost of funds and the credit risk of customers) rises. While factoring is more expensive as a source of credit than bank finance, it must be emphasized that factors provide more services and provide larger advances against accounts receivable than do banks. Again, factoring is not for all lines of business.

V. Megafactors, Niche Factors, and Community-Based Factors

In the 1960s the comptroller of the currency allowed commercial bank holding companies (BHCs) to purchase factors, fueling a drive toward merger and consolidation that created huge factor companies—the megafactors. As discussed above, most of the *volume* of factoring is undertaken by BHC-owned factors; similarly, most of the *volume* of factoring is undertaken by the megafactors, most of which are BHC-owned. At the same time the number of community-based, primarily independent, factors has declined in absolute terms, and their share of the volume of factoring has declined even faster. However, simple extrapolation of these trends would lead to mistaken projections. The prospects for the megafactors are quite different from those for the community-based factors. The megafactors are involved in a highly competitive financial sector that serves primarily medium to large corporations that are able to use a variety of

alternative sources of financial services, while the community-based factors serve niche markets that are not subject to these same competitive forces.

A. *Megafactors*

Total U.S. factoring volume grew from $26 billion in 1978 to $46 billion in 1988 (and will reach a projected $52 billion in 1993), of which about 94 percent was undertaken by BHC-owned megafactors (Matthesen 1992). Between 1981 and 1987 the number of major factors declined from 35 to 23; by 1993 the number shrank to 15 (Doherty 1993; Andersen Consulting 1990a). In November 1993 it was announced that CIT was to buy Barclays Commercial, which would create the largest factoring company combination ever. As discussed above, commercial banks had moved into factoring since the 1960s, and by the mid-1970s BHC-owned factors were dominant. The primary reason for such bank purchases was the perceived high return on assets and equity in the factoring business. Between 1983 and 1988, however, most of the large money-center banks sold their investments in factors because they found that the business was too labor-intensive.

The position of money-center banks was filled by regional banks, which believed they could reduce the costs and increase the volume of factoring (Andersen Consulting 1990a). Recent data appear to demonstrate that they have been successful at expanding business, increasing or at least maintaining profitability, and minimizing losses (Andersen Consulting 1990a). The volume of factoring business continued to grow in the first half of 1993 even with the sluggish economy and a depressed apparel industry. While factoring in the apparel business was essentially flat, new business in nontraditional areas accounted for most of the growth.

By mid-1993 the three largest factors were CIT Group/Commercial Services, BNY Financial, and NationsBanc Commercial; these insti-

tutions experienced growth of 7.6 percent, 9 percent, and 9.7 percent, respectively, in the first half of 1993 compared to the same period in 1992 (refer again to Table 3). CIT's total volume during the six-month period was $3.7 billion; BNY's was $3.65 billion. BNY expects its factoring business to total $7.5 billion in 1993, as compared to $7 billion in 1992. As mentioned, CIT (jointly owned by Dai-Ichi Kangyo Bank Ltd. and Chemical Banking Corporation) has agreed to acquire Barclays Commercial Corporation; in 1992 the two firms had a combined factoring business of about $12 billion, or about 23 percent of the volume of the top 16 companies.

Crocker National Bank's experience with United Factors is an example of what can go wrong when a commercial bank moves into the factoring business (Rutberg 1989). In 1978 United Factors had a factoring business of nearly $2.5 billion, the largest in the business. Crocker was negotiating to purchase United just as United was filing for bankruptcy under Chapter XI, a bankruptcy forced to a great extent by the failure of one of its largest customers. Nonetheless, Crocker purchased United. Crocker soon found that retail factoring (about 60 percent of United's total business) is labor-intensive and costlier than it had expected. It also discovered that it had to take write-offs as a regulated institution that United had not been forced to take, which led to losses that had not been recognized by United. Crocker also found that factors are highly specialized service companies with a mercantile business that conflicted with a banking culture. Thus, in 1981 Crocker decided to get out of factoring.

