

THE COLOR OF THE CAPITAL GAP

Increasing
Capital Access
for Entrepreneurs
of Color in
Massachusetts



ACKNOWLEDGMENTS

This report was catalyzed by the Economic Inclusion Strategy team at the Boston Foundation, led by Corean Reynolds and Anna Jen. The Economic Inclusion Strategy's goal is to break down barriers for entrepreneurs of color, so that they can launch and grow their enterprises, thus building wealth for themselves and their communities. This is done by making grants to business serving organizations, creating access to capital through the Business Equity Fund, and research and thought leadership in the field to inform the work. The team is grateful to Orlando Watkins and Stephen Chan for their continuous support and thoughtful leadership.

The report was also made possible by vital contributions from many other community leaders, advocates, experts and practitioners. Among them are Carmen Panacopoulos, Sara Chaganti, Amy Higgins, Marybeth Mattingly, Desiree Allen, and Brian Clarke of the Federal Reserve Bank of Boston; Jessica Battisto of the Federal Reserve Bank of New York; Ruth Caplan, Nancy Ryan, and Christine Desan of Massachusetts Public Banking; Dedrick Asante-Muhammad of the National Community Reinvestment Coalition; Angie Liou of Asian Community Development Corporation; various members of the Coalition for an Equitable Economy and their Capital Access subcommittee, including Glynn Lloyd of the Foundation for Business Equity and Mill Cities Community Investments, Karen Kelleher of LISC Boston, Lawrence Andrews of Mass Growth Capital Corporation, Deborah Frieze of Boston Impact Initiative, Betty Francisco of Amplify Latinx, Amine Benali of Local Enterprise Assistance Fund, Anthony Rust of the Business Equity Fund; Ben Forman of MassINC; Orlando Watkins of the Boston Foundation.

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ABOUT BOSTON INDICATORS

Boston Indicators is the research center at the Boston Foundation, which works to advance a thriving Greater Boston for all residents across all neighborhoods. We do this by analyzing key indicators of well-being and by researching promising ideas for making our city more prosperous, equitable and just. To ensure that our work informs active efforts to improve our city, we work in deep partnership with community groups, civic leaders and Boston's civic data community to produce special reports and host public convenings.

ABOUT THE BOSTON FOUNDATION

The Boston Foundation is one of the largest and oldest community foundations in America, with net assets of \$1.3 billion. The Foundation is a partner in philanthropy, with some 1,100 charitable funds established for the general benefit of the community or for special purposes. It also serves as a major civic leader, think tank and advocacy organization dedicated to bringing people together and advancing opportunity for everyone in Greater Boston.

ABOUT THE COALITION FOR AN EQUITABLE ECONOMY

The Coalition for an Equitable Economy is a broad cross-sector coalition of stakeholders from across Massachusetts aligned around a shared commitment to building an equitable small business ecosystem and to the values of racial equity, collaboration, and shared leadership. The Coalition's mission is to ensure equitable access to capital, business networks, education, technical support and other resources for Black, Latinx, immigrant and low-income small business owners in Massachusetts. We aim to build, on the foundation of existing assets, a highly collaborative, innovative and effective ecosystem that delivers to diverse entrepreneurs the resources necessary to start, stabilize and grow profitable businesses that fuel the Massachusetts economy.

Dear Friends:

With summer fast approaching, COVID-19 vaccine distribution reaching critical mass, and businesses reopening, a sense of hope is filling the air. Yet, it will take much longer for things to return to “normal” and even longer for the Commonwealth to heal from the economic inequity that the pandemic intensified. This is true of our state’s small businesses, especially the smallest businesses and those owned by people of color.

This report is the second in a series that the Coalition for an Equitable Economy will issue to support the advancement of inclusive entrepreneurial ecosystems in Massachusetts. The first report released in March, [*Unleashing the Potential of Entrepreneurs of Color in Massachusetts: A Blueprint for Economic Growth and Equitable Recovery*](#), was released earlier this year by MassINC, and sets the stage, outlining on the broad issues facing entrepreneurs of color and the strategies needed to address them. This report goes deeper on the number-one issue that entrepreneurs cite: access to capital.

Cash is king. While entrepreneurs have always needed capital to start, run, and grow their businesses, the age-old adage has heightened importance in the wake of the economic shutdowns and business closures that we have seen since March 2020. That’s because the pandemic has shed light on just how undercapitalized, underinvested and vulnerable many entrepreneurs of color are, due in large part to systemic barriers. Even the government relief programs meant to reach entrepreneurs of color and other underserved groups were inequitably distributed.

The report, **The Color of the Capital Gap: Increasing Capital Access for Entrepreneurs of Color in Massachusetts**, was produced with our partners at the Boston Foundation, with research led by Boston Indicators. It lays bare the wide disparities in capital access and their root causes. The report also provides a foundation to advance bold and timely actions, policies and investments for the state, foundations, corporations, and individuals to help narrow the gap. With national attention focused on the struggle of entrepreneurs and the oppression of people of color in our society, and with large amounts of federal funding for small businesses on the way, we have a unique opportunity to implement transformative solutions that set up our entrepreneurs of color for success.

