

# Scaling Lending to Entrepreneurs of Color: Part I

## Core Operational Challenges



As the Biden administration settles into office amid the ongoing COVID pandemic, there continues to be tremendous concern among policymakers, corporate leaders and philanthropists about the financial health of U.S. small businesses – especially the smallest ones. Meanwhile, we are still very much in the throes of a racial reckoning, with the pandemic further laying bare the economic fragility of households of color and the deep racial inequities that continue to plague our country. Because business ownership has been a means for many Americans to build wealth, providing loans and grants to diverse entrepreneurs has been seen by many as an important way to address the racial wealth gap.<sup>1</sup> Corporate America’s response to the current crisis has included several initiatives aimed at making more small business loans to entrepreneurs of color, primarily working through community development financial institutions (CDFIs). American Express, Citi, Costco, Google, JPMorgan Chase, Netflix, Square, Twitter, and Wells Fargo, among others, have recently made or announced plans to make large investments in funds designed to get capital to diverse entrepreneurs. The Biden administration, too, has placed a high priority on driving capital to small businesses owned by and employing people of color.<sup>2</sup>

Given the significant resources being channeled to CDFIs for the purpose of lending to entrepreneurs of color, it seems like a good time for the Business Ownership Initiative to take stock of what we have learned over our many years of studying and partnering with CDFIs that have sought to serve just these markets. Much of our work has focused on the challenges that Black and Latinx entrepreneurs face in accessing capital, and below we frame our findings by describing their experiences. Although successfully reaching other excluded entrepreneurs will require practices and competencies that meet their specific contexts, the lessons we have learned and practices that have proven successful will apply to all entrepreneurs who face barriers in accessing credit because of low levels of wealth, thin or nonexistent credit files, differences in cultural experiences and languages, discrimination, and/or the amount of credit they are seeking. This includes Indigenous, Asian American and Pacific Islander, and women entrepreneurs, as well as individuals with disabilities.

1 <https://live-future-of-building-wealth.pantheonsite.io/wp-content/uploads/2021/09/Sec5-Ch40-Klein.pdf>.

2 For example, after the first round of PPP loans went overwhelmingly to larger white-owned firms, the second round established set-asides to allow CDFIs and Minority Financial Institutions to specifically targeted disadvantaged small businesses. Likewise, the new rules for the renewed round of the State Small Business Credit Initiative (SSBCI), requires all states to include in their applications plans for how they will make sure the funding supports loans that reach disadvantaged small business owners. Another example is the SBA’s \$28.6 billion Restaurant Relief Fund. Congress and the Administration ordered a 21-day “exclusivity period,” during which only businesses owned by women, veterans and “socially and economically disadvantaged” individuals could apply. After white business owners sued, this policy was struck down by federal courts.