Large megafactors tend to be successful when they take advantage of large economies of scale and produce high volumes of factoring business per employee (Andersen Consulting 1990a, 1990b). This dictates offering a narrower range of services—or plain vanilla factoring—particularly purchases of receivables and the provision of credit insurance and letters of credit. Indeed, megafactors are increasingly factoring "with recourse," which means that their clients are responsible for the debts of customers. The megafactor does not assume the credit risk of customers, but rather is subject only to the credit risk of clients. This sort of business favors larger manufacturers or retailers who are creditworthy and have billing and collection departments. Such clients generally have access to other forms of finance and turn

to factors only when the factors can offer competitive financing arrangements.

Megafactors can compete successfully with commercial banks in the accounts receivable business because the Federal Reserve requires that banks hold equity against the total volume of accounts receivable purchased, while factors consider only the *net* funds—the difference between accounts receivable purchased and credit balances—at risk. Banks, then, typically measure their profit rate as the ratio of pre-tax returns to total assets, while factors measure their profit rate as the pre-tax return on average *net* cash employed. If, for example, credit balances are equal to half of total accounts receivable, then the measured rate of profit for a factor will be twice that of a commercial bank engaged in the same business (Andersen Consulting 1990a). On the other hand, megafactors could face rising competition from finance companies, which are now larger than factors. Like factors, finance companies engage in asset-based lending, lending against collateral such as inventory, equipment, receivables, and real estate. Unlike factors, however, finance companies hold a lien on the collateral rather than taking title to the collateral.

Andersen Consulting, in two reports on the factor business, foresees hard times ahead for megafactors (Andersen Consulting 1990a, 1990b). Although megafactors recently have been moving into other areas, most of their business remains in the textile and apparel industry, an industry going through rough times, partly because of sluggish retail sales, high leverage, and overambitious expansion during the 1980s with its resulting bankruptcies and consolidations. Andersen predicts that when a few, healthy retailers emerge and the sector stabilizes, it will seek nonfactor finance. Furthermore, recent changes in production methods and inventory management have reduced the time required for production, distribution, and final sale for apparel. As the temporal gap between production and final payment decreases, discounting of accounts receivable becomes less desirable compared to traditional forms of finance.

In order to grow, megafactors need to move into new areas and diversify out of textiles and apparel. They will need to increase the pace of

innovation (in general, innovations in factoring have been at the niche level) so that they can maintain market share in the presence of competition from other asset-based lenders, particularly finance companies. They also will need to increase their presence in international trade finance. A major opportunity will be to develop pipeline finance, the financing by a single factoring company of the total production-to-market movement of an industry's product, dealing directly with the materials suppliers, manufacturer, wholesaler, and retailer.

B. Niche Factors

Niche factors serve small to medium firms, generally providing a much broader range of services to their clients than do megafactors. We will distinguish the niche factor from the community-based factor, although in the past they were considered essentially the same thing. Until quite recently, the term niche factor was applied to small, independent, and community-based factors, which most often served textile and apparel firms. As the term is now used, niche factors are those that serve small to medium clients in a particular industry without regard to the community in which the client is located, although niche factors may tend to be regionally based.

The type of niche factor that is growing fastest provides services to medium to small *manufacturers* in a particular industry with sales of $500,000 to $5 million annually (Rutberg 1993). For example, Omni Commercial Corporation is a niche factor whose small manufacturing clients average about $1.5 million in sales annually. Another niche player, Merchant Factors, does an annual business of about $180 million with small manufacturers, which it actively recruits and tries to help grow. When a manufacturer becomes too large, Merchant seeks participation by another lender or refers the manufacturer to a megafactor. Another example, Century Business Credit Corporation, recently created a new division, Century Factors, to provide factoring services to businesses with sales between $500,000 and $3 million annually; once a firm achieves sales greater than $3 million, it becomes a client of the parent, Century Business.

Niche factors serve small manufacturers, some with as little as $100,000 in annual revenue. Recently, China Trust Bank started a factoring department to serve manufacturers in the apparel manufacturing business with annual sales of $100,000 to $5 million. The department is organized as a niche factor specializing in refactoring (through the use of a megafactor), providing credit, checking, and back office services for China Trust. This enables China Trust to operate its factoring department with a minimum of employees. According to Thomas Chen, the president of China Trust Bank, the market niche has "excellent growth potential and brings all the services of the bank together" (*Daily News Record*, September 17, 1993, p. 10). The niche factor is also able to provide counseling and hands-on service to new and growing companies.