In this spirit, we present this near-term policy blueprint with full conviction that it will generate productive dialogue, greater energy and momentum for the cause, and tangible near-term policies and programs to eliminate our current racial disparities and achieve equitable entrepreneurship in Massachusetts by 2030.

Sincerely,
The Coalition for An Equitable Economy



Introduction

As a Commonwealth we should ensure that every entrepreneur with a good idea and a strong plan has a fair chance to succeed. To do this, businesses need access to capital to hire employees, rent or purchase real estate, fund daily operations, conduct research and development, market products and services, and more. Apart from just being the right thing to do, ensuring that all entrepreneurs have equitable access to capital to support their businesses also helps to propel broader economic growth, generate new jobs and drive innovation statewide. But each year many businesses go without the capital they need to thrive. Prior to COVID-19, 51 percent of small businesses nationwide had unmet need for capital, but among entrepreneurs of color the share with unmet capital needs was between 66 and 76 percent.¹ In Massachusetts, we estimate the annual unmet demand for capital among entrepreneurs of color to be at least \$574 million. And the pandemic has made matters worse. In this report we analyze troubling racial gaps in access to small business capital and we explore a range of local strategies for expanding access. Closing gaps in access to capital for entrepreneurs is one critical way to bolster civil and economic rights, as part of the broader racial justice movement in the United States.

“Apart from just being the right thing to do, ensuring that all entrepreneurs have equitable access to capital to support their businesses also helps to propel broader economic growth, generate new jobs and drive innovation statewide.”

THE REPORT IN BRIEF (Organized by Report Section)

Part 1: Racial Discrimination and the Racial Wealth Gap as Key Determinants of Capital Access Disparities

Because two thirds of entrepreneurs use personal or family savings to start a business, one major determinant of capital access disparities is the racial wealth gap: White families have 5-8 times more wealth than Black or Latinx families.² Entrepreneurs of color who cannot tap financial resources in their family or social networks often turn to banks, credit unions, angel investors, and venture capitalists for capital, but they are less likely than White applicants to obtain capital through these channels even when controlling for creditworthiness.

- A growing body of research shows that entrepreneurs of color receive less favorable treatment by small business loan officers, which has been shown to violate fair lending laws and represents direct racial discrimination.
- The undercapitalization of firms owned by people of color, and especially Black- and Latinx-owned firms, makes them smaller and less profitable, and more likely to struggle and fail. This may explain in part why rates of business ownership are especially low among Black and Latinx communities, despite the fact that they start about as many businesses per capita as other racial groups.^{3,4}

Part 2: Racial Gaps in Access to Capital

To conduct this analysis we rely on racial/ethnic categories as they are defined by the U.S. Census Bureau and other research organizations. In many cases these data show that Black and Latinx entrepreneurs have especially low levels of capital access, and we highlight these instances throughout the paper. We use these racial categories because they are instructive in broad strokes, but they often mask tremendous differences within groups. For example, some Asian entrepreneurs are highly educated with strong social networks to tap while growing a business, while others are more recent immigrants who face language barriers, have fewer resources at their disposal, and experience more direct discrimination. Further, survey data that is not collected in various languages could fail to capture the unique challenges facing immigrant entrepreneurs with low English language proficiency. Ideally, data on entrepreneurship and capital access would be gathered in multiple languages and capture other demographic characteristics like place of birth, ancestry, wealth, and other characteristics to support more precise analysis across groups. Even still, the best available data on entrepreneurs' capital access show stark racial disparities. For instance:

- The share of Black-owned firms that receive none of the debt financing that they apply for is almost double that of White-owned firms (38 percent versus 20 percent, respectively).
- Among entrepreneurs with a high-risk credit profile, 72 percent of entrepreneurs of color received none of the debt financing they requested, compared to just 46 percent of White-owned firms.
- In Massachusetts, 18 percent of entrepreneurs are people of color, but loan transaction data reveal that only 10 percent of small business loans go to neighborhoods that are majority people of color.
- Nationally, Black and Latinx firms received a combined 3 percent of venture capital investments, compared to 25 percent for Asian-owned firms and 72 percent for White-owned firms.
- In Massachusetts, 81 percent of White-owned firms received their full Paycheck Protection Program loan request, while just 71 percent of Black and Latinx firms and 69 percent of Asian-owned firms received the full amount they requested.

Part 3: Local Solutions to Close Racial Gaps in Access to Capital

Given the complexity of historic root causes and the many public and private actors in the capital markets, there is no silver bullet solution to eliminating racial disparities in capital access. Therefore, local stakeholders will have to work on multiple fronts simultaneously to make a meaningful difference. With this in mind, we organize the local solutions section of this paper into four broad domains, with specific action recommendations flowing from each of them. Unprecedented levels of federal and state recovery funding related to COVID relief efforts—including an estimated \$136 million from the federal State Small Business Credit Initiative—provide a unique opportunity right now to act on many of these recommendations.

