THIRD WAY

REPORT *Published September 28, 2022 · 16 minute read*

Five Reasons Minority Borrowers Can't Access Capital

Imani Augustus, *Director of the Alliance for Entrepreneurial Equity*

Takeaways

Business owners of color are more likely to struggle accessing startup funding, growth funding, and capital with affordable interest rates. In this report, we explore five trends in the lending market that hurt diverse business owners:

1. Branch closures hurt minority businesses more than others.
2. Low-wealth and minority business owners have fewer collateral options to secure loans.
3. Underwriting criteria are more stringent for young, often minority-owned, businesses.
4. Minority-owned businesses have fewer banking relationships.
5. Incentives for the loans minority borrowers need are too low.

A year ago, the Joint Center for Political and Economic Studies surveyed 1,200 small businesses across the country with a focus on Black and Latino business owners. Their findings should be a wake-up call to anyone looking to expand entrepreneurship in America. Most notably, a whopping 6 in 10 Black business owners faced challenges obtaining capital—even before the pandemic began. [1] Over a third of Latino business owners faced the same. Business owners of color were more likely to struggle accessing startup funding, growth funding, and capital with affordable interest rates.

This is by no means the only proof highlighting how minority entrepreneurs struggle to secure the financing they need. According to the Federal Reserve, Black entrepreneurs are denied loans at nearly twice the rate of white business owners. [2] And despite seeking pandemic-related assistance at similar rates as white business owners, minority businesses were more likely to receive none of the financing they applied for or experience a funding shortfall in 2020. [3]

Historically, lending in low-income and minority communities has been marred by unjust acts of overt discrimination. Despite today's reformed views, the racially motivated vandalism and avoidance of businesses seen throughout the country during the pandemic—particularly in Asian

American communities—shows that bias still harms financial security. [4] Nevertheless, the importance of small minority-owned businesses endures. They play a significant role in stabilizing their communities by providing jobs, filling gaps in access to basic goods and services, and restoring commercial life to underestimated areas. Expanding access to credit and increasing financial inclusion are central to changing the tide. In this report, we explore five barriers to lending among diverse business owners.

1. Branch closures hurt minority businesses more than others.

Today, fewer institutions control more of the country's banking assets as the decades-long trend toward consolidation continues. Digital adoption, mergers, and competition have led branches across the country to shut their doors—so much so that about two-thirds of North American bank executives surveyed by The Economist believe the branch-based model will be dead within five years. [5] We've already seen things trending that way; since 2000, the number of large banks, credit unions, and community financial institutions has shrunk by more than 40%. [6] What's more, these closures are adversely impacting minority communities.

Since 2010, the branch footprint in majority-Black areas has shrunk 15% compared to 10% in all other communities. [7] A 2016 investigation by the Federal Reserve Bank of New York found that people in low-income census tracts are more than twice as likely to live in a banking desert than their counterparts in higher-income tracts. [8] And a third of residents in banking deserts identify as racial or ethnic minorities. [9]

Branch closures can lead to a decline in business lending and stiffer competition for whatever financial services remain. This could lead to less capital to launch a business, greater difficulty hiring, and fewer opportunities to expand. Without access to financing alternatives—such as digital offerings—closures can contribute to financial exclusion and a lack of access to credit in the communities and among businesses that need it most.

Fortunately, regulators are keeping an eye on digital adoption and its impact on underserved communities. Earlier this year, three federal agencies responsible for monitoring the banking industry proposed updating rules on how online and branchless banking are being used to foster access to credit. [10] The Community Reinvestment Act, which governs how banks should meet the credit needs of low- and moderate-income customers, currently focuses only on activities around their physical branches. A 2018 Federal Reserve study found that banks without a local branch were much less likely to originate small business loans in the surrounding community. The same study found that self-employed people are more likely to use their in-person branch than people who work for an employer. [11] In short: if banks continue to move away from a branch model, businesses in low-income and minority areas have the most to lose and will need targeted policies focused on digital inclusion.

2. Low-wealth and minority business owners have fewer collateral options to secure loans.

Banks rely heavily on assets whose value can be easily established to mitigate the risk of lending to small businesses. Insufficient collateral is a common obstacle for businesses trying to access credit, but what's surprising is how much collateral requirements put low-wealth borrowers at a disadvantage. Having a higher net worth, owning property, or holding other assets often allows a business owner to borrow against their value or use personal wealth to invest in the growth of their company.