Niche players are primarily independent (not BHC-owned), information-intensive factors that develop close relationships with their clients and have been innovative in both the types of firms they serve and the services they provide to clients. Compared with megafactors, niche factors' labor costs are higher and volume per employee lower, but they are able to reduce costs to their clients with the range of services that they offer. Niche factors also provide letters of credit for their clients and are willing to provide other credit beyond financing accounts receivable. They also make it easier for the small firm to obtain credit from commercial and investment bankers by improving balance sheets and establishing credit records for clients. Niche factors are particularly important for fast-growing firms, since factoring volume increases automatically with sales. A recent study found that most employment growth is generated by "gazelles," or firms that are growing quickly, rather than by small or large firms per se (Birch and Medoff 1993). Niche factors can play a significant role in stimulating the economy by financing the small- to medium-size gazelles.

Niche factors can have advantages over alternative sources of financing. Although the cost of using niche factors is high relative to traditional bank credit, factors provide more services. In any case, the cost of credit may not be of overriding significance to fast-growing firms, which appear to find output constraints more important (Fazzari

1993). Niche factors are also willing to accept smaller minimum guaranteed fees than megafactors and to service clients with far smaller equity. Because the niche factors are often small, privately held firms, data on their factoring volume are not easily obtainable. However, niche factoring is growing rapidly and is an extremely profitable business (Rutberg 1993, Doherty 1993).

As indicated by their name, niche factors have found a market that is unlikely to be served by other types of financial firms, be they megafactors, finance companies, or commercial banks. Thus, unlike the case of megafactors, the prognosis for niche factors is for continued strong growth. Since 1991, for example, the number of niche factors servicing only small apparel manufacturers has grown from two to six (Doherty 1993).

C. Community-Based Factors

A community-based factor (CBF) is a particular type of niche player whose area of specialization is a community rather than a particular type of industry. A CBF might provide financial services to local manufacturers, wholesalers, and retailers. Its typical client would probably be even smaller than that of a niche factor, perhaps with annual sales in the range of $75,000 to $500,000, a substantially untapped market. Factoring companies such as China Trust are intimately connected to the communities they serve and provide a model for the establishment of community-based factors. They can play a major role in the revitalization of communities. CBF's can offer management advice, provide equity either directly or indirectly (by pursuing sources for clients), help arrange credit lines, supply billing and collection services, and buy accounts receivable.

As part of our proposal to develop a system of community development banks (CDBs), we called for the creation of commercial bank and investment bank "subsidiaries" of the CDB to provide "ordinary commercial bank business for clients in its neighborhood," including business checking accounts (Minsky et al. 1993). In addition, the investment bank subsidiary would provide equity and "longer-term

debt funding to existing business as well as new business in its community." We recognized that one function of a CDB loan officer would be to "discover the potential entrepreneurial resources in the community that require financing" and that the officer's duties would include developing knowledge about business prospects in the community, soliciting business for the CDB, structuring loans to meet the needs of clients, and supervising loans to ensure minimal losses.

It is clear that a community-based factor can operate as an adjunct of the commercial and investment banking arms of a community development bank. Like the loan officer of these subsidiaries, the supervisor of the factoring business would be required to develop an intimate knowledge of the creditworthiness of the businesses in the serviced community. The CBF would be able to provide financing in those cases in which a commercial or investment subsidiary was not able to do so. In particular, the CBF could provide finance to the rapidly growing firms that have good, creditworthy customers. We envision the possibility that many minority-owned, service sector firms could qualify for CBF financing, even if they could not obtain more traditional financing, if the customers they serve provided discountable invoices. Similarly, small manufacturing firms that provide finished or partially finished products to creditworthy manufacturers, wholesalers, or retailers are potential clients of the community-based factor subsidiary of the community development bank. The CBF may also be able to recruit equity funding for its clients where growth potential appears good. *Because it is the creditworthiness of the customers and not of the clients themselves that is crucial for the success of the CBF, it may turn out that factoring is superior for the financing of small business in depressed communities than financing provided by commercial and investment banking, even by the commercial and investment banking subsidiaries of a CDB.* Factoring is particularly suited for the relatively lower volume, higher markup businesses in which slightly higher interest costs are more than offset by the billing and collection costs offered by the factor, as well as the other costs associated with more traditional sources of finance.

