Bridging the Capital Access Gap:

An Overview of the Small Business Finance Industry

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Executive Summary: The Industry at a Glance

Banks

- Banks consistently account for the greatest proportion of small business lending in the U.S. They accounted for 44 percent of loan applications in 2018-19.
- Nationwide, local banks have been merging and consolidating into larger regional or national banks for the past 20 to 30 years. This has been a problem for local small businesses, which do better when the lending environment is responsive to their needs.
- Bank loans are relatively difficult to receive because of credit and collateral requirements but usually carry favorable interest rates. In 2019, small banks had around 78 percent borrower satisfaction and large banks had 67 percent borrower satisfaction.

Credit Unions

- Credit unions are nonprofit financial cooperatives. Each one typically has one or a few branches and operates within a single metropolitan area or region.
- Like banks, credit unions have been consolidating. From 2011 to 2021, the number of credit unions nationwide decreased from 7,292 to 5,064, while the number of members increased from 90.8 million to 125.7 million and loan volume roughly doubled.
- Historically, credit unions have been devoted largely to residential mortgages and consumer loans. However, small business loans are making up an increasing part of their lending.
- Credit unions consistently have borrower satisfaction around 80 percent, the highest of any major small business financing option.

Community Development Financial Institutions (CDFIs)

- Community Development Financial Institutions (CDFIs) are a class of smaller nonprofit lending and depository whose primary purpose is to promote the economic development of low- and moderate-income (LMI) areas.
- Banks, credit unions, loan funds, and venture capital funds all can qualify as CDFIs if they follow the federal conduct and reporting guidelines.
- Specialized CDFI programs, such as the Native Initiatives and the Health Food Financing Initiative, are extremely important for providing particular funding and assistance to businesses that might not receive it through more general financing options.

Minority Depository Institutions (MDIs)

- Minority Depository Institutions (MDIs) are a class of depository and lending organizations whose board of directors and served population are both more than half people of color.
- MDIs suffered the worst of the 2008 financial crisis, in part because BIPOC consumers and borrowers were disproportionately affected by the financial collapse, especially surrounding residential mortgages.
- The number of Black- and multiracial-owned MDIs has decreased since 2001.
- When MDIs merge, they usually consolidate their holdings into other MDIs.

Finance Companies

- Finance companies are a loose category of companies that provide loans on less stringent terms than traditional lenders. This group is primarily made up of credit card companies, equipment leasing companies, and insurance companies.
- Finance companies provide supply-chain finance, a form of lending for business-to-business exchanges that helps make up short-term lack of capital.

- Small businesses increasingly use finance companies to meet short-term operating demands. Auto or equipment rental is becoming the most common application.

Fintech

- Short for "financial technology," fintech includes any financing options that integrate digital technology into the process of soliciting or distributing capital.
- Most fintechs fall in one of three categories: online balance sheet lenders (which usually fill short-term loans at high cost to the borrower), peer-to-peer lenders (which include all crowdfunding-type platforms), and lender-agnostic marketplaces (which group different financing options onto one platform for consumer comparison).
- Fintechs offer loans with loose credit requirements and short loan turnaround times but often have unreasonable repayment terms and do not provide counseling to borrowers.
- Online lenders have the lowest borrower satisfaction rates in the small business finance industry.

Small Business Administration (SBA) Products

- The SBA does not grant loans but rather insures loans distributed by its network of partner institutions, such as Small Business Development Centers (SBDCs), Women's Business Centers (WBCs), and local community organizations.
- The Microloan program is designed for small, short-term infusions of working capital (funds available for renting equipment, buying inventory, payroll, and other everyday operating costs).
- 7(a) loans account for the greatest volume of SBA-backed lending and are geared toward helping middle-aged businesses with needs for working capital or modest expansion.
- 504 loans are larger, long-term loans designed primarily for helping well-established businesses with expansion.

Equity Finance

- As opposed to debt finance, where funds are loaned and repaid with interest over time, equity finance involves investment in exchange for some ownership share in the company.
- Equity finance makes up about 2 percent of the overall small business finance market.
- Venture capital is a kind of private equity investment that focuses on financing startups and small businesses with high growth potential, usually ones that offer a novel technology or innovation. Providers of venture capital may work individually or in venture capital firms. Individual venture capitalists are called angel investors.
- Over half of the venture capital in the U.S. is concentrated in Silicon Valley and 18 percent is in New York City.
- Community Development Venture Capital (CDVC) offers a more accessible, mission-driven form of equity capital, especially for businesses in underinvested areas or with owners from historically disadvantaged backgrounds. However, CDVC remains a relatively small market.

Introduction

Although entrepreneurship is often touted as an arena of equal opportunity, there are major systemic barriers to realizing this ideal. The landscape of small business ownership in the United States does not reflect the demographic makeup of the nation. Although 12.6 percent of the U.S. population is Black, only 2.1 percent of small employer firms are Black-owned. Hispanic and Latino people are 16.9 percent of the population yet own only 5.6 percent of employer businesses.[1] Additionally, women owned just 21 percent of small businesses in the US in 2021.[2] In addition to being underrepresented among business owners, the financial situation of women and people of color who do own businesses is often worse than average. In 2020, 77 percent of Black owned firms and 79 percent of Asian-owned small businesses characterized their financial situation as "fair" or "poor," compared to the national average of 57 percent.

A preexisting landscape of wealth, income, credit, and asset inequality in the United States is an important reason for these differences in business ownership and success. A business owner's financial situation and social networks matter deeply to the vitality of their business. As of 2020, 88 percent of firms used their owner's credit score to take out a loan and 56 percent reported borrowing money from friends or family in the past five years for business purposes.[3] Accordingly, financial discrimination that affects individuals and their communities also affects the businesses they own. Differing outcomes among small businesses partially reflect the racial wealth gap and the racial asset ownership gap, which have continued to expand steadily over the past ten years.[4]

Although overall economic inequality sets up barriers to successful entrepreneurship for women and BIPOC business owners, discrimination within small business finance worsens the issue. Non-white business owners are 3 times more likely than white borrowers to be denied bank loans and, when approved, they have to pay higher interest rates. (In 2018, business owners of color paid an average interest rate of 7.8 percent, compare to 6.4 percent for white business owners.[5]) Mystery shopping experiments, which send matched pairs of borrowers who are identical in every respect except race to apply for loans, have consistently found evidence of racial discrimination by bank representatives in loan interviews.[6] The lending industry not only amplifies existing inequalities but also does a poor job of enforcing anti-discrimination laws.

Racial and gender inequality in entrepreneurship result in a large gap in revenue throughout the life cycle of a small business. Minority-owned businesses earn around $100,000 per year less than average in their first two years and this gap increases to around $700,000 per year after 11 to 15 years of operation (data based on 2014 estimates).[7] This feeds back into the widening divide in asset ownership and wealth between communities of color and the rest of the nation. Working toward an equitable future in which entrepreneurship is a tool for building generational wealth will require working to repair systems of exclusion in capital access and educating business owners about which forms of financing best suit their needs.