Among large and small banks alike, business equipment and real estate are commonly accepted forms of collateral for financing. [12] Yet, they are not the top choice for minority businesses. While over half of white business owners use business assets—like vehicles, inventory, and machinery—to secure their loans, only a third of Black- and Hispanic-owned businesses relied on the same. [13] Recent surveys by banking regulators don't divulge much about what other forms of collateral are used to secure small business credit, but researchers identified long ago that homeownership significantly increases the chances of loan approval and is a helpful benchmark for wealth. [14] Consider the following:

- Homeowners have 40 times more net worth than renters. [15]
- The homeownership rate for whites is almost 30 percentage points higher than Blacks, 25 points higher than Hispanics, and 15 points higher than Asians. [16]
- Hispanic and Black people have wealth levels on average seven times lower than whites. [17]

Still, only 7% of entrepreneurs dip into home equity for startup funds, so homeownership does not fully capture the capital gap. [18] According to the FDIC, the primary form of real estate accepted as collateral by banks is commercial. Ninety percent of small lenders and 77% of large banks accept commercial real estate (CRE) as a guarantee for their business loans. That's compared to 70% of small banks and just 58% of large banks that commonly accept personal real estate assets. [19] Not surprisingly, there isn't much balance in who holds non-residential properties. A new study by the Brookings Institute found only 3% of Black households own commercial real estate compared to 8% of white households. [20] Among those with CRE assets, whites hold on average $30,000 more in nonresidential properties than Blacks.

Some argue these disparities are attributable to appraisal bias, which results in low valuations for property in majority-minority neighborhoods. [21] A paper from researchers at the Federal Reserve underscores the importance of this problem. Higher asset valuations relax collateral constraints, help borrowers secure financing, and allow business owners to increase investment. [22] Yet, relying on assets many communities don't have, or undervaluing the assets they do, inadvertently limits the chance that minority borrowers can meet collateral requirements.

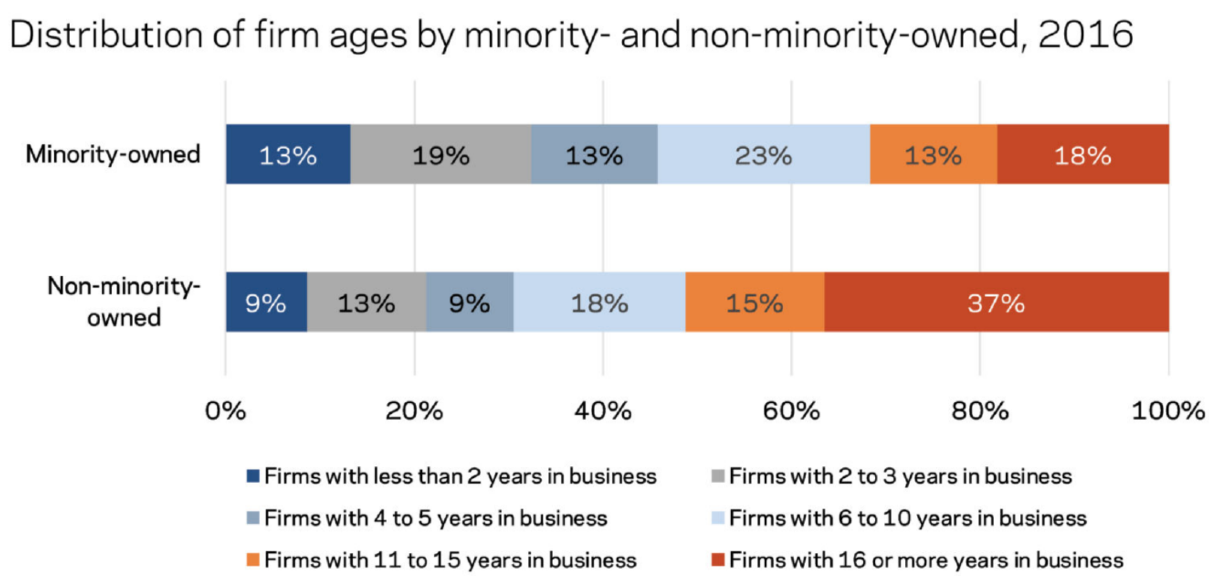
Spotlight: Michael Tidwell, an LA-based appraiser, was skeptical when a bank outright rejected his valuation of a commercial property in a predominately Black neighborhood. After months of insisting the lot was priced too high, the bank reviewer ultimately agreed with the appraiser's original report. Tidwell believes the bank failed to see the potential profit to be made in the community because of historical assumptions about neighborhoods that still drive appraisal methods today. [23]

3. Underwriting criteria are more stringent for young, often minority-owned, businesses.

A healthy track record is vital to building a successful business profile. And how long a business has been in operation can shed light on its financial condition. That's why lenders frequently use firm age as one of several factors to determine creditworthiness and assess risk. When surveyed, 71% of small banks and 87% of large banks report that business age is always or almost always used as an underwriting criterion for small businesses. [24]