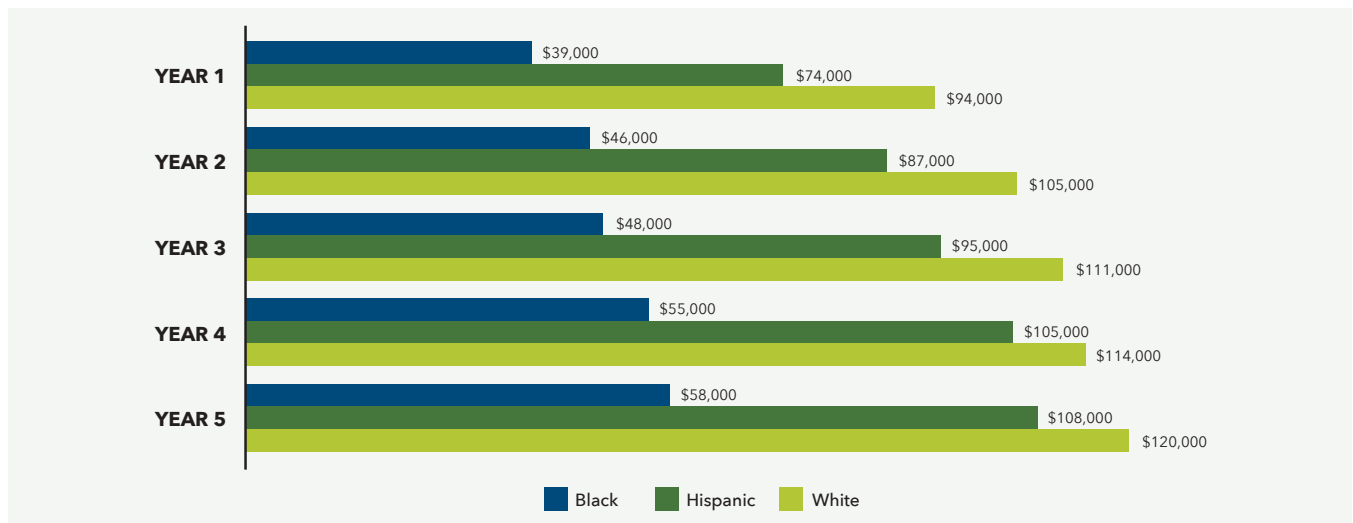
# LANDSCAPE OF BLACK AND LATINX BUSINESS OWNERSHIP

Despite the challenges posed by historic and ongoing structural racism, between 2014 and 2018, Black and Latinx Americans had a higher rate of entrepreneurship than their white counterparts.<sup>3</sup> This is likely due in part to barriers that Blacks and Latinx individuals continue to face in accessing opportunity in the labor market, leading to higher rates of “necessity entrepreneurship”.<sup>4</sup> Meanwhile, one in four new businesses is now started by a Latinx entrepreneur, with Latinx people believed to be starting businesses at the fastest rate of any demographic group in the U.S.<sup>5</sup> Black-owned employer firms employ just under 1 million people,<sup>6</sup> while Latinx-owned firms employ about 3 million.<sup>7</sup> Black-owned firms

are concentrated in three sectors: healthcare and social assistance; professional, scientific and technical services; and administrative and waste management.<sup>8</sup>

While Black and Latinx Americans are starting and running more businesses than ever, their businesses remain, on average, smaller than white-owned firms. A recent report from the JPMorgan Chase & Co. Institute found that among firms created in 2012 and 2013, the median revenues of Black-owned firms were consistently less than half those of white-owned firms, and the median revenues of Latinx-owned firms were about three-quarters of their white counterparts.<sup>9</sup>

## Median Revenues for Small Businesses in the 2013 and 2014 Cohort



Note: Sample includes firms founded in 2013 and 2014.

Source: JPMorgan Chase Institute

- 3 Academics at Babson University have analyzed data collected as part of the Global Entrepreneurship Monitor to identify trends in entrepreneurship across race and gender. See <https://entrepreneurship.babson.edu/gem-data-black-entrepreneurship-us> and <https://hbr.org/2021/05/black-women-are-more-likely-to-start-a-business-than-white-men>.
- 4 Estimates developed by the Kauffman Foundation of data from the Current Population Survey find that Black and Latino entrepreneurs have lower rates of “opportunity entrepreneurship” and higher rates of “necessity entrepreneurship” than Asian and White entrepreneurs. Fairlie, Robert and Sameeksha Desai (2021) National Report on Early-Stage Entrepreneurship in the United States: 2020, Kauffman Indicators of Entrepreneurship, Ewing Marion Kauffman Foundation: Kansas City. [https://indicators.kauffman.org/wp-content/uploads/sites/2/2021/03/2020\\_Early-Stage-Entrepreneurship-National-Report.pdf](https://indicators.kauffman.org/wp-content/uploads/sites/2/2021/03/2020_Early-Stage-Entrepreneurship-National-Report.pdf).
- 5 <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/slei-report-2018-latino-owned-businesses-shining-light-national-trends.pdf>.
- 6 <https://www.blackbusiness.com/p/facts-statistics-black-owned-businesses.html>.
- 7 <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/slei-report-2018-latino-owned-businesses-shining-light-national-trends.pdf>.
- 8 <https://usafacts.org/articles/black-women-business-month>.
- 9 <https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/institute/pdf/institute-small-business-owner-race-report.pdf>.