Navigating the Small Business Finance Industry

Demand for financing was fairly stable before the coronavirus pandemic, with 43 percent of small businesses applying for new credit in 2019, 43 percent in 2018, and 40 percent in 2017. Probably because of the Paycheck Protection Program (PPP) and changes in traditional lending brought about by the pandemic, the share of firms that applied for financing declined from 43 percent in 2019 to 30 percent in 2020, and the share of firms that received all of what they asked for declined from 51 percent to 37 percent over the same period. In the past year, as a result of the immediate

financial strains caused by the pandemic, businesses were much more likely to use this money for operating expenses than they were in earlier years.[8]

Generally speaking, the more selective a lender or the more work-intensive a loan application process, the more favorable the terms of the loan. For example, options such as credit cards and online lenders often involve quick turnaround rates (less than a week or sometimes even a day), are fairly easy to apply for, and are less likely to be secured (require collateral or need good credit). However, they often carry very high interest rates and short repayment schedules. On the other hand, traditional financing from banks or credit unions carries stringent credit requirements, specific requirements for collateral (something of value a borrower agrees to forfeit if they cannot pay their loan), and takes longer to obtain. However, it is usually easier to manage and is generally offered on more agreeable repayment terms.

What Is a Small Business?

Many people think of small businesses as local establishments with one or a few locations, offering consumer goods or specializing in small-scale manufacturing. Enterprises such as main street "mom-and-pop" shops, restaurants, landscapers, solo entrepreneurs, and other similar operations often come to mind.

However, there is no one formal definition of a small business. The Small Business Credit Survey (SBCS), which is administered annually by the Federal Reserve Banks, defines a small business as any enterprise with fewer than 500 full- or part-time employees. This casts a considerably wider net; only when compared to the largest companies in the nation could a 499-employee firm seem small. However, about 79 percent of the businesses that responded to the SBCS in 2019 had 10 or fewer employees.[9] Moreover, businesses that would benefit most from technical assistance and training around financing are likely small enough to not have a designated financial officer. In 2021, the vast majority (81 percent) of small businesses had no employees.[10] BIPOC-owned businesses are almost twice as likely to have no employees as are white-owned businesses.[11] In these kinds of businesses, the owner or primary operator is required to "wear many hats" to keep the business functioning.

Even the Small Business Administration (SBA) does not have a universal definition for small businesses. The definition varies by industry, and the SBA has an online calculator that businesses may use to determine whether they qualify.

This report is designed to assist microenterprises (businesses that employ fewer than ten people) and businesses without employees, as these are the kinds of small businesses that fit more intuitively into the common understanding of what a small business is and that are the large majority of small businesses in the U.S.[12]

Common Uses for Small Business Finance

	Definition and Uses	Providers	Best Fit
Startup Capital	Funds for product development, securing commercial space, initial hires, or any other costs associated with starting a business.	-Personal wealth and assets -Crowdfunding -Bank loans -Venture capital and angel investment	Venture capital and angel investment are beneficial because they do not require repayment but they are highly selective. Crowdfunding makes startup investment accessible to more small businesses.
Working Capital	Funds available for renting equipment, buying inventory, payroll, and other everyday operating costs.	-Finance companies -Online lenders -Lines of credit -Credit cards -SBA Microloans	A line of credit offers low interest rates, fast turnaround, and helps a business build a relationship with a lender.
Debt Refinancing	Settling existing debt by taking out a new loan, ideally on better terms.	-Bank loans -CDFI loans -Credit union loans	Banks offer low interest rates, which are good for refinancing. CDFIs and credit unions often help small businesses refinance predatory loans.
Expansion	Growing a business by increasing its capacity, hiring more employees, opening new locations, or moving into new markets.	-Bank loans -CDFI loans -Credit union loans -SBA 504 loans	SBA-backed 504 loans offer stable, low-interest long-term financing and are primarily designed for business expansion.

Banks

Banks remain the primary lenders for small businesses. In 2021, 45 percent of small businesses that received loans reported having taken a loan from a large bank and 49 percent reported having taken one from a small bank.[13] (These figures don't add up to 100 percent because some businesses received loans from both large and small banks.)

Commercial banks and savings and loan (S&L) institutions are the major types of bank. They differ in several ways. Commercial banks are often much larger, for-profit, and geared toward large business transactions. Although they may maintain numerous local branches, the bulk of commercial banks' business is not conducted for or with local small businesses. In contrast, S&L institutions, such as local banks and credit unions, focus more on consumer loans, residential mortgages, and some small business lending. They are also more community-oriented. Credit unions are always nonprofit.

There is a well-documented gap in small business lending between large commercial banks and smaller depository institutions. It is common to distinguish between large banks (ones with at least $10 billion in deposits) and small banks (ones with deposits of less than $10 billion). Although business lending is a larger part of the portfolios of smaller banks, large commercial banks originate a majority of small business loans by volume. As of 2016, S&L institutions held $54.8 billion in small

business loans, while commercial banks held $551.6 billion. S&Ls held $25.1 billion in microloans (loans of less than $100,000), compared to $132.8 billion for commercial banks.[14]

This gap in lending results in part from a long-term trend of bank mergers and acquisitions and in part from shrinking federal insurance for banks. S&Ls are reluctant to fill business loans because they are less profitable and involve higher risk than consumer loans. (This is especially true for startup loans, as younger businesses are more likely to default). Because small business lending is a small proportion of the portfolios of commercial banks (which mostly manage the accounts of large corporations), the risk of lending to small businesses is diminished. In comparison, S&Ls take on greater risk when lending to small businesses because a larger proportion of their portfolios are already devoted to riskier consumer loans.

Most small business loans by banks from 2017 to 2019 were small and short-term. During the 2017-2019 period, the most active category of small business loan was under $100,000. Business owners used these loans mainly for operating expenses and business owners usually backed them using their personal financial resources. Although large banks are more willing to make the riskier, less cost-effective small business loans, loan recipients are less satisfied with large banks than with small banks.[15] This is likely because small banks are better tied to local and regional markets, and provide "relationship lending," which includes coaching and more communication with a loan officer. This helps business owners develop soft skills such as time management, negotiation, and problem-solving.[16]

Large and Commercial Banks	**Small Banks and Savings Institutions**
• Greater capacity to make small business loans (in 2016, *$551.6 billion in small business and $132.8 in microloans)*. • For banks with over $10 billion in assets, loans to microbusinesses were around 1 percent of the loan portfolio. • Less likely to have a local focus or community embeddedness. • Poor borrower satisfaction (66 percent satisfied), some explicit dissatisfaction (7 percent dissatisfied), and more than a quarter of borrowers (27 percent) saying their satisfaction was "neutral."	• Lesser capacity to make small business loans (in 2016, *$54.8 billion in small business loans and $25.1 billion in microloans)*. • For banks with under $10 billion in assets, loans to microbusinesses were 4 percent of the loan portfolio. • More likely to offer relationship lending and respond to local needs. • Better borrower satisfaction (78 percent satisfied), lower explicit dissatisfaction (5 percent dissatisfied), and fewer borrowers saying their (17 percent) saying their satisfaction was "neutral."

Vehicles and Types of Lending

These are the most common options available through all depository institutions, including banks, credit unions, CDFIs, and Minority Depository Institutions.