But all too often, little public information exists about the performance of new companies just starting out. To minimize the risk involved with lending to an untested start-up, banks often consider additional underwriting criteria, such as additional guarantees and documentation, and even consider the owner's personal characteristics like their training and education. [25] These requirements create substantial barriers for new businesses to obtain a loan. Since young firms are typically unable to provide the necessary performance history required to receive financing, they are left with few traditional credit options. [26] This phenomenon is especially true for minority-owned companies, 45% of whom are less than five years old. [27]

Yet, it is precisely within the first five years that many businesses are in need of capital to grow and survive. According to a recent study by JPMorgan Chase, exit rates are higher among minorities in the first five years of operation. [28] Many factors can lead a business to close its doors, including low revenue, profit, and cash reserves. Black- and Hispanic-owned businesses score lower than white-owned companies in all three categories. [29] These factors shed light on the persistent challenges Black- and Hispanic-owned businesses face to mature successfully and withstand market disruptions. Notably, although 20% of Black Americans start businesses, only 4% of Black-owned businesses survive the start-up stage. [30]



Source: https://eig.org/minority-and-women-owned-businesses-vulnerable-recession/ & US Census Bureau Annual Survey of Entrepreneurs

As cashless businesses and digital payments become more universal, underwriters are finding new ways to extend services to businesses lacking traditional performance records. Digital payments giants, like Square and PayPal, have steadily increased their loan portfolios by using transaction data to measure the overall health of businesses and make loan determinations. [31] These alternative lenders are leaner than traditional banks and can underwrite small loans for businesses at a fraction of the cost. Later in this report, we find these characteristics made fintech lenders central to the small business response during the pandemic. Using alternative data, like transaction history, presents a major opportunity for traditional banks if they can figure out how to leverage it.

4. Minority-owned businesses have fewer banking relationships.

The FDIC calls community lenders "relationship banks," as they tend to base credit decisions on specialized knowledge gained through close ties to a business, its owners, and the community. [32] Because information on new companies is limited, these relationships help lenders monitor the firm's health and inform how flexible they can be when making decisions about credit terms. [33]

Banks large and small cite existing relationships as the top reason loan officers would make exceptions to underwriting criteria and loan policy. [34] Familiarity with and personal insight into business operations allow community banks to provide loans that are larger in size, more hands on, and require longer periods of administration. [35] Where regulations allow for discretion, some community-based lenders offer favorable exceptions to collateral requirements and interest rates to businesses they have existing relationships with. And the results are more profitable for the lenders too, as relationship-building loans typically have lower default rates and more satisfied borrowers. [36]

Unfortunately, minority entrepreneurs have a harder time establishing business lending relationships. According to the Small Business Administration, when Black businesses attempted to establish relationships with banks, credit unions, and other financial institutions, 53% were unable to secure the funding they needed, compared to 25% of white borrowers. [37] As the first tranche of the Paycheck Protection Program (PPP) demonstrated, it's important for businesses to have these relationships before an emergency arises. Among businesses that applied for PPP through a bank, approval rates were higher for those with pre-existing relationships with a lender. [38] Even still, Black businesses stand out as an exception in new data from the Federal Reserve. Although 72% of Black-owned firms had existing relationships with small banks, just 28% were fully approved for the PPP financing they sought from these lenders. Compare this with Hispanic-owned businesses, who were less likely to have relationships with small bank lenders, yet outpaced Black-owned businesses in receiving all their funding by 24%. [39]

Most borrower-lender relationships can begin through checking and savings accounts, but communities of color struggle with broad adoption of even those accounts. Hispanic, Black, and Native households are over six times more likely to be unbanked compared to their white and Asian counterparts. [40] Unless small minority-owned businesses can get the personalized engagement they need to successfully make it through the loan process, they may lose access to credit opportunities.

Spotlight: The importance of lender relationships was demonstrated for African American business owner, Letha Pugh, when she was just getting her bakery off the ground in Ohio. "Just having a bank account isn't a relationship with a bank," she recounts. The best relationships go deeper than the surface. Not until she was able to "pick up the phone and reach out" to a lender that "knew and understood" her was she able to access the working capital her business needed. [41] A relationship with a bank helped Letha access PPP loans early on when other businesses were shut out.