- **Increase access to small business loans:** Small business loans are the most common form of financing that entrepreneurs seek, but many firms cannot get a loan because of low credit scores or lack of collateral. Creating a statewide credit enhancement fund to guarantee small business loans would increase lenders' willingness to lend to firms with riskier credit profiles and those that have fewer assets to use as collateral (these are often entrepreneurs of color). Mission-driven funds (including Community Development Financial Institutions and others) that focus on entrepreneurs of color can be scaled up for much greater impact. The state should provide grants to mission-driven funds like CDFIs to increase their capacity to make loans and provide technical assistance to entrepreneurs. The state could also establish a public bank that would partner with other lenders to dramatically expand the supply of small business capital and lend at lower rates, with a focus on entrepreneurs of color.

- **Increase access to equity investment, grants, and alternative financing structures:** Many small businesses need financing but are not well positioned to take out loans. Other funding options like equity, grants, and alternative structures like crowdfunding and revenue-based financing can help fill gaps in capital access. The state should establish a venture development fund to make equity investments in entrepreneurs of color. To aid in the pandemic recovery, a local economy preservation fund should be established to save struggling local businesses that seem likely to succeed in a post-pandemic economy. Direct grant funding can provide new entrepreneurs with critical startup capital and help close racial gaps in rates of entrepreneurship. A crowdfunding matching grant would allow for a more diverse range of investors. Lastly, a fund dedicated to innovative capital structures like revenue-based financing should also be established to drive innovation of products that support entrepreneurs of color that tend to be smaller, have slimmer profit margins, and lack the growth profile of businesses best suited for equity.

- **Regulate the small business financing sector:** There are many ways in which the regulatory framework for the small business financing sector fails entrepreneurs of color, and we can work to fix this in Massachusetts. First, we can combat direct racial discrimination in lending by administering matched pair “mystery shopping” experiments through the office of the state Attorney General. In addition, under the leadership of the Massachusetts Division of Banks, we could expand Community Reinvestment Act performance evaluations and mandatory data reporting to include race and ethnicity. Finally, for financial technology platforms that currently avoid bank regulations, the state should pass new regulations based on the Truth in Lending Act. This would impose disclosure rules and limit excessive interest rates.

- **Increase diversity in capital allocation roles and increase funding for capital providers owned and/or operated by people of color:** Racial and ethnic diversity is very low among bank executives and equity investors and this contributes to unequal treatment of entrepreneurs of color when seeking out capital investments. One way to improve capital access is to increase the participation of people of color in capital allocation decision-making. To diversify staff who make financing decisions, with a goal of mirroring the diversity of communities served, state agencies should gather and share racial and ethnic demographic data for staff at financial institutions that operate in the small business financing sector. Another important strategy is for investors and grantmakers to increase their support for capital providers (e.g., banks, mission-driven funds, venture capital firms) already owned and/or operated by people of color. Specifically, private investors and philanthropic organizations should make equity investments in capital providers operated by people of color (including Minority Depository Institutions) in order to expand their impact on small business capital access.

PART 1: Racial Discrimination and the Racial Wealth Gap as Key Determinants of Capital Access Disparities

A variety of factors shape the development and growth of businesses, and while we focus in this paper on the role that access to capital plays, it's important to acknowledge up front that a range of other factors also hold back the potential of entrepreneurs of color in Massachusetts. This report is the second in a series designed to advance ideas for a more robust and inclusive entrepreneurial ecosystem in the Commonwealth. The first report, [Unleashing the Potential of Entrepreneurs of Color in Massachusetts: A Blueprint for Economic Growth and Equitable Recovery](#), which was released earlier this year by MassINC, outlined three strategy areas to improve business success for entrepreneurs of color: skills and relationships, access to capital, and access to markets and customers. That foundational report details a host of factors that influence the ability of prospective entrepreneurs of color to form a business in the first place, as well as other factors that shape their ability to succeed once a business is formed. The skills and education that an entrepreneur has can be influential in the

performance of their firm. And we know that many people of color do not have equitable access to high quality education (and the networking that comes with it). Relationships and access to markets are also critical determinants of business success. Individuals who grow up in lower-income neighborhoods often have different social networks and may participate in different markets. Knowing other business owners or investors can make a big difference for would-be or early-stage entrepreneurs, but not everyone has those connections. Access to markets is another important piece. Businesses need customers, but there are some significant barriers to access that can restrict a firm's customer base. One relevant example is local government contracts: Recent analysis of access to Boston city contracts confirmed that entrepreneurs of color have received an exceedingly small share of those opportunities.⁵ In order to meaningfully unleash the potential of entrepreneurs of color and create a more vibrant economy for all we must work on all of these important fronts at once.

Before we analyze current racial disparities in access to small business capital, we want to call attention to some of the key factors that determine capital access. These factors are deep rooted and complex, but we know that among them historic and persistent racial wealth disparities and racial discrimination by lenders loom large.