- <u>Consumer loans</u>. Although these are not designed for business purposes, a majority of small businesses are started with funds borrowed by their owner. Around 55 percent of firms were financed by their owner in 2014, using consumer loans, home equity, personal

savings, or retirement funds. Only around 20 percent of these infusions exceeded $250,000.[17]

- Commercial and industrial (C&I) loans. These types of loans are typically borrowed for working capital or operating expenses, are short-term, and can be collateralized by the owner using their personal financial resources.

- Commercial real estate (CRE) loans. Real estate loans for operating premises are usually longer-term and the real estate is used as collateral. A business owner can lose the property they are financing if they fall behind on payments.

- Business lines of credit. A line of credit is a relatively inexpensive way to routinely fill a business bank account for operating expenses. A borrower requests money from their financial institution through a prearranged channel and then pays it back with interest over time. This approach is advantageous because it allows a business owner to borrow only when they need to, rather than paying interest on a single loan over longer periods of time, typically at lower interest rates than a credit card. Repeated punctual repayment also demonstrates a borrower's creditworthiness and can help build a strong relationship with a lending institution.

Who this is right for

Commercial banks are consistently the most used sources of small business finance. However, not all borrowers have equal chances of approval. Good credit history and enough personal assets to secure a loan are essential for success in obtaining a traditional term loan (a loan with a predetermined interest rate and repayment period) from a bank. Larger firms with less credit risk are more likely to be approved and larger loans are more cost-effective for banks to originate. CRE and C&I loans are likely best for businesses that have been stably established for some time and have had a chance to accumulate good credit, while lines of credit can help younger businesses accumulate good credit. The coronavirus pandemic resulted in fewer businesses applying for and receiving traditional term loans, probably because of the high demand for short-term capital.[18] Smaller businesses are likely to have better experiences with smaller banks, as they are more often locally focused or deal in individual consumer lending, which is more compatible with the needs of small businesses. This sort of lending facilitates the sharing of soft skills and results in better lender-borrower relationships.

Benefits

- Banks generally offer more reasonable interest rates on loans than lenders that offer unsecured loans. Interest rates on bank loans hovered below 6 percent during the last decade.[19]
- These loans involve dependable, regular monthly payments. The routine nature of repayment plans can more easily help a small business establish good credit that is distinct from that of the owner.
- Unlike some lenders, which attach specific requirements or restrictions on the uses of the cash, banks offer loans that are available for many purposes and in many different sizes. These could range from relatively small amounts borrowed on a line of credit and used for working capital to large long-term loans for major expansions.

- Once a small business owner is approved for bank financing, regular interaction with a banker (often called "relationship lending") can help the owner learn soft skills, be savvier with their financial decisions, and develop trust.

Drawbacks

- There are clear signs of race- and gender-based discrimination in bank loans to small businesses.
- Male-owned businesses were more likely to have received traditional financing than female-owned businesses and they also received larger loans. Black and Hispanic or Latino business owners were less likely to receive bank loans, although the size of bank loans did not differ by race.[20]
- An audit-type study of lending institutions reveals that banks not only approved fewer loans for entrepreneurs of color but also were less friendly in interactions, asked them for more personal financial information, and gave them less information about loan terms than they gave to white entrepreneurs.[21]
- Bank loans are one of the most difficult types of debt financing to obtain, especially for smaller businesses.
- Banks are often reluctant to lend to younger businesses because they are more likely to fail. (One- to two-year-old businesses are five times more likely to fail than nine-year- old businesses.[22]
- Banks prefer not to lend to small businesses because it is often harder for them to track down financial information about small firms. The proportional cost of figuring out creditworthiness is also high compared to the generally smaller loans microbusinesses require, making these transactions less profitable.[23]
- The market for bank lending became much less favorable for small businesses during the 2008 financial crisis because the perceived risks of lending to smaller businesses increased. Although loan opportunities for small businesses are improving, acquiring a bank loan remains more difficult than before the Great Recession.[24]
- Some evidence suggests that banks' investments in small businesses are lagging far behind the capital they accumulate. In New York City, deposits increased 100 percent between 2008 and 2016, while lending decreased by nearly 40 percent.[25]

Promising Practice: Racially Equitable Underwriting

Underwriting is the process of determining the risk to a lender associated with a potential borrower. It makes a big difference to how favorable the terms of financing are for a small business. It is a fairly secretive process and borrowers know little about it. Determining the viability of a loan usually revolves around the "Five C's of Credit": capacity, collateral, character, conditions, and capital.

- "Capacity" refers to a business's demonstrated ability to repay a loan. This involves an evaluation of cash flow, business expenses, and the way a business owner typically handles their money.
- "Collateral" means the assets, such as equipment, real estate, or other financial resources that a lender might appropriate in the event that the borrower cannot repay their loan.
- "Character" is a highly subjective measure but generally involves evaluating how financially savvy, organized, or trustworthy a borrower is.
- The "conditions" surrounding a business include the relative strength of the borrower's target market and general economic trends at the time of lending.
- For the purpose of underwriting, "capital" is the percentage of the cost of the project (for which the borrower is seeking a loan) that they have already invested. This is sometimes thought of as the borrower's "skin in the game." Having already invested significant resources demonstrates a borrower's commitment to the project.

Recent evaluations of inequity in bank lending have shown that the underwriting process helps keep borrowers from accessing the financing they need. Black-owned firms were more likely than any other group to report access to credit as their primary business concern in the past year and there has been a decline of 5 percent in bank loans to Black-owned businesses since the Great Recession.[26] Although broader conditions of economic inequality may make lending to certain business owners more or less risky, it is the norms and practices of lenders that result in Black-owned businesses' reduced access to capital.

Suggested changes to the way the "Five C's" are used in underwriting include:

- Using credit as an enhancement rather than an exclusionary tool. Borrowers with good credit could benefit from more favorable terms but those with bad credit wouldn't be automatically disqualified. Additionally, underwriters could consider data that do not usually appear in consumer credit reports, such as rent or bill payments, when evaluating an applicant's creditworthiness.
- Disentangling racial bias from evaluations of character. Implementing sensitivity training or educating loan officers about racial stereotypes surrounding financial literacy could help prevent them from allowing the borrower's race to influence their evaluation of a loan.
- While performing asset appraisals, underwriters should acknowledge the legacy of redlining in predominantly BIPOC neighborhoods and consider the value of that property if the intentional devaluation of property had not occurred.
- Improving access to equity investors for businesses that do not qualify for loans. If a business owner does not qualify for a loan, being able to direct them to an investor as an alternative source of capital could be very useful.[27]

These changes could help leverage the immense resources and convening power of the banking industry to direct resources where they are most needed rather than simply filtering for the most desirable borrowers. To reverse decades of *de facto* financial exclusion, lenders will need to revise their practices.

