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PATH TO 15 55

Equitable Underwriting Will Unleash Capital for Black-Owned Businesses

Tynesia Boyea-Robinson

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FURTHER READING

- "Closing the Black employer gap: Insights from the latest data on Black-owned businesses," Brookings
- "Investor Blueprint for Racial and Economic Equity," Corporate Racial Equity Alliance
- "Who is driving Black business growth? Insights from the latest data on Black-owned businesses," Brookings
- "Black-owned businesses in U.S. cities: The challenges, solutions, and opportunities for prosperity," Brookings
- "To expand the economy, invest in Black businesses," Brookings
- "How Usable Capital Will Unleash Black Business Growth," Path to 15|55

ABOUT

Black business ownership is a proven path to wealth and job creation that concurrently stimulates the U.S. economy. Deep-rooted, systemic challenges limit their growth-inhibiting economic prosperity and preventing generational wealth.

Path to 15|55 is a collaborative initiative, among experts from every sector, designed to grow Black businesses and their communities based on research that proves: if just 15% of Black-owned businesses are able to hire at least one more employee, the American economy could grow by $55 billion.

Path to 15|55 is galvanizing government agencies, nonprofits, financial institutions, and investors working to achieve major social impact with practical, innovative strategies.

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EXECUTIVE SUMMARY

Many assume underwriting is a set, standard analytical decision-making process, but in reality, it has been developed based on generations of assumptions. Financial institutions and other investors rely on various tools and processes to determine what makes a “risky” investment, many of which are informed by racist stereotypes.

For example, a credit score is a common tool used in underwriting processes for a loan, but credit scores are derived from, in part, an individual’s net worth or collateral, which is frequently tied-up in homeownership. Because of historical segregation and redlining, people of color were denied access to homeownership to build generational wealth, causing them to on average, have consistently lower credit scores.

Many smaller, specialized lending institutions have taken on more equitable underwriting practices. These practices have been proven, yet need to be scaled through adoption in larger, more mainstream organizations. Path to 15|55 created a “Community of Action” to understand what it would take to spread these practices across the financial industry.

To create more equitable underwriting practices, financial institutions need to undertake a change management process with these five steps:

- **Review existing policies or practices.**
- **Determine which elements of the existing practices can be altered or changed to produce different outcomes.**
- **Determine what outcomes you want to change and how to measure them.**
- **Implement a “pilot” change to the underwriting process and track the results, collecting data on the prioritized outcomes.**
- **Review the data and change the practices as needed.**

Lenders and other financial institutions that take these steps can create a more equitable business ecosystem and help Black-owned businesses grow and thrive. Making these changes will support the unleashing of more usable and accessible capital. Each step will be explored in more detail within the playbook.

CURRENT STATE OF UNDERWRITING

THE UNDERWRITING PROCESS—LIKE THE NOTION OF RISK—IS SEEN AS STANDARD, BUT IS ACTUALLY SOCIALLY CONSTRUCTED. THE PROCESS RELIES HEAVILY ON ASSETS AND COLLATERAL, WHICH PUTS PEOPLE OF COLOR AT A SYSTEMATIC DISADVANTAGE.

Generations of discriminatory practices have limited the ability of people of color to acquire and build wealth, and in some cases, this wealth has been stolen from them outright or through policy. Redlining deemed neighborhoods of color as unworthy of investment, preventing those residents from building wealth through homeownership. Thriving communities of color—such as “Black Wall Street” in Tulsa, Oklahoma—were frequent targets of white violence and destruction. Local and national policies, such as the Federal Highway Act or the Urban Renewal movement, uprooted communities of color in the name of “progress”, destroying those communities based on the dictations of white officials who had no ties to the neighborhoods. This has allowed white people to accumulate wealth at the expense of people of color. Because white people have higher levels of wealth (up to seven times by some estimates), they are more likely to be seen as a “safe” investment because of the amount of assets they are able to present to the underwriter. This puts them at an advantage to secure loans. In addition, research shows that,

REGARDLESS OF THE CHARACTERISTICS OF AN INDIVIDUAL, PEOPLE ARE MORE LIKELY TO CONSIDER SOMEONE WHO IS SIMILAR TO THEM AS A “SAFE” INVESTMENT.