5. Incentives for the loans minority borrowers need are too low.

In 2020, over 60% of minority business owners sought financing for $100,000 or less. [42] Because banks must consider all elements of the lending process, including origination, underwriting, compliance, and monitoring costs, these loans don't always make economic sense. Small community lenders typically can't afford the time or risk involved in microfinancing, so they've slowly ceded their share of the small-dollar lending market to large banks over the past decade. Until recently, interest rates sat at historic lows, giving lenders an even greater incentive to focus on increased loan sizes and tighten requirements to guarantee sufficient interest income to cover costs. [43]

One group of researchers found that because small loans are less profitable to originate than larger ones, the competition for those smaller-dollar loans disproportionately impacts minority borrowers. [44] As noted above, a large proportion of these businesses are young and small. They also operate on less revenue when starting out. Over half of Black respondents to the Federal Reserve's Small Business Credit Survey said they operate on $100,000 or less in annual revenue, compared to 30% of Hispanic businesses, and less than 20% of white and Asian businesses. [45] As more minority-owned businesses are born, the demand for these microloans will grow and the market will have to adapt to fill the gap.

Amid this landscape, nonbank lenders and fintechs have expanded their presence. For example, the average loan amount for fintech lenders who administered the Paycheck Protection Program (PPP) was $31,000. Researchers found that the lower cost structure and higher processing capacity of automated lenders allowed them to issue smaller loans during the pandemic. As a result, fintechs played an enormous role in getting relief to Black businesses, accounting for more than 50% of all PPP loans to this community. [46] A clear path to appropriate regulatory oversight of the online lending market could usher in robust access to credit for small minority-owned businesses.

Promising Efforts

Lenders and the federal government have been taking action to broaden access to credit for borrowers that have often been turned away. In February, federal agencies urged lenders to improve services to borrowers from historically disadvantaged backgrounds through credit programs designed just for them. [47] These Special Purpose Credit Programs, or SPCPs, allow banks to introduce new products, relax eligibility requirements for existing products, or modify policies for certain groups who would otherwise be denied credit or receive it on less favorable terms. [48] So far, SPCPs have been underutilized by banks but have the potential to increase business credit and capital access.

While regulators further clarify how financial institutions can provide tailored credit services to vulnerable borrowers, lenders are experimenting with other innovations to serve under-resourced entrepreneurs. For example, the revenue-based financing model is not actually a loan product. It helps businesses attract the cash they need and secures payments from a portion of the proceeds made each month. [49] This kind of product is best for fast-growing businesses that are looking to avoid taking on more debt and want an infusion of capital without incurring interest or losing equity, but it's not for everyone. Minority-owned businesses are overrepresented in low-revenue, low-growth industries and may not be candidates for this financing model.

Lenders are also aiming their philanthropic efforts at diverse entrepreneurs. At the height of the pandemic, when minority-owned businesses were closing at twice the rate of their counterparts, the Goldman Sachs Foundation invested $25 million to support Community Development Financial Institutions (CDFIs) and other mission-driven lenders. [50] These institutions provide financial services to meet the specific needs of low-income and distressed communities. They are often favored by minority borrowers for their community-based approach and low-cost rates. According to the Federal Reserve Bank of Atlanta, Black- and Hispanic-owned enterprises are nearly two times more likely to apply for a loan at a CDFI than a white-owned business. [51]

Wells Fargo also recognized the importance of CDFIs who have deep ties and specialized knowledge of the communities they serve. (Note: Support for our work comes in part from AEE's Industry Council, which includes Wells Fargo as one of the founding partners.) Through its Open for Business Fund, Wells Fargo donated $420 million to help small businesses. [52] The program supported CDFIs as well as nonprofits nationwide to provide the capital, technical expertise, and long-term recovery resources needed to help women and diverse entrepreneurs during the pandemic.

These philanthropic efforts not only get help to where it's needed, they also aid in developing good faith between underserved communities and lending institutions. Hispanic and Black business owners are far more likely to cite discouragement as a reason they avoided financing. Therefore, efforts by lenders to meet entrepreneurs where they're at can have a positive impact on the dissatisfaction and discouragement that some minority business owners feel.

Conclusion

Equal access to small business credit is a crucial precursor to broad-based economic opportunity. [53] If minority businesses cannot access the credit they need, we can expect them to continue to underperform, slowing economic growth in communities of color while others emerge from the COVID-19 pandemic. The possibility of an even wider racial wealth gap is a real threat should minorities continue to fall behind in securing the capital their businesses need.

Lending isn’t an exact science. But when we build our programs on inequities that already exist in the banking system—like only reporting on activity around physical branches, valuing some assets over others, and reducing the amount of small loans to business, to name a few—lending becomes an unlevel playing field. To increase fairness throughout the market, borrowers need to find the courage to start a new banking relationship, lenders must open their doors even wider to new customers, and lawmakers should ease regulation while fostering a more entrepreneur-friendly ecosystem. Doing so can expand access to credit and banking services in low- and middle-income communities and rebuild the relationship between minorities and the lending sector.

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