Credit Unions

Credit unions are nonprofit financial cooperatives owned by their members and usually operate at the metropolitan or regional scale. They are primarily depository institutions and provide consumer loans, mostly for home mortgages.[28] Like banks, credit unions have been experiencing a long-term trend of consolidation and loss of federal insurance. From 2011 to 2021, the number of credit unions nationwide decreased from 7,292 to 5,064, while the number of credit union members increased from 90.8 million to 125.7 million and loan volume increased from $560 billion to $1.17 trillion.[29]

Although credit unions still originate a very small percentage of small business loans, this proportion has grown substantially in recent years. Between 2012 and 2016, credit unions' outstanding business loans increased by 53.4 percent, while outstanding business loans from commercial banks increased by only 1.4 percent.[30] Credit unions provided less than 1 percent of all small business loans in 2003, but this figure grew to 7 percent in 2011.[31]

In 2013, around 10 percent of households running small businesses used credit unions as their primary financial institution.[32] An entrepreneur who has a good preexisting relationship with a depository lender for consumer finances might be expected to conduct their commercial financial business with the same lender. Borrowers report extremely high satisfaction with this avenue of lending. In 2019, credit unions had 80 percent borrower satisfaction and only 2 percent dissatisfaction. [33]

Vehicles and Types of Lending

Credit unions specialize in consumer and home mortgage lending. They offer business lines of credit and commercial loans but these are generally a smaller portion of their portfolios.

Who this is right for

Because credit unions currently specialize in consumer lending, they are probably a better lending option for microbusinesses or owners who are seeking simply structured, relatively small amounts of capital over shorter periods of time.

Benefits

- Credit Unions have the highest borrower satisfaction rate of any lender at 80 percent.
- Borrowing from credit unions carries many of the same benefits as borrowing from banks: low interest rates, regular monthly payments, and patient terms.
- Because credit unions are cooperatives serving local markets, borrowers have greater control over their finances, are more likely to find financial advice, and have a closer personal relationship with the lending institution.

Drawbacks

- Credit unions are primarily used for individual consumer credit and have relatively limited capacity for small business lending.
- Because they are largely geared toward providing consumer credit, credit unions are not a good choice for businesses seeking large long-term loans for expansion.

- Mortgages, unsecured credit cards, and auto loans make up an overwhelming majority of credit union-originated loans. These types of loans made up a combined 88 percent of credit union loans in each year between 2011 and 2021).[34]

Promising Practice: Greenlining and Community Reinvestment

The Community Reinvestment Act of 1977 (CRA) is one of the most important federal legislative tools for combating disinvestment in low- and moderate-income (LMI) communities. It is essential for the enforcement of fair lending to small businesses. Three agencies (the Federal Reserve Board, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC)) monitor whether large banks in the U.S. are adequately meeting the credit needs of LMI areas. Banks are evaluated every one to five years (depending on size and previous performance) in three areas: their lending practices (in commercial and residential loans), investment (in volume and number of equity and low-income housing tax credit investments) and services (the number of branch locations and overall ease of acquiring loans). These data are essential to holding large financial institutions with a presence in underinvested areas accountable for their practices.

Organizations such as the National Community Reinvestment Coalition (NCRC) and the California Reinvestment Coalition (CRC) leverage the power of the CRA to bolster the economic infrastructure of LMI areas across the U.S. During the 2019 merger of BB&T and SunTrust (which would result in the sixth-largest bank in the U.S.) the NCRC used the CRA reporting data to negotiate a $6 billion community reinvestment plan, which included $7.8 billion in small business loans, and the establishment of 17 bank branches in LMI or predominantly BIPOC neighborhoods.[35]

In 2021, the CRC and its affiliated organization, the Greenlining Institute, secured a $1.4 billion agreement with the Bank of California to increase investments in the state's LMI areas over the next five years. Most of this agreement was about investing in equitable housing and commercial development and bolstering the rights of LMI residents against displacement.[36]

The CRA has long been essential to ensuring the accountability of large financial institutions to their most vulnerable markets but it should not be taken for granted. A 2020 ruling by the OCC allows banks control over the locations and composition of their investments as long as the overall ratio of investment to bank assets meets the CRA requirements. This gives them more leeway to determine the structure and location of their investments based on profit and risk rather than the immediate needs of the communities they serve.

Community Development Financial Institutions (CDFIs)

Community Development Financial Institutions (CDFIs) are a class of smaller nonprofit lending and depository whose primary purpose is to promote the economic development of LMI areas. Several national networks of CDFIs, such as the CDFI Fund and Opportunity Finance Network, provide federal and private capital through research-informed programs that are designed to serve the needs of under-resourced, underbanked communities in the U.S. CDFIs lent more than $34 billion between 2011 and 2015, around $6.8 billion per year.[37] About 64 percent of CDFI lending during the same period went to neighborhoods with one or more indicators of being underserved. [38]Through the early 2000's, the CDFI industry grew rapidly but its growth has slowed in recent years. Between 2000 and 2005, the number of certified CDFIs grew from 415 to 750, while between 2014 and 2020 certifications grew from 917 to 1141).[39] This slight decline in the growth rate of CDFIs is likely related to the introduction of more stringent certification criteria.

The capacity of CDFIs remains far below the demand for their services. In 2010, the gap between funding requests from CDFIs and federal grants allocated to the CDFI Fund was $340 million. By 2016, this gap had widened to over $400 million. This suggests that CDFIs are underfunded, making it difficult for them to expand, invest in capacity building, and meet all the assistance demands of small businesses. The funding situation may explain why CDFIs prefer more profitable and sustainable products, such as real estate loans, over business and microenterprise loans, which made up only $3.2 million of $22.5 million lent by CDFIs in 2018.[40]

CDFI Certification

The CDFI Fund, a federally funded organization housed within the U.S. Treasury Department's Office of Financial Institutions, oversees certifications of CDFIs. In 2016, it added annual reporting requirements to the certification process. Certified CDFIs must now submit data to the Annual Certification and Data Collection Report (ACR) so that the CDFI fund can ensure compliance and collect performance data on the industry. These requirements may be related to the slight decrease in certification rates over the past half-decade but ultimately result in a more intelligent and effective landscape of CDFIs.

According to the CDFI Fund, to qualify for certification a financial institution must:

- Be a legal entity at the time it applies for certification.
- Have a primary mission of supporting community development.
- Principally serve one or more target markets. The definition of a CDFI target market is complicated but it generally refers to geographic areas or demographic groups that are disproportionately low-income.
- Be an insured depository institution or offer financial products as its primary business.
- Provide development services, such as technical assistance or counseling, in addition to financing.
- Maintain accountability to its target market.
- Be a non-governmental organization that is not controlled by any government agency.

There are four primary types of organizations that can qualify as CDFIs: banks, credit unions, loan funds and venture capital funds.[41] However, a business development organization (BDO) is eligible to become a certified CDFI if it meets all the above requirements. Certification applications and further compliance information are available on the CDFI Fund website.[42]

Vehicles and Types of Lending

CDFIs provide more development services than some other depository lenders, including loans for people or projects that might not otherwise qualify, transparent consumer banking services, more agreeable loan terms especially on unsecured loans, and more involved counseling services. Reporting requirements also keep CDFIs accountable to their community development mission.

Who this is right for

CDFIs provide targeted assistance to small businesses and entrepreneurs from underserved areas. Because of their dynamic approach and diverse capital streams, CDFIs can help particular industries, flexibly serve specific demographic groups of business owners in need, and adapt relatively quickly to meet on-the-ground need.