Almost 98% of assets under management are controlled by white men, which puts people of color at a further disadvantage. Financial institutions and other investors rely on various tools and processes based on assets and wealth to determine what makes a "risky" investment. For example, a credit score is a common tool used in underwriting processes for a loan, but credit scores are derived from, in part, an individual's net worth or collateral, which is frequently tied-up in homeownership. Because of historical segregation and redlining, people of color were denied access to homeownership to build generational wealth, and even now they are more restricted to "Black" or "brown" neighborhoods, which still suffer from underinvestment and lower property values.

This leads to lower credit scores, even though the individual may not be any more "risky" of an investment than a white person with similar characteristics. This limits the full potential of our economic system:

PEOPLE OF COLOR REPRESENT ABOUT 40% OF THE POPULATION, BUT JUST 18% OF BUSINESSES ARE OWNED BY PEOPLE OF COLOR.

Unlocking this potential for additional business through an equitable underwriting process could help grow our economy and add thousands of jobs to our economy. Looking at Black business alone, if just 15% of Black-owned businesses are able to hire at least one more employee, that would add around 600,000 jobs to the economy.

EQUITABLE UNDERWRITING WILL UNLEASH CAPITAL FOR BLACK-OWNED BUSINESSES

Underinvesting in Black-owned businesses leaves money on the table for our economy. Our current underwriting process limits the ability for Black-owned businesses to access capital, grow, and thrive.

If we want to unlock the potential of Black-owned businesses, we must create a more equitable underwriting process. This will unleash more capital and better structured capital that fits the unique needs of Black-owned businesses.

Equitable underwriting processes have been proven, but to secure greater adoption, institutions need to become comfortable with change. To get to long-term change within the industry, we recommend these financial institutions take the five steps mentioned earlier.

CASE STUDY: COMMUNITYWORKS

Problem

Debt-service coverage ratio (DSCR) is a frequent underwriting metric to determine whether or not a business can receive a loan. A DSCR of 2 means that the business can cover twice the amount of its debt with revenue. However, many small businesses have low DSCRs, which automatically disqualifies them from a loan, even if they have strong revenue projections.

Solution

CommunityWorks established a lower DSCR standard, focused more on revenue or growth projections, rather than current debt and revenue. They will focus on start-ups who meet specific criteria and allow them to present to a Community Advisory Council, who will make the decision about whether or not the business should receive a loan.

CommunityWorks
Building People & Places

CommunityWorks is a CDFI providing resources to support small business growth, entrepreneurship, affordable housing and homeownership.

5 Cs of Credit

Underwriting typically considers “5 Cs” to determine if an investment is risky or not: collateral, capital, character, capacity and condition. These 5 Cs are all grounded in misguided assumptions about risk that create barriers for equitable investing.

CURRENT USES OF THE 5 Cs OF CREDIT

COLLATERAL

Asset as security for a loan

- Real estate
- Vehicle, equipment
- Cash, savings, personal assets of the guarantors

CAPITAL

Money contributed by the borrower/down payment as a % of the total need shows lenders you're serious

CHARACTER

Reputation for paying back debts

- Credit reports and credit scores (payment history) “Your personal integrity and good standing—and the integrity and standing of those closely tied to the success of the business—are critically important.” B of A
- Perception and reputation for honesty and integrity.
- Background, education, industry knowledge and experience, licensing
- Lack of criminal record

CAPACITY

Ability to repay a loan

- Debt-to-income (DTI) ratio (1.25+)
- Length of time in business/employed at their current
- job and future job stability
- Payment history of current loans and expenses.