VI. Policy Implications

Data on mortgage lending and payment services provided to households clearly demonstrate that some communities are underserved (Papadimitriou, Phillips, and Wray 1993). Unfortunately, comparable data on commercial lending do not exist. However, we believe that sufficient evidence does exist to allow a presumption to be made that there are underserved communities that would benefit from increased lending to small firms. We also believe that some of this unmet need could be met by the extension of factoring companies into these communities. In an earlier *Public Policy Brief* we argued that the main function of the financial structure is to advance capital development and that this can be encouraged by the provision of a broad range of financial services to various segments of the U.S. economy, including consumers, small and large businesses, retailers, developers, and all levels of government (Minsky et al. 1993). We also argued that the existing financial structure is particularly weak in servicing small and start-up businesses and that this problem has become more acute because of the decline in the number of independent financing alternatives and the rise in the size distribution of financing sources. For these reasons we called for the development of a system of community development banks. President Clinton's community development financial institutions proposal is a movement in that direction. Extension of his proposal to include a role for community-based factors would help to meet the concerns we have raised here and in our previous policy research.

While the factoring component of a CDB could provide assorted services to small firms, it might at the same time be able to provide working capital to small and start-up firms. There would be little credit risk for the CDB, as it is the customer of the client firm whose creditworthiness is important. Existing factors sometimes provide capital to their clients and bring together clients and venture capitalists. Such solicitation would seem to be appropriate in the case of CBFs.

While all CBFs would have the same goal of service to their community, CBFs could take several forms. Some existing CBFs might be

allowed to join the proposed system of CDFIs; other CBFs might become subsidiaries of new or existing CDBs. Some new CDFIs might choose to develop factor subsidiaries. As long as the factoring business of the CBF (whether independent or part of a CDB) served community-based firms in distressed communities, there is no reason why it should not have access to funding provided by the president's CDFI program. The Small Business Administration can also play a leadership role in encouraging factors to lend to small business. Lending by a bank-owned factor to small businesses in the bank's community (as defined for Community Reinvestment Act compliance) could count toward fulfillment of the bank's CRA obligation. We also recommend that President Clinton's CDFI proposal provide a significant role to be played by factors to increase lending to small business. A CDB might directly administer a factor subsidiary or an existing factoring company might qualify as a CDFI and be eligible for funding under the president's CDFI plan.

In *Public Policy Brief* no. 6 we called for strengthening the CRA and for commercial bank investments in CDBs be counted toward CRA compliance (Papadimitriou, Phillips, and Wray 1993). It is clear that commercial bank investments in CBFs should also count toward CRA compliance to the extent that this encourages lending by the CBFs in the communities of the commercial banks. In this way, the CBFs would complement existing and proposed programs to ensure that financial services are supplied to presently underserved communities. As we argued, "it is unrealistic to expect that any financial institution can meet all the needs of any community." There is, therefore, a role for CBFs to play in distressed communities.

As we also have argued, we do not believe that small business by itself can be the engine of growth for the entire U.S. economy. However, increased lending to small business can help expand employment and other economic opportunities, particularly in distressed communities, even if this lending does not by itself solve the significant problems present in the national economy both today and in the foreseeable future.

We believe that the CBFs have an important role to play in revitalizing distressed communities, particularly because they can provide

niche financing to small businesses in those communities and generate employment opportunities where they are most needed. If, as seems clear from anecdotal evidence, redlining and discrimination in lending are common in these neighborhoods, and if small business in general faces a credit crunch, then programs that can increase the supply of credit to small business in such communities are desperately needed. The CBFs would supplement other efforts, including those of CDBs and community credit unions. CBFs certainly cannot fulfill all needs in these communities; rather, they will fulfill some specific needs of certain types of firms. In particular, CBFs will serve relatively rapidly growing, small firms that provide intermediate and finished goods or services to creditworthy customers.

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