These data back up an essential finding from the work we've done over the years—**loans of less than \$50,000—or microloans—are the financing product that will reach the greatest number of Black and Latinx entrepreneurs, given where they are today.**

This is because the policies and systems that have precluded Black and Latinx people from building or retaining wealth have had the effect of generally segregating them into industries that have low barriers to entry, lower revenues, and lower margins. That, in turn, means that their businesses are smaller. We fully support efforts to provide more capital to larger Black and Latinx-owned firms; but, to reach the vast majority of entrepreneurs of color, microloans will have to be the core of the effort—at least at the beginning.

Given that most lenders will size a small business loan at about two times monthly revenues, the Chase data suggests that in Year 5 the median Black-owned firm would qualify for a loan of about \$9,700 and the median Latinx-owned firm would qualify for a loan of \$18,000. Even firms with revenues twice the median level would only qualify for loans smaller than \$40,000. These data are consistent with findings from the Federal Reserve's Small Business Credit Survey, which showed that 76% of Black-owned businesses and 63% of Latinx-owned firms were seeking loans of less than \$100,000.<sup>10</sup> Lower revenues are not always a barrier to larger loans. For example, an early-stage firm owned by an entrepreneur with significant financial assets (such as home equity) or significant connections to wealth is often able to borrow from a conventional lender based on projections of future income, or to

receive equity investments. But here again, our country's history of segregation, redlining and discrimination has led to a situation where few entrepreneurs of color own homes with substantial equity, have other financial assets to serve as loan collateral, or can raise equity capital.

There are, of course, some Black and Latinx-owned firms that are larger, are growing rapidly and can absorb larger loans, and we want there to be more of them. But we will not achieve that by lending smaller firms more money than they can reasonably afford to repay. Providing greater amounts of equity (versus debt) to BIPOC-owned firms could significantly enhance their potential for growth. But while we are aware of efforts to address that issue, to our knowledge there is not yet a model that has successfully done equity investing in microenterprises in the U.S.<sup>11</sup> That leaves us with two alternatives: grants and microloans. There have been many small business grant programs conducted during the COVID pandemic, with both corporate and government money. Most, if not all, were meant to provide short-term relief rather than growth capital. The due diligence associated with these grant programs has been, in general, limited to verifying that the business is a legitimate concern located in the targeted geography—with the goal of preventing fraud. Grant recipients have not been underwritten to assess their potential to grow and create jobs. It would be interesting to experiment with small business equity grant programs that seek to provide growth capital, after screening prospective recipients for their capacity to grow and create jobs and wealth in communities of color.<sup>12</sup> At the Business

10 <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf>.

11 The challenges are numerous and include small transaction sizes, lack of exit opportunities and reluctance on the part of business owners to give up a share of ownership.

12 There have been experiments with small-scale equity-like financing in Pakistan (where Islamic law constrains certain forms of debt, leading to creative equity-like capital programs; Bari, Faisal & Malik, Kashif & Meki, Muhammad & Quinn, Simon, 2021. "[Asset-based Microfinance for Microenterprises: Evidence from Pakistan](#)," [CEPR Discussion Papers](#) 15768, C.E.P.R. Discussion Papers.), in Kenya (with loans collateralized with a major asset "granted" to entrepreneurs; Jack, William & Kremer, Michael & Laat, Joost de & Suri, Tavneet, 2016. "[Borrowing Requirements, Credit Access, and Adverse Selection: Evidence from Kenya](#)," [CEPR Discussion Papers](#) 11523, C.E.P.R. Discussion Papers.), and Sri Lanka (a direct effort at providing microequity investments; De Mel, Suresh & Mckenzie, David J. & Woodruff, Christopher M., 2019. "[Micro-Equity for Microenterprises](#)," [Policy Research Working Paper Series](#) 8799, The World Bank)

Ownership Initiative, we are completely supportive of providing subsidized capital to disadvantaged entrepreneurs, and it is not a stretch to go from subsidized interest rates to outright grants, especially on smaller amounts, when there is little interest income to be earned anyway.