CONDITIONS

- Loan interest rate and principal
- Use of loan
- Outside of the borrower's control: economy, industry trends, legislative

HOW THE 5 CS CREATE BARRIERS

Each of the 5 Cs is influenced by the economic history of systemic racism. We cannot use these criteria to consider what is a “risky” investment without an analysis of how each further perpetuates exclusionary practices that keep people of color from being full participants in our economy.

Here are the different ways the 5 Cs are problematic due to the influence of systemic racism:

	COLLATERAL	CAPITAL	CHARACTER	CAPACITY	CONDITION
SYSTEMIC RACISM HAS LED TO	• No or reduced home equity • Less established Black-owned businesses • Greater reliance on service businesses, with less assigned value • Reliance on alternative ownership models to grow businesses	• Lower wealth – homes, home values, savings, retirement accounts • Less friends and family money • Fewer networks with money and connections	• Lack of or little credit history • Lower credit scores • Implicit and/or explicit bias • Targeted criminalization and incarceration • Industry credit reporting processes, resulting in negative reporting, but not positive reporting of a person's repayment activity	• Higher debt • Higher cost debt • Lower appraisals • Lower incomes and income stability • Smaller, lower profit margin, and newer businesses	• Smaller, lower profit margin and newer businesses • Different legal systems to navigate

OVERCOMING BARRIERS WITH EQUITABLE UNDERWRITING

Equitable underwriting is a proven practice. Through greater adoption, we can break down the barriers created through systemic racism.

Many pioneers are already doing so:

COLLATERAL	1863 Ventures offers loans with little to no collateral requirement, instead relying on a revenue-based financing model.
CAPITAL	City First Enterprises (CFE) offers homebuyers a downpayment assistance of up to 20% of the purchase price. This is in the form of a lower-interest loan that doesn't require payment or accrue any interest for the first five years, allowing people to purchase a home without a down payment.
CHARACTER	The Credit Builders Alliance acts as a bridge connecting nonprofit organizations to the credit bureaus, offering technical assistance and training resources to help individuals with poor or no credit participate in the mainstream financial system by building credit. Many lenders are reducing or removing credit score requirements, others are interviewing borrowers to learn more details and context about any negative credit history, and many are adding more data sources to show a more complete picture of an applicant's repayment history.
CAPACITY	Founders First works with companies that may not have capacity for high growth investment opportunities, but have decent cash flow that can be leveraged for gradual, sustainable growth.
CONDITION	Runway, a financial innovation firm based in Oakland, CA, pairs funding with weekly coaching and a peer community to not only improve knowledge of a borrower's conditions, but help strengthen those conditions which helps set the partnership up for success.

CASE STUDY: GROWTH PARTNERS ARIZONA

Problem

In Arizona, small businesses are struggling to secure microloans and are falling victim to predatory lenders. Most lenders require collateral, two or more years in business,
and other traditional underwriting criteria, leading to only about 0.1% of small businesses that apply for a loan becoming approved.

A program of

Growth Partners ARIZONA

Solution

Growth Partners Arizona partnered with a local community development corporation and nonprofit organizations to deploy microloans through their programs,
including a BIPOC Loan Fund, a Green Loan Fund, a Revenue-Based Loan Fund, and a KIVA Managed Fund. They undertook a six-month program to test and validate/confirm assumptions around capital needs, viability of the project, statement interest and support, and evaluation of models and potential impact.

Growth Partners Arizona is a mission-driven CDFI that is committed to building an inclusive economy for local nonprofits and small businesses.

FIVE QUICK STEPS TO CREATING A MORE EQUITABLE UNDERWRITING PROCESS

QUICK START GUIDE

TO BEGIN ON A PATH TO EQUITABLE UNDERWRITING, FOLLOW THESE STEPS:

01 Review existing policies or practices within the financial institution to determine what may be creating inequitable results. These include things like a reliance on credit scores or placing disproportionate burdens on small businesses for additional information to receive a loan.