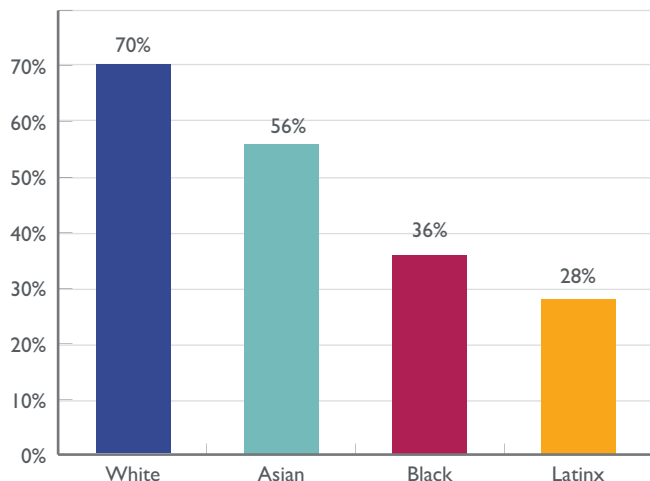
Because two-thirds of entrepreneurs rely on personal or family savings to start their business, wealth levels in one's family and broader social network have a big impact on whether one can start and grow a business. Racial wealth disparities serve to limit capital access for people of color in two ways: 1) Entrepreneurs of color have less cash on hand and in their families or social networks that they could invest into a business; 2) Entrepreneurs of color have fewer assets, such as savings or home equity, they could use as collateral (or a personal guarantee), which lenders usually require to approve a business loan.

The most recent national data show White families had a median family wealth of \$188,200, compared to just \$24,100 and \$36,100 for Black and Latinx families, respectively.⁶ Because median wealth for families of color has been stagnant for several decades as White families increased their median wealth, the racial wealth gap has widened significantly.⁷ Differences in wealth—which accounts for total assets, such as home equity, savings, or investments, minus debts—can be especially pronounced because they tend to compound over time and can be passed down from one generation to the next. In Boston, racial wealth disparities are particularly stark: According to a 2015 study, the median net worth for Black families ranged from \$8 for African Americans to \$12,000 for those of Caribbean origins. Among Latinx families, median net worth was \$0 for Dominicans, \$3,020 for Puerto Ricans, and \$2,700 for others of Latin American descent. By contrast, median net worth for White families was \$247,500.⁸ While the sample size upon which the estimates were based was quite small,⁹ there are other ways to gauge racial wealth disparities locally.

Homeownership is the primary way that most families build wealth and pass it down from one generation to the next. Communities of color, however, have faced systemic barriers to homeownership for generations. Redlining is one well known historic example of how the Federal Housing Administration refused to insure mortgages in African-American neighborhoods, which led to chronic underinvestment and reduced wealth. But there are other more subtle mechanisms that remain in place today. Many localities around the country have long used zoning laws to prohibit the construction of denser and more affordable housing. This in effect locks many lower

Figure 1: Massachusetts has a large racial homeownership gap.

Homeownership rate by race and ethnicity, Massachusetts, 2019.



Source: American Community Survey 2019 1-year estimates

income would-be homeowners out and disproportionately affects people of color and immigrants, who are more likely to have lower incomes.

In Massachusetts, there are pronounced racial disparities in homeownership. While the White homeownership rate is 70 percent, it is much lower among Asian (56%), Black (36%), and Latinx (28%) households (Figure 1).

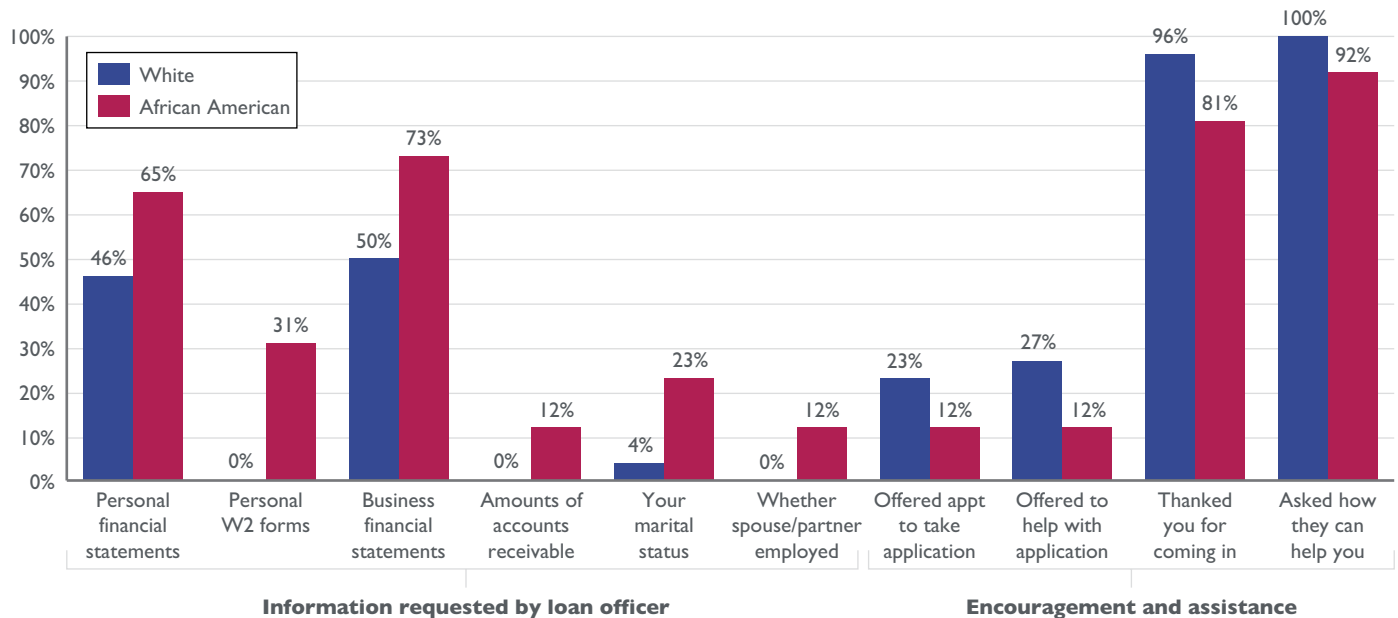
Even as racial discrimination has played a prominent historic and contemporary role in generating homeownership and wealth disparities, there are also current cases of direct racial discrimination in the small business lending market itself. The National Community Reinvestment Coalition has for several years conducted experiments where they send pairs of individuals with equal qualifications, one White and one a person of color, to meet with a loan officer at various banks. Findings are similar across numerous experiments that include Black, Latinx, and women applicants. Statistical analysis of these experiments reveals that loans officers ask people of color for more information, they are less helpful, and they sometimes ask for information that violates fair lending laws (such as information about a spouse’s employment status). These outcomes are documented below for Black small business loan seekers (Figure 2). Other past studies that employ rigorous analysis of nationally representative data also find evidence of lending discrimination.^{10,11} This is an especially egregious prob-