Benefits

- Unlike banks, CDFIs provide technical assistance and financial mentorship services as a standard part of their interactions with borrowers.
- Specialized CDFI programs, such as the Native Initiatives or Health Food Financing Initiative, can be more effective at funneling resources to businesses that fit within their specific demographic or mission-based guidelines. This is especially important for smaller businesses, which are often less able to obtain capital in more general financing markets or are seen by conventional lenders as less desirable borrowers.
- Although CDFI certification has slowed slightly over the past half-decade, this industry remains one of the most promising options for inclusive, effective small business finance and should be considered a best practice model in the industry.
- CDFIs are more likely to lend without collateral than banks.

Drawbacks

- Despite significant advances in the past 10 years, the coverage of CDFIs in the U.S. is still very thin. CDFIs are not well geographically distributed across the U.S. 31 states have 10 or fewer CDFIs while four (CA, LA, MS, and NY) have over 50.[43] In 2015, 27 percent of counties saw no CDFI lending.[44] CDFIs are concentrated in major cities and access in rural areas is more variable.
- Although the overall volume lent by CDFIs has grown, a lack of local coverage limits their ability to provide personalized or customized business assistance, which is one if their strong suits.

Minority Depository Institutions (MDIs)

A minority depository institution (MDI) is defined as any federally-insured depository institution that:

- Has 51 percent or more of its voting stock owned by minority individuals.
- Has a majority of its board of directors who are minority individuals.
- Serves a community that is predominantly not white.

MDIs include but are not limited to financial institutions collectively owned by a group of people of color (such as BIPOC-majority credit unions).[45] Of the 5,400 FDIC-insured institutions as of December 31, 2018, 149 were designated as MDIs.[46] MDIs are more likely to be commercial real estate lending specialists than are most community banks. In 2018, 34 percent of their loans were for commercial real estate, 18 percent were mortgage loans and 11 percent were commercial and industrial loans.[47] MDIs are more resilient than community banks, which are also strongly embedded in their communities. From 2001 to 2018, the number of MDIs declined by 9.1 percent while the number of community banks declined by 42.2 percent. Over this period, the number of Asian and Hispanic or Latino MDIs increased and the numbers of Black MDIs and multi-racial MDIs decreased.

Because they are the only organizations in the lending industry whose foremost concern is tailoring finance to meet the needs of particular racial or ethnic communities, MDIs are powerful players in the movement toward inclusive small business financing. MDIs originate a greater share of mortgage loans to borrowers in LMI neighborhoods and in neighborhoods with higher minority proportions of residents. MDIs originated a greater share of SBA 7(a) loans in LMI neighborhoods and neighborhoods with larger minority population percentages than did non-MDI banks.

Who this is right for

MDIs are designed to provide financial assistance to BIPOC business owners and often also serve low- and moderate-income areas.

Benefits

- MDIs are one of the most effective types of organization at providing financial support for people of color and addressing both the explicit discrimination within small business finance and larger market failures resulting from racial wealth disparities.
- Despite the ongoing consolidation of MDIs, primarily through mergers and failures, more than three-fourths of the assets of the merged institutions and 86 percent of the assets of the failed institutions remained with MDI institutions.[48] This demonstrates a continued institutional commitment to financially underserved populations.

Drawbacks

- There are too few MDIs to serve the needs of all business owners of color. MDIs are only around 2 percent of FDIC-insured depository institutions.
- The industry shows signs of significant decline, especially among Black-owned MDI's. The number of Black-owned MDIs dropped by half between the 2008 financial crisis and 2019.

Finance Companies

Finance companies include lenders such as mortgage companies, equipment dealers, insurance companies, and auto leasers. Despite offering many of the same products, finance companies are different from commercial banks because they are always non-depository institutions and typically deal in shorter-term loans for smaller amounts. Finance companies were the third most-used type of lender among small business owners who sought financing in 2020, making up 18 percent of the small business lending for that year. In 2020, borrower satisfaction with non-depository finance companies was around 67 percent, about the same as with large banks (66 percent).[49]

Vehicles and Types of Lending

- Supply Chain Finance. Finance companies commonly act as third parties to smooth the flow of capital between buyers and suppliers in non-retail commerce. For small businesses with less operating capital, especially those in manufacturing or who are deeply dependent on supply chains, being able to quickly borrow money against outstanding payments can be crucial to maintaining operations. Invoice financing and factoring are the most common methods of supply chain financing. In both invoice financing and factoring, a business sells its receivables or forthcoming profits at a discount to a finance company in return for early payment. In factoring, the finance company purchases the invoices, whereas in invoice financing the business collects on its invoices but pays the finance company interest to receive its payout earlier.
- Vehicle or Equipment Financing. A primary activity of finance companies is the leasing or rental of expensive equipment, machinery, or vehicles to small businesses. In 2017, vehicles or equipment made up 13 percent of the outstanding loans by non-depository finance companies to small businesses. [50]
- Credit Cards. Credit cards are functionally similar to lines of credit. Credit cards are more popular than lines of credit but they charge much higher interest rates. However, the credit requirements for credit cards are typically lower than for other financing options provided

by banks. Although flexible enough to rectify short-term cash-flow issues, credit card debt can accumulate rapidly because of credit cards' relatively high interest rates and penalty fees, and relying too heavily on this option can cause more problems than it solves. Probably because of pre-existing financial insecurity, BIPOC business owners rely on credit cards more often than white business owners. Black entrepreneurs use credit cards for business purposes at the highest rates. As of 2017, 17.6 percent of Black-owned businesses relied on credit cards, compared to 10.3 percent of white-owned businesses.[51]

Who this is right for

- Non-depository finance companies are often a good option for businesses that need loans for working capital, that are younger or smaller, or that have credit scores that are too low to qualify them for bank loans.
- Small businesses with lower credit scores turned to online lenders (35 percent) and nonbank finance companies (23 percent) much more often than did their counterparts with higher credit scores (11 percent).[52]

Benefits

- Finance companies offer relatively quick turnaround on a loan, which can help small businesses deal with cash flow issues.
- Finance companies are more flexible about their customers' credit than depository lenders and are less likely to have stringent collateral requirements.

Drawbacks

- It can be much more expensive to obtain cash or working capital through finance companies than through lines of credit or fixed-rate loans.
- Supply chain finance is typically useful only for manufacturing firms or other businesses whose profits come mainly from a few customers. It is not useful for retail businesses or most other business-to-consumer businesses.
- Although credit cards can help address short-term lack of money or bridge the gap between periods of more stable finance, failure to keep up with repayment can often worsen a business owner's credit and further prevent them from accessing good financing options in the future. This cycle can contribute to the racial credit gap.

Financial Technology (Fintech) and Crowdfunding

Fintech (financial technology) is a term used to describe virtually any sort of financing option that integrates digital technology into the distribution or solicitation of funding. Fintech companies, sometimes called "fintechs," leverage new financial technologies to offer finance in novel ways. There is no clear way to distinguish this sort of financing from traditional finance companies, banking institutions, or equity investment. Generally speaking, fintechs operate as intermediaries between a borrower and one or more of these other types of institutions. Fintechs are better distinguished by their networking capacity and the speed and ease at which they facilitate connections than by any particular type of financing.