02 Determine which elements of the existing practices can be altered or changed to produce different outcomes. Resources to support this analysis include this playbook, Beneficial States Equitable Banking Standards, The Investor Blueprint for Racial and Economic Equity, and Due Diligence 2.0 Commitment.

03 Determine what outcomes you want to change and how to measure them. For example, you could choose to track and expand the number of small businesses in the lending portfolio.

04 Implement a “pilot” change to the underwriting process and track the results, collecting data on the prioritized outcomes.

05 Review the data and change the practices as needed. As the pilot is implemented and refined, continue to make additional changes to your underwriting practices through other pilots in an iterative feedback loop process.

CASE STUDY: IMPACT VENTURES

Problem

There is a “missing middle” in capital deployment. Many traditional lenders have very inflexible capital, yet lend large loans. The most flexible lenders give loans at sizes below $50,000-$100,000. Therefore, there is a gap for flexible capital in the $50,000-$250,000 range.

IMPACT
VENTURES

Solution

Impact Ventures offers loans in this “missing middle.” To better serve these borrowers, they are co-creating an underwriting rubric that reimagines and redefines the traditional 5C's of credit. They will establish a Community Advisory Council to create that underwriting rubric that puts people, equity, and justice back into the center of the underwriting process.

Impact Ventures offers accelerator programs that provide critical mentorship, education, technical assistance, connections, and resources for diverse and under-resourced entrepreneurs.

Equitable Underwriting Community of Action

To help identify and solve these barriers to equitable underwriting, Path to 15|55 convened a "Community of Action" to tackle the subject. The Equitable Underwriting Community of Action was designed to help institutions adopt proven practices to remove barriers to more equitable underwriting practices.

Communities of Action are focused efforts to advance one or more of the Path to 15|55 KPIs. Through trusted partnerships, we develop a 6-12 month cohort model to build capacity and share lessons learned broadly with the field. In addition to peer learning and capacity building, the Path to 15|55 Fund serves as catalytic capital to incentivize innovation and behavior change.

Equitable Opportunities: The Equitable Underwriting Community of Action

The Equitable Underwriting Community of Action (COA) was a six-month virtual cohort program for banks and financial lending institutions to adopt equitable underwriting practices at their institution and demonstrate increasing access to debt financing to Black business owners. The Community of Action was convened by Path to 15|55, with our curriculum partner, Beneficial State Foundation.

The Equitable Underwriting Community of Action cohort was comprised of financial lending organizations and institutions that touch nearly every region of the United States.

The group met regularly over the six months to identify common challenges and experiences in implementing equitable underwriting.

Through its efforts, the Community of Action jump-started an ecosystem for greater adoption of equitable underwriting among CDFIs as well as large financial institutions. We determined best practices and identified lessons learned, as well as created a community of both lenders and borrowers dedicated to the implementation of equitable underwriting.

TOOLS

The COA relied on many change management tools to support the adoption of equitable underwriting practices. One helpful tool was the **Change Readiness Assessment** , developed by the University of California- Berkley, which supports any type of change initiative.

CASE STUDY: PARTNER COMMUNITY CAPITAL

Problem

Relying on credit scores led to a denial of loans that would have gone to creditworthy businesses and support their growth.

Partner Community Capital (PCAP) is a non-profit community lender that uses a triple-bottom-line framework to generate financial returns along with social and environmental good.

Solution

Partner Community Capital hid the credit score from the underwriting report for loans under $200,000. Instead, they developed an assessment matrix to more holistically gauge "ability to repay/character." They also established a procedure for reading/interpreting credit report, questions to ask, and when to add alternative credit options so lenders and underwriting are consistent in their approach.

Partner Community Capital™

One of our major insights from the experience centers on the barrier of regulation. Many banks and CDFIs (incorrectly) assume that regulations prevent equitable underwriting practices.

The concern of regulation creates incentives for lending institutions to focus on the downside of new investment opportunities, rather than considering the up-side benefit.