lem that we try to address head on in our solutions later.¹²

Barriers in access to capital, including low personal and family wealth, as well as racial discrimination, lead to the persistent undercapitalization of firms owned by people of color. Capital gaps also likely explain a portion of racial disparities in business ownership: Rates of business ownership are far below average in Black and Latinx communities, even though on a per capita basis Black and Latinx entrepreneurs start just about as many businesses as other groups.^{13,14} This is because more than half of entrepreneurs of color are unable to stay in business over the long run, often due to unmet capital needs.¹⁵

Figure 2: Mystery shopping experiments demonstrate persistent discrimination in bank lending toward African American applicants.

Percentage of interactions by White (n=26) and African American (n=26) loan seekers and type of information requested and given at 17 banks in two large Metropolitan Statistical Areas in the Eastern US, 2018.



Source: National Community Reinvestment Coalition

PART 2: Racial Gaps in Access to Capital

As mentioned previously, just over half of entrepreneurs nationally have unmet need for capital. Yet for entrepreneurs of color, the share with unmet capital needs ranges from 66 percent to 76 percent. **We estimate that entrepreneurs of color in Massachusetts have unmet capital demand on the order of \$574 million annually, or nearly \$2.9 billion over a five-year period.**¹⁶ To calculate these figures we began with Census data on the nearly 14,000 firms owned by people of color that have at least one employee in Massachusetts. We then used the Fed's Small Business Credit Survey data to estimate the number of these firms that applied for financing, how much they requested, and how much they received.¹⁷ Because we have no way of controlling for creditworthiness, the total unmet capital demand estimate is biased upwards due to the inclusion of unmet demand from some unqualified applicants. But there are other ways in which this is more likely an underestimate. For one thing, it does not include non-employer firms, which far outnumber employer firms and also have demonstrated capital needs. It also does not factor in the many firms that needed capital but did not apply for it in the first place, often out of an expectation that they may not be approved. The estimate also does not measure unmet demand for equity financing. Before delving deeper into the racial disparities in capital access and financing outcomes that drive the capital gap, it is helpful to understand why businesses need capital and the broader capital markets context.

Businesses need access to capital for a variety of reasons. The most common reason is to expand the business, including hiring ahead of revenue, purchasing new equipment to meet growing demand, and other related investments. Many businesses need "working capital" to meet day-to-day operating expenses including wages, rent, and other expenses (often this is short-term capital given mismatches in timing of revenues and expenses). They also seek capital to refinance existing debt and replace capital assets.