Fintech platforms fall into three major categories:

- Online balance sheet lenders, which function much like payday lenders or merchant cash advance services.

- Peer to Peer (P2P) lending, which includes all crowdfunding-type platforms that connect borrowers and lenders. Kiva, GoFundMe, and Crowdrise are popular P2P platforms.
- Lender-agnostic marketplaces, which gather a number of lending options for a borrower to choose from, reducing search costs and time.[53]

These companies serve a variety of consumer and business clients but have been most influential for small businesses through supply chain finance, peer-to-peer lending, and several types of crowdfunding.[54] Crowdfunding fintechs are most effective at bridging systemic barriers to conventional finance.

Most industry-level data on online lending exist only since the passage of the Jumpstart Our Business Startups (JOBS) Act of 2016, which granted small business owners the ability to raise up to $1 million annually though crowdfunding.

Vehicles and Types of Lending

- Accredited investor crowdfunding. This approach involves raising unlimited amounts from high net worth investors.[55] About 13 percent of U.S. households qualify under the SEC definition of "accredited investor," a high net worth category whose members are eligible to participate in financial offerings that are not open to less wealthy households. Accredited investor crowdfunding accounted for $210 billion in startup investment in 2019. This sort of crowdfunding is essentially bulk, tech-driven angel investment and is not accessible to most small businesses.
- Regulation crowdfunding. In its first year as a federally recognized, regulated mode of capital access (May 2016 to May 2017), crowdfunding raised about $30 million and a total of 326 businesses tried raising capital this way.[56] In 2018, the regulation crowdfunding market had expanded to $54 million.
- Revenue- and profit-sharing crowdfunding. In this model, a business receives a loan funded by multiple investors and pays back the full amount based on future profits, similar to a merchant cash advance. In the United States, platforms include Ripple, Stripe, Coinbase, Square, and Propel.
- Equity crowdfunding. A business or entrepreneur trades securities in exchange for an investment in their company. These securities could be stocks, debt, revenue-sharing agreements, or other instruments. This is a more accessible option than accredited investor crowdfunding.[57]
- Reward- or donation-based crowdfunding. In this model, a business or entrepreneur solicits donations via a website, typically in small amounts from a large number of donors. In the case of reward-based crowdfunding, if the fundraising goal is met, contributors receive tangible non-financial gifts at a later point. Examples of this are GoFundMe, Crowdrise, and (although they were originally designed for consumer rather than business use) Paypal, Cashapp, and Venmo.
- Invoice trading. Digital technology has helped revolutionize supply chain financing. Unlike conventional factoring, which usually involves one intermediary between supplier and buyer, fintech platforms allow a business to sell its invoices at a discount to a pool of individual investors or firms. Although some sources consider invoice trading to be distinct from crowdfunding, it is included here because multiple investors participate.

Who this is right for

If used judiciously, online lenders can be a good option for borrowers who might not qualify for traditional loans.

- About 35 percent of firms with lower credit scores turned to online lenders in 2021, while only 11 percent of firms with high credit resorted to these options.[58]
- Startups and early-stage companies often turn to fintech lenders. About 43 percent of firms who participated in regulation crowdfunding during its first year were one year old or younger and 88 percent were five years old or younger.[59]
- Reward- or donation-based crowdfunding is best for retail microbusinesses or businesses without employees that have specific financing shortfalls (e.g., equipment replacement, upgrades, media campaigns). These businesses are likely to have a reward on hand, such as older merchandise. Because this sort of crowdfunding likely depends on an existing customer base, in most cases it is only appropriate for smaller amounts of funding.

Benefits

- Many online lenders offer very quick approval. For example, Lending Club advertises that potential applicants can receive a quote in minutes and that the approval and funding process typically takes seven days. Kabbage advertises same-day approval for small business loans. OnDeck can provide funding in a little as 24 hours.[60]
- Peer-to-peer loans are typically provided in smaller amounts over a shorter period than conventional bank loans. Therefore, they may fill a need for smaller, quicker capital infusions. (Lending Club offers loans up to $35,000, but most are between $5,000 and $10,000.[61])
- Because so many individual lenders are involved in crowdfunding, there is an opportunity to borrow large amounts at low risk.
- Maintaining full control over a company's assets is a primary benefit of peer-to-peer lending over equity crowdfunding.
- Anonymity between lenders and borrowers could also reduce discriminatory lending practices, which are common in conventional lending.[62]

Drawbacks

- Despite being fairly easy to obtain, short-term loans from online balance sheet lenders often carry exorbitant interest rates (sometimes far above 100 percent of the amount borrowed). P2P loans can carry interest rates that are twice or many times what traditional lenders ask.[63]
- Online lenders have some of the lowest borrower satisfaction rates of any small business finance options. Satisfaction with online lenders, which was already poor, decreased tremendously during the pandemic, from 37 percent satisfied in 2019 to 25 percent satisfied in 2020.
- Online lending is complicated. Terms can vary enormously between platforms, while lending practices in traditional finance are more standardized. Fintech is a realm of rapid innovation; new vehicles emerge as new digital technology does. The industry is seeing increased reliance on decentralized systems with multiple involved parties, which can be difficult for the average small business owner to navigate.
- There are virtually no counseling services attached to this sort of finance. In fact, online lenders pose a problem to more hospitable relationship-based lenders because their quick

turnaround times and ease of application may make them seem an attractive alternative to CDFIs, credit unions, or local banks.

Promising Practice: Crowdfunding for All

Prior to the 2016 JOBS Act, only individuals certified as "accredited investors" (a very small percentage of wealthy people in the U.S.) were eligible to invest in startups. In the years before regulation crowdfunding became legal, investment fintech existed largely to amplify and concentrate the investment potential of investment firms and high net worth individuals in these potentially lucrative ventures.[64] Through equity crowdfunding, small businesses could benefit enormously from infusions of capital without having to pay interest or provide collateral. However, this financing method remains largely unattainable for a majority of small businesses. A few existing platforms offer promise for a future with more inclusive startup equity.

Wefunder is an investment crowdfunding platform that provides some of the advantages of both traditional finance and fintech. In Wefunder's crowdfunding campaign model, individual investors can offer as little as $100 and are repaid if the campaign does not meet its goal. Additionally, each client is connected with a "lead investor," a counselor in charge of organizing the micro-investors on a campaign as well as advising the founder or business owner.