However, the most likely path to rapid progress in getting capital into the hands of entrepreneurs of color is by building on existing community lending efforts. The rest of this paper, therefore, will focus on microloans as the best available option to provide capital to entrepreneurs of color at scale.

## LOAN OPTIONS FOR VERY SMALL BUSINESSES IN THE U.S.

Understanding the small business financing landscape in general is useful for better understanding the necessary elements for reaching entrepreneurs of color. Today there are many possible channels for accessing capital – in some ways more than there ever have been. Still, most small businesses use channels other than small business loans, and most rely on “traditional” sources of capital: savings, personal or business credit cards, home equity, or borrowing from family and friends.

It’s only when these options are not available, or not sufficient, that entrepreneurs turn to small business loans from banks. There’s a reason for this – getting a small business loan from a bank is difficult and often quite slow. It has gotten even more difficult since the 2008 financial crisis: small business lending by banks has never really recovered from that crash. Why? Primarily because small business loans are significantly less profitable and riskier than loans to larger firms. A small loan generates less interest income than a larger loan; small businesses close at higher rates than larger businesses; and small loans require just as much, if not more, underwriting than larger loans. The dearth of small business lending by banks is the primary reason the Small Business Administration (SBA) and its counterparts at the state level exist. The SBA provides guarantees

to take most of the risk out of small business lending for banks, but even with the risk reduced, bank lenders gravitate toward making larger loans because they are more profitable.

While small business lending has decreased among mainstream banks, a huge number of alternative debt financing providers have emerged since 2008. There is a handful of responsible online small business lenders – like Funding Circle and Camino Financial, for instance – that have emerged to fill some of the small business lending gap, but these lenders tend to target the least risky small business borrowers. Most non-bank small business credit providers offer merchant cash advances or loans repaid via a daily debit from a checking account. With few exceptions, these new options are very high cost, with APRs that reach into the triple digits.<sup>13</sup> They also tend to be short-term and have deliberately murky disclosures about interest rates, prepayment penalties, and fees.

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<sup>13</sup> Two of the best-known providers of short-term high-cost small business credit—OnDeck and Kabbage—may have experienced unsustainable losses as a result of the pandemic and its negative effect on small businesses. Both were sold to third parties under duress during the pandemic, demonstrating the challenge in lending profitably to non-bankable small businesses—even at the very high interest rates both companies charged.

This is the environment that entrepreneurs of color seeking financing face.

Because of our nation's history of systemic racism, the most common options for financing are rarely available to entrepreneurs of color. Most do not have the wealth or savings to self-finance or borrow against, nor do their family and friends have the necessary resources to chip in. They do not have home equity to draw on and their credit scores do not allow them to open credit card accounts to meet their needs.

Commercial banks are generally uninterested in making loans of the sizes these entrepreneurs qualify for. Even for banks that are participating in SBA-backed lending programs such as the 7(a) program or for responsible online lenders, the requirements of such loans include relatively high credit scores, collateral, and lengthy track records.<sup>14</sup> Of course, direct racism remains an issue. For instance, there's suggestive evidence of direct discrimination against black business owners in PPP lending, even though the program was structured to be essentially risk-free for lenders.<sup>15</sup>

That means the only available options for financing are CDFIs and alternative lenders like merchant cash advance providers.