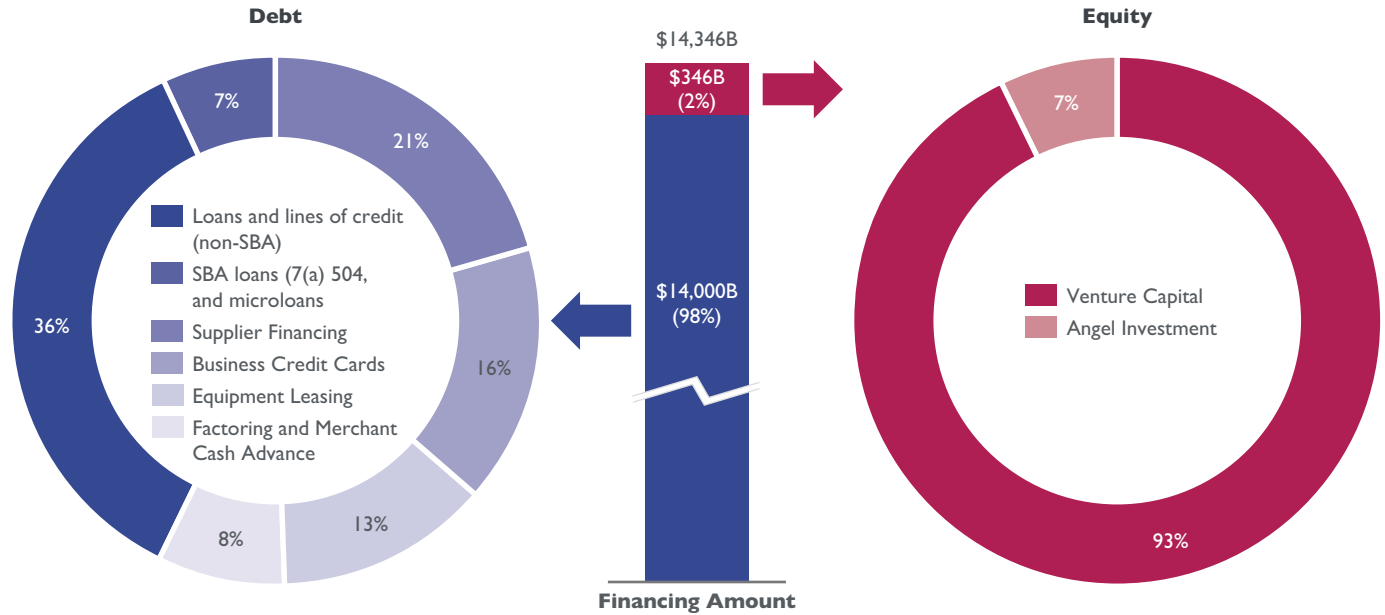
Depending on the stage, size, growth-profile, or industry, businesses use different types of capital from different sources. Early-stage businesses without a financial track record tend to rely on personal savings and assets, or friends and family gifts, but some obtain loans or equity investments (mostly from venture capital firms as well as angel investors). Most startups (64%) rely on personal and family savings, with smaller shares receiving bank loans (17%) or venture capital (0.5%).¹⁸ The heavy reliance on personal resources is in large part due to entrepreneurs' inability to qualify for more traditional financing like bank loans. As discussed earlier, because so many entrepreneurs use personal or family savings, lower wealth levels among people of color constrain the capitalization of young firms of color. For this reason, programs that direct grants or equity-like investments to early-stage businesses are a powerful tool that we will revisit later. Established employer businesses (those with at least 1 paid employee) tend to rely on business credit cards, lines of credit, and loans (mostly from banks, but increasingly from non-bank alternative "FinTech" lenders). Employer firms most commonly use banks for external capital—44 percent report obtaining a bank loan within the past five years,

followed by online lenders (20%).¹⁹

The small business financing marketplace is vast and complex in terms of financing institutions and financing products. A large majority (98%) of external financing for small businesses comes in some form of debt, including term loans, lines of credit, business credit cards, or other alternative structures such as invoice factoring and cash advances (Figure 3).²⁰ On the other hand, equity financing is a small but critically important segment of the small business financing market (summing to about 2%).^{21,22} Equity investment is cash in exchange for a share of ownership in a company. Instead of regular repayment like a loan's principal and interest payments, equity investors are repaid when another investor buys the company, or when the business owners buy back the investor's ownership shares. Equity investment is well suited to idea and early-stage companies that don't yet have revenues or profits to repay a loan. The main types of equity investors for small businesses are individuals ("angel investors") and venture capital firms. Angel investors tend to make smaller investments in earlier stage companies ("seed investments"), while venture capital firms tend to make larger investments in later stage companies. Until recently, equity investment has been limited to high-net-worth individuals (so-called accredited investors), but new regulations have begun to democratize equity investment, including the crowdfunding provisions in the JOBS Act. Equity investment often flows to high growth companies and frequently in high tech industries. In the analysis that follows we explore racial disparities in access to various forms of capital.

“Rates of business ownership are far below average in Black and Latinx communities, even though on a per capita basis Black and Latinx entrepreneurs start just about as many businesses as other groups.”

Figure 3: Debt financing makes up the vast majority of small business capital.



Note: the above data reflect outstanding debt, but not the total or original amounts offered. Venture capital is based on total assets under management. Due to data limitations, angel investment represents annual investment in 2018.
 Sources: Consumer Financial Protection Bureau; Center for Venture Research; National Venture Capital Association

ACCESS TO DEBT

In 2018, the most recent year for which data are available before the 2020 pandemic (which we analyze separately), about 43 percent of small businesses applied for financing, according to national survey data from the Federal Reserve.²³ Entrepreneurs of color applied for external financing at higher rates and had greater unmet capital needs. Survey data reveal that 50 percent of Latinx-owned businesses and 45 percent of Black-owned employer businesses applied for financing compared to 43 percent of White-owned and 36 percent of Asian-owned employer businesses.²⁴ Across all small businesses that sought external financing, less than half received the full amount they applied for. A greater share of entrepreneurs of color stated that they received none of the financing that they applied for; nearly double the share of Black-owned employer businesses reported receiving none of the financing that they applied for compared to White-owned employers.²⁵

Several factors determine differences in access to capital. Financing outcomes are not entirely related to racial discrimination. The industry in which a firm operates can affect profit margins and other firm characteristics that influence its ability to obtain capital. But even such characteristics are not unrelated to race. Entrepreneurs of color locally and nationally tend to cluster in food and accommodation services, which have lower profit margins, for example.