Additionally, the threat of disciplinary action keeps institutions from experimenting with different approaches.

CASE STUDY: ICA

ICA provides coaching, connections, and capital to grow Bay Area businesses and close the gender and racial wealth gap.

Problem

VC-style equity investments focus on a high growth model with traditional exits that involve a large initial public offering (IPO) or similar. Many companies do not fit the typical profile for a VC investment, but have decent cash flow that can be leveraged for gradual, sustainable growth. Ignoring this market leaves out potential investment opportunities that can be leveraged for sustainable growth.

Solution

ICA established a new equity investment vehicle that addresses these problems, structured as such:

- Generates short-term liquidity for the investor via equity redemption
- Is more flexible than debt by using revenue/profit share instead of fixed schedule
- Maintains long-term equity upside through residual equity or warrants
- Does not require collateral/security
- Uses social impact milestones to give equity back and align incentivize with founders

THREE PATHS TO MOVE FORWARD

Besides change management, the other major barrier to success is fear of regulation. On this issue, the Community of Action proposed these paths forward:

01 **Establish standards around equitable underwriting and banking to help all players get on the same page about what is and is not possible**.

02 **Continue pilots with different approaches to adopting equitable underwriting**.

03 **Spread the message around equitable underwriting**.

PATHS TO MOVE FORWARD

01

The first is to **establish standards around equitable underwriting and banking to help all players get on the same page about what is and is not possible**. This work has been largely completed by our partner in the COA, Beneficial State Foundation, which published equitable banking standards. These standards, while broad and generally focused on equity, rather than equitable underwriting, offer a starting point for banks and other financial institutions to understand the value of equity in loans and other financial products.

PATHS TO MOVE FORWARD

02

The second is to **continue pilots with different approaches to adopting equitable underwriting**. Many of the COA members shifted their underwriting processes during the COVID lockdowns out of necessity. Some of these modifications included shifts in how credit scores were used, as well as reliance on collateral. Many of these changes are similar to ones required by an equitable underwriting process. Now that we are a few years removed from these shifts, we can look at their effects in practices and help inform future adoption. The results can help make the case for equitable underwriting being a safe and secure way to approach loan distributions.

03

Third and perhaps most importantly, we recognized that **more work needs to be done to spread the message around equitable underwriting**. CDFIs and collaborative groups like Path to 15|55 should not be the only entities pushing equitable underwriting practices. Regulators and large financial institutions should also be supporting these efforts as a signal that equitable underwriting is possible, needed, and meets fiduciary responsibilities of lending institutions. To that end, Path to 15|55 is exploring a partnership with the Federal Reserve to convene a group of financial institutions specifically on this topic to set a baseline understanding of what is possible and secure buy-in from high-profile leaders in the industry.

CASE STUDY: SELF-HELP VENTURES FUND

Self-Help is a nonprofit loan fund capitalized with loans and grants from foundations, religious organizations, corporations, and government sources.

Problem

Similar to Growth Partners Arizona, small businesses were struggling to access microloans, limiting their ability to secure necessary capital and scale and grow their operations.

Solution

Self-Help expanded its small business lending to the entire credit union footprint, offering an unsecured working capital loan to existing businesses. To do this, the organization shifted away from using collateral in their underwriting processes, something they always required, as they found collateral does not impact borrower repayments. This allowed them to be more responsive and transparent to the needs of their borrowers.

MAKE THIS PROMISE A REALITY

We can unleash the capital needed to support Black-owned businesses and recognize the promise of Path to 15|55. Equitable underwriting is a critical tool for doing so. Through the five steps outlined in this playbook, financial institutions can overhaul their practices and develop more equitable processes that improve their bottom line.

The “5 Cs ”of credit are holding us back. If we are to capture the additional $55 billion to the economy through the growth of Black-owned businesses, we need to design a new, equitable solution for the financial sector. Path to 15|55 will continue to act on the findings to make this promise a reality.

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