Although the corporate donors and investors mentioned earlier have generally turned to CDFIs as a channel to reach diverse entrepreneurs with loan capital, the reality is that the CDFI industry has struggled to grow originations of small business loans under \$50,000. There are well over 7 million small businesses owned by entrepreneurs of color in the country. As far as we know, there is no source of updated information on the volume and borrower demographics of CDFI microlending. Data for 2017 from the US Department of Treasury's CDFI Fund suggests that the 300 CDFIs that had an active

grant from the Fund (a group that almost certainly includes most if not all of the highest performing CDFI microlenders) were servicing a mere 19,271 micro and small business loans across all demographic groups.<sup>16</sup> Obviously not all small businesses are seeking loans, but it is clear CDFIs are a long way from meeting the needs of entrepreneurs of color.

**What will it take for CDFIs to reach more small business owners of color? Our collective experience indicates that the two most important challenges are 1) finding effective and efficient methods of acquiring customers and, 2) addressing the underlying economics of microlending. Other key challenges include underwriting efficiently and responsibly at scale, the role of borrower technical assistance, and CDFI capitalization.**

Part II of this paper, to be released later this fall, will describe these challenges in detail and address how high-volume microlenders and their partners are addressing these issues.

Here we summarize the challenges:

- **Customer Acquisition:** The target population is generally unfamiliar with CDFIs, while being exposed to a great deal of targeted marketing from high-cost and predatory lenders. These entrepreneurs are also chronically short of time and resources, which makes the relatively time- and attention-intensive CDFI process unappealing compared to the "get cash quick" appeals of alternative lenders. Acquiring customers in this environment will require that CDFIs speed up their decisioning and closing procedures and form effective referral partnerships with both community organizations and corporations that are spending advertising dollars in this market.
- **Economics of Microlending:** There are very good reasons for commercial banks abandoning business loans under \$100,000

14 The 7(a) program is the U.S. Small Business Administration's most common loan program. It provides a partial guarantee on loans issued by participating lenders, such as banks and credit unions.

15 Howell, Sabrina T., Theresa Kuchler, David Snitkof, Johannes Strobel, and Jun Wong., 2021. *Racial Disparities in Access to Small Business Credit: Evidence from the Paycheck Protection Program*, NBER Working Paper 29364. DOI 10.3386/w29364

16 CDFI Fund operates an annual competitive grant program annually that provides permanent equity grants to community development financial institutions.

– it is very, very difficult to make a profit at affordable interest rates. The costs of underwriting and servicing a small loan are the same – if not higher – than a much larger loan that provides much more interest income.

- **Underwriting:** For all the reasons discussed above, entrepreneurs of color often don't have the cash flow, credit scores, documentation, and experience to easily move through an automated underwriting process. They require assistance – and underwriters who understand them, their communities and their businesses – to complete the process and ensure they are qualifying for a loan amount and type that will boost their business, not strangle it with unsustainable debt.
- **Technical Assistance:** Many CDFIs view providing technical assistance and training to small businesses of color as core to their mission. But delivering technical assistance is both difficult and expensive to do well. That puts even more pressure on the economics of microlending.
- **Capitalization:** Most CDFIs that originate small business loans are balance sheet lenders, which means they hold loans until they are paid off. This means that as they grow originations, they need to raise grant funding to support their capital base *and* low-cost debt needed to reduce their cost of capital and keep interest rates to borrowers affordable. Up until the current influx of capital stimulated by the pandemic and commitments to addressing racial equity, meeting these capital needs has been a primary barrier to growth for large-scale microlenders.

Meeting the financing needs of entrepreneurs of color will be critical in both ensuring the health of our small business sector, and in living up to commitments to address racial inequities. To meet those needs, we must find way to meet business owners of color where they are – and that means scaling the supply of affordable, responsible microloans.

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This brief was developed as part of the Global Inclusive Growth Partnership, a collaboration between the Aspen Institute and the Mastercard Center for Inclusive Growth



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