The financial health and creditworthiness of an entrepreneur (and their business) also figure prominently in their ability to access external capital. Financial health and access to capital are mutually reinforcing. Without

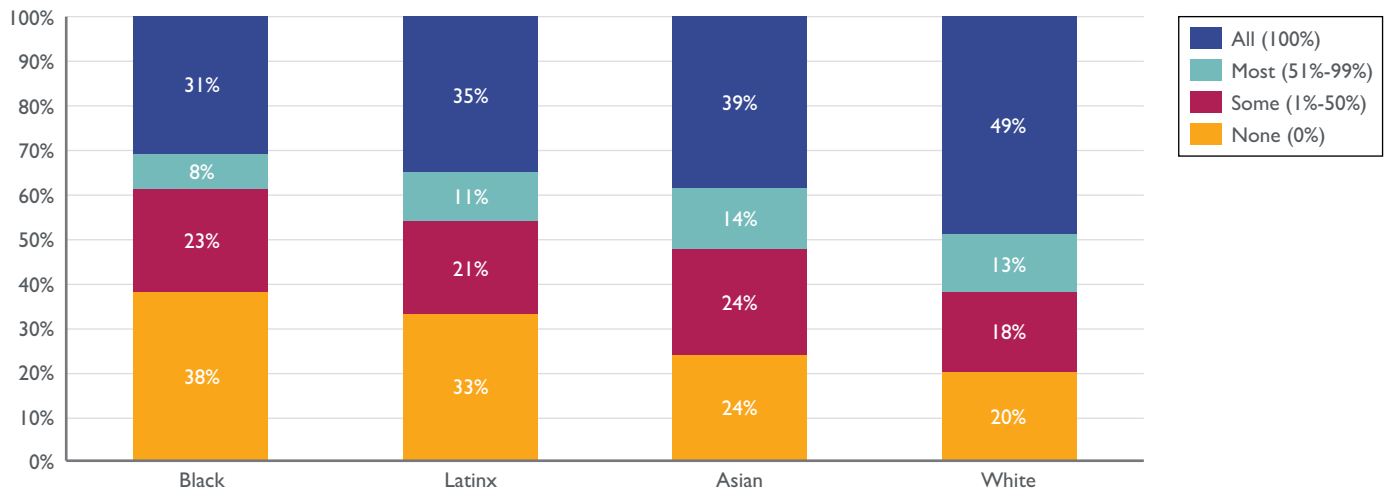
solid financial health, businesses and their owners are denied external financing. At the same time, external financing can be a determinant of financial health.

Financial health and creditworthiness are critical to understanding how credit decisions are made and to making sense of capital access disparities. While decision criteria and weighting vary by lender type and specific institution, most of their criteria are captured in the age-old five Cs of credit: character, capacity, capital, collateral, and conditions. *Character* in this context is mostly defined by the applicant's credit history, or track record of repaying debts; lenders commonly rely on both personal and business credit scores (personal scores are more important for small and younger businesses). *Capacity* is defined as an applicant's ability to repay the loan and commonly includes a review of past financial performance and the debt-to-income ratio of the business' financial projections. *Capital* refers the investment that the business or the business owner puts toward the project being financed (like a down payment on a house); it demonstrates "skin in the game." *Collateral* refers to business or personal assets that are pledged to the lender if the loan is not repaid; personal guarantees are often in addition to, or in place of, asset-based collateral. Lastly, *conditions* refers to the macroeconomic market conditions and other factors.

Businesses owned by people of color tend to have poorer financial health, which inhibits their ability to qualify for financing because they have fewer assets to pledge as collateral and less income to demonstrate their ability to repay. Black and Latinx business owners have lower average industry and startup experience and more limited access to business networks and

Figure 4: The share of Black-owned firms that received none of the financing they requested is almost double that of White-owned firms.

Percentage of financing requested that small employer firms ultimately received by race and ethnicity of firm owner, US, 2018.



Source: Federal Reserve Banks Small Business Credit Survey

mentors that can impart knowledge and skills necessary for entrepreneurial development.²⁶ For these reasons, entrepreneurs of color tend to have lower levels of cash and assets, in addition to being less profitable on average. Entrepreneurs of color also tend to have lower personal and business credit scores, which affects their access to loans. Loans backed by the Small Business Administration, for example, all but require a credit score of 680 or higher. Among those who apply for financing, Black and Latinx entrepreneurs are far more likely to have scores below this critical threshold (46 percent and 28 percent, respectively), compared to Asian and White entrepreneurs, of whom 18 percent and 16 percent have scores below 680, respectively.²⁷ That said, research shows that credit scoring implicitly penalizes people of color for factors unrelated to a borrower's ability to repay debt (e.g., by considering where someone lives, or the products they consume).²⁸ Yet financial health and creditworthiness do not fully account for differential access to capital.