This application of fintech addresses several of the major perils of online borrowing. First, risk is distributed among many lenders, so interest rates can be kept relatively low. Second, the lead investor helps a business owner learn to master a digital lending innovation. Finally, equity investment avoids the aggressive repayment schedules that have come to characterize online merchant cash advance and short-term loan services.[65]

Small Business Administration (SBA) products: 7(a), 504, and Microloans

The U.S. Small Business Administration runs three primary programs designed to provide small businesses with financial support, technical assistance, and financial counselling. Each serves a slightly different type of business and the programs offer loans for different though complimentary purposes. Under the Microloan, 7(a), and 504 loan programs, the SBA insures local lenders. The SBA does not provide loans but rather insures loans distributed by its network of partner institutions, such as Small Business Development Centers (SBDCs), Women's Business Centers (WBCs), and local community organizations. An analysis of data from 2001-2004 shows that 504 and 7(a) loans go to firms that face a capital opportunity gap and that these loans are given on equivalent or somewhat more favorable terms than non-SBA-insured commercial loans despite higher risk.[66] However, more recent research suggests that the 7(a) local lenders are not reaching their intended borrower populations.[67]

Vehicles and Types of Lending

<u>SBA 7(a) Loan Program</u>
By applicants and volume, the 7(a) program is the largest of the three programs and makes up around 7 percent of small business lending nationally.[68] These loans, typically larger than Microloans and smaller than 504 loans, are used for working capital or operating costs. Although it has some overlap in loan size with both the 504 and Microloan programs, the 7(a) loan program is distinguished by its target market. These loans are mostly for medium-sized businesses seeking working capital rather than startups or later-stage small businesses seeking to expand. In fiscal

year 2020, the SBA approved 42,302 7(a) loans totaling nearly $22.6 billion. The average approved 7(a) loan was $533,075.[69] The SBA backs 75 to 85 percent of loans made by lending partners. Federally insured loans typically carry lower interest rates for business owners than uninsured loans.

Although these products were designed to assist businesses in underserved areas, the most recent data suggest that SBA loans may not be reaching their intended populations. Black- and Hispanic- or Latino-owned businesses appear to receive disproportionately small shares of SBA 7(a) loans; In 2018, Black-owned businesses were 9 percent of all businesses (including those without employees) but received only 3 percent of 7(a) loan dollars, while Hispanic- or Latino-owned businesses were 13 percent of all businesses but received only 6 percent. Asian business owners were overrepresented among loan recipients.[70]

SBA Microloan Program

The SBA Microloan program offers short-term loans up to $50,000, though lending partners are urged to maintain an average loan amount of less than $10,000. In 2020, the average Microloan was $14,434 and carried a 6.5 percent interest rate.[71] Although all SBA loan programs are meant for business owners facing a capital access gap, the Microloan program is tailored to the very smallest and earliest-stage firms. Microloans are often used for more than one purpose. In 2020, 80 percent of recipients reported using their loans for working capital, 20 percent used them for equipment, 16 percent for materials and supplies, and a third of a percent for inventory.[72]

According to the SBA, the Microloan program is open to all entrepreneurs but is meant especially for new and early-stage businesses in "underserved markets, including borrowers with little to no credit history, low-income borrowers, and women and minority entrepreneurs in both rural and urban areas who generally do not qualify for conventional loans or other, larger SBA-guaranteed loans."[73]

In 2020, of those firms that reported their race, BIPOC-owned or -controlled firms received 51.5 percent of the number of Microloans issued and 38.7 percent of the dollar amount issued, while making up 18 percent of small employer firms in the United States. Women-owned or -controlled firms received 46.6 percent of the number of microloans issued and 38.0 percent of the amount issued, while making up 21 percent of small employer firms in the U.S.[74]

Between 2010 and 2020, the number of SBA Microloans to small businesses rose from 3,729 to 5,890 and the total amount lent increased from $44.1 million to $85.0 million. In fiscal year 2020, startup companies received 30 percent of the number of Microloans issued and 28 percent of the volume lent.[75]

Microloans are for no longer than 6 years and terms are negotiated between borrower and lender. Although there is some overlap in loan size between smaller 7(a) loans and larger Microloans, the Microloan program is distinguished by its focus on seed- or very early-stage businesses and underserved business populations.

SBA 504 Loans

504 loans are on average larger than either 7(a) loans or Microloans. They are geared toward assisting with business growth and job creation. They are less desirable for working capital, equipment, or short-term needs. Because they are federally insured long-term bank loans, 504 loans are some of the most stable and desirable types of debt capital available. However, they are

designed almost exclusively for long-term expansion efforts and are not appropriate for most seed- or early-stage businesses.
These loans can be as large as $5 million. They are repayable over up to 10 years for equipment or up to 20 years for real estate. They are offered at fixed interest rates.[76] Interest is approximately 3 percent of the debt and may be financed with the loans.

Venture Capital and Angel Investors (Equity Investment)

This report has mostly been about debt financing, in which a business borrows funds from a lender and repays them over time with interest. In 2018, debt financing accounted for 98 percent of the small business finance market. Equity financing made up the remaining 2 percent.[77] With equity financing, a business receives funding from one or many investors in exchange for partial ownership of the company. Although some small business owners take on friends or family members as business partners, most larger-scale equity financing for small businesses is highly selective and is geared toward startups with high potential for growth.

Major Types of Equity Financing

Venture Capital. Venture capital firms provide funding to businesses in return for ownership shares of a company. Venture capital makes up the vast majority of the equity investment in the U.S.; it accounted for 93 percent of the $346 billion equity market in 2018. The total amount invested by venture capital firms grew from about $41 billion in 2012 to almost $80 billion in 2015 before declining slightly to about $71 billion in 2016. The number of firms receiving funding from a venture capital firm followed a similar trend, climbing from about 7,900 firms in 2012 to 10,400 in 2015 before falling to 8,400 in 2016.[78] In 2020, venture capital accounted for less than 0.5 percent of startup funding.[79]

Community Development Venture Capital (CDVC). A few venture capital firms are designed to provide equity capital to historically underserved populations, underinvested markets, or businesses with a demonstrated interest in community development. At its best, CDVC pursues a "double bottom line"—making profitable investments while also creating jobs, building wealth, and spurring entrepreneurship in low-income or underinvested communities.[80] This industry expanded rapidly from the late 1990s to the early 2000s. It is backed by two federal programs, the New Markets Venture Capital Program and the New Markets Tax Credit.[81] Whether or not a venture firm qualifies as a mission-based investor depends largely on federal evaluations under the CRA.

Angel Investors. This term refers to individual venture capitalists who invest in high-potential business startups, often in their immediate social circles or family. In 2018, 334,000 angels invested $23.1 billion into slightly over 66 thousand business ventures, with most individual investments falling between $5,000 and $100,000. Angel investment was only 7 percent of the equity finance market in 2018.[82]

Who this is right for

Businesses with extremely high growth potential are usually the ones that receive equity financing from venture capital firms (including CDVC firms) or angel investors. Although micro-venture capital exists, in a majority of cases this sort of investment is made with the expectation that the investors will receive a return on their investment in the form of an initial public offering (IPO). Becoming large or lucrative enough to "go public" is not something most small businesses desire or should expect.

Benefits

- As it is not loaned, this capital carries no risk of defaulting on payments. Collateral is not required.
- Venture capital and angel investment come with financial and operational guidance. An angel investor or venture firm often has a wealth of prior business knowledge to draw on and acts as a counselor to the entrepreneur they are funding.

Drawbacks

On the whole, equity capital is very exclusive.

- Venture capital is highly concentrated in technology and economic hubs, especially Silicon Valley and the New York metropolitan area.
- The networking required to obtain venture capital is impossible for many small business owners because they do not have the time (months or years) to break into the right social circles.
- All equity investment comes with diminished control over the fate of the company. Owners may not have a say in the future acquisition of the company or management of its finances.
- This market remains exclusionary toward people of color and women.[83]
- Around 2 percent of the venture capital granted in 2018 went to all-female founding teams, around 10 percent to mixed-gender teams, and around 75 percent to all-male teams. This likely reflects the lack of diversity within venture capital firms; 71 percent of venture firms have no female partners.[84]

Promising Practice: Impact Investment

Equity investment is a highly selective form of finance that is not right for most small business owners. Most angel investors and venture firms support a business with the expectation that it will expand rapidly and ultimately become highly profitable. Equity financing usually excludes startups and small businesses that are not in research and development or rapidly expanding markets.

Impact investment, which currently constitutes a small corner of the equity finance industry, considers the possible social or environmental benefits in determining investments. Although measuring social impact in any standardized way is difficult, impact investing represents one of the most promising developments in expanding the enormous power of equity capital to a wider variety of businesses.[85]

The ICA Fund, a Bay Area-based investment group and business accelerator, is a great example of the potential of impact investment to address the failures of the equity capital market. In selecting funding recipients, ICA considers whether a business aligns with mission-driven criteria, such as commitment to closing the racial and gender wealth gaps and fair profit distribution among its workforce, in addition to return on investment. ICA further improves flexibility by offering two investment products directed to different points in a business' lifecycle: a shorter-term "seed" package and a longer-term, larger-sum "growth" package. ICA gives preference to businesses that participate in its technical assistance and accelerator programming. ICA offers loans in addition to equity. Whereas denial by a conventional investor leaves a business with little recourse, the variety of options available through ICA makes pairing a recipient with the correct form of capital much more likely.

Challenges for Early-Stage Businesses

A majority of startups rely in some way on the financial resources or credit of their founders. In 2020, 88 percent of firms used their owner's credit score to start the business. Of the 40 percent of firms that had up to $100,000 in debt, a majority used an owner's personal financial resources as collateral.[86] By one estimate, 69 percent of small emerging businesses used personal loans for business purposes.[87] As most people do not have the cash on hand to pay the upfront costs of renting a space, purchasing equipment, producing merchandise, or undertaking any of the other major activities necessary to lift a business off the ground, many budding entrepreneurs turn to their social networks. In 2019, 56 percent of small business owners reported borrowing money from friends or family in the previous 5 years for business purposes.[88] Therefore, whether they borrow capital through formal or informal avenues, the financial health and assets of an individual are closely related to their ability to effectively start and scale a business. As a result, wealth inequality by race and gender makes it harder for women- and BIPOC-owned businesses to succeed.

The proportion of businesses started by women has grown since the early 2000's. Women founded only 4 percent of small businesses that were founded in 2001, but accounted for 21.6 percent of small business formation in 2018.[89] However, women are still far from reaching parity with men in business ownership. Although this is partly a result of the broader system of sexism and gender roles in the United States, the unequal treatment of women in startup finance plays a large part in the underrepresentation of female entrepreneurs. In 2018, the average startup cost of a women-owned business was $54,000, compared to $80,000 for men. Women were only quarter of people seeking venture capital in 2018, and received 17 percent of the funding they requested, while venture capital-seekers overall received 23 percent.[90]

People of color also encounter systemic barriers in obtaining equity capital to start and scale their businesses. Black-owned businesses that seek equity funding ask for only about $35,000 to start their businesses, while white-owned businesses ask for $106,000 on average. Black-owned businesses that obtain equity capital receive an average of 22 percent of the amount they requested, compared to 23 percent for all businesses.[91] These disparities exist partly because venture capital firms are overwhelmingly run by white men. People of color are only 5.3 percent of angel investors and 21 percent of partners (high-ranking employees who often own shares of their company) in venture capital firms. Of these non-white firm partners, Asian partners were 17 percent, and Black and Hispanic or Latino partners were each 2 percent.[92]

In some cases, the desire and need for financing among disadvantaged entrepreneurs exists but discrimination and self-perpetuating systems of wealth inequality prevent these individuals from accessing the startup funds they need. In other cases, entrepreneurs are reluctant to pursue financing. Either from a lack of knowledge about the available options or a lack of trust in lending or investing institutions, some individuals may not seek out the capital necessary to seed their business.

This phenomenon, known as the "trust gap," makes people of color, immigrant entrepreneurs, and business owners whose primary language is not English less successful in securing loans. Around 60 percent of Black entrepreneurs do not apply for the loan they need because they think they will be denied, compared to the 47 percent average among all entrepreneurs.[93] Discouragement for businesses located in predominantly BIPOC neighborhoods has been estimated at 22 percent,

compared to the 15 percent average for all businesses.[94] What's more, there is a lack of reliable data on business owners who forgo formal financing, so lending to or investment in businesses whose owners who feel excluded by the financial system is probably much lower than estimated.

Evidence of discrimination shows that these reservations are warranted. But a sweeping dismissal of all forms of institutional finance could keep entrepreneurs from connecting with more productive financing options and ultimately limit their success. Erasing the trust gap will require addressing the effects of generational poverty, low educational attainment, language barriers, international differences in business practices, and other factors that result in discouragement for so many entrepreneurs.[95] Much of this is beyond the scope of work a BDO can realistically carry out. However, increasing the prevalence of multilingual materials and hiring staff whose cultural background reflects that of a BDO's clientele could help these business owners overcome language barriers and become more familiar with U.S. business practices.

Conclusion: The Future of Small Business Lending

It is difficult to speculate about the future of small business finance in the years following the coronavirus pandemic but some features of the financing system are unlikely to change soon. If the still-incomplete recovery from the 2008 economic recession is any model, inequity in small business finance in the years after COVID will not improve immediately, making efforts to identify and overcome existing failures within the financial system all the more crucial.

Since 2008, banks have been reluctant to fill smaller or less profitable loans. The loosening of the requirements of the CRA means that the largest, most stable financers of small businesses are unlikely to expand assistance on the basis of need in the coming years. Current trends show that online lenders are increasingly serving the neediest borrowers, whom banks usually view as the least desirable candidates for loans. In 2020, the overall applications to online lenders decreased by around a third. (Twenty percent of businesses who applied for a loan in 2020 elected an online lender, as opposed to 33 percent in 2019.[96]) However, applicants with medium to high credit risk were far overrepresented (35 percent) among fintech applicants when compared to businesses with better credit (11 percent). If these trends continue, the most predatory lenders will concentrate further on the borrowers with the greatest and most urgent needs and stand a good chance of outcompeting better options, such as CDFIs or traditional lenders.

There are also several promising changes occurring within small business finance. Companies that harness digital innovations for inclusive community-based development, or that aim to bridge structural gaps between abundance of capital and demonstrated need, are uniquely positioned to overcome the social and technological barriers that currently exclude many entrepreneurs. If they can do this, they may be able to push traditional financers toward more innovative or flexible solutions. The expanding capacity of CDFIs and community-based lending institutions is one of the more promising trends in the pursuit of fair and inclusive small business finance. Although securing funding for their expansion will not be easy, the enormous surplus demand by CDFIs for federally backed funding over the past ten years indicates that the groundwork for considerable expansion and capacity-building in this industry has already been laid.

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