Racial disparities in capital access persist even when adjusting for credit risk.²⁹ A majority (72%) of high-risk entrepreneurs of color received none of the financing they sought while most high-risk White-owned businesses received at least some of the financing they sought (Figure 5).³⁰ The disparities persist, albeit to a lesser extent, for medium-risk and low-risk applicants.

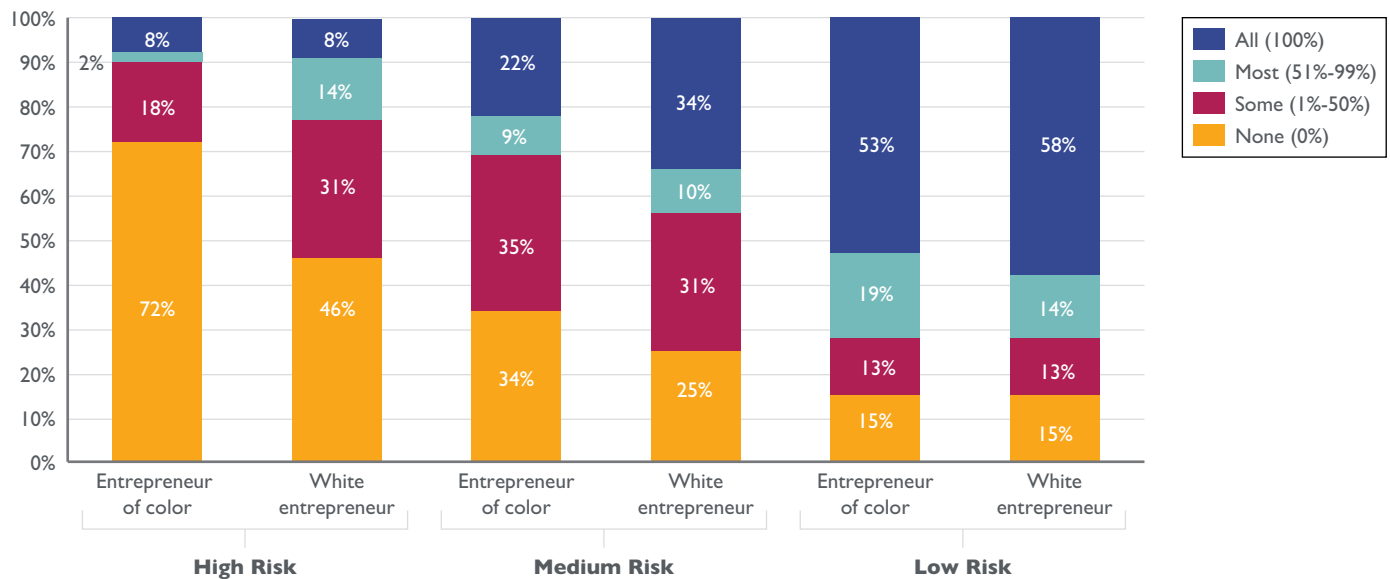
Even across different types of lending institutions, loan applications from entrepreneurs of color tend to have worse outcomes. Entrepreneurs of color are approved for loans at lower rates across all conventional lenders, including large and small banks, and among online or financial technology ("FinTech") lenders. Data are limited by small sample size (some racial groups and financial institutions, such as credit unions, did not have

sufficient data), but we are still able to observe some racial disparities across different types of lenders. Disparities appear to be greatest at small banks, where the approval rate for Black- and Latinx-owned firms is 40 and 42 percent, respectively, compared to 73 percent for White-owned businesses (Figure 6).³¹ At larger banks, the gaps in approval rates between White-owned firms and those owned by people of color vary. Asian-owned firms and White-owned firms have approval rates of 60 percent and 57 percent, respectively, while approval rates are much lower for Latinx firms, at 50 percent, and Black firms, at 29 percent. Online lenders have higher approval rates overall, but the approval rate for White-owned firms is 84 percent, compared to just 70 percent for Black-owned firms and 65 percent for Latinx-owned firms. Online or FinTech lenders have increased their market share in recent years and provide more access to people of color, but some take advantage of small cash-strapped firms.³² Later in our solutions section we explore regulatory ideas that could expand access to safe and affordable capital through FinTech.

Banks are by far the most common lenders to small business. However, when entrepreneurs of color do receive loans, some evidence indicates they—at least historically—have been charged higher interest rates than White-owned businesses. A national study in 2003 showed that entrepreneurs of color paid 7.8 percent on average for loans compared with 6.4 percent for White-owned businesses.³³ More recent data from the Fed's Small Business Credit Survey show that Asian and Latinx-owned firms struggled more with loan applications and higher interest rates than White or Black-owned firms (at large banks—the only type of lender with complete data).³⁴ Black and Latinx firms were more likely to face unfavorable repayment terms. White-owned firms, on the other hand, were least likely to face these

Figure 5: Entrepreneurs of color are less likely than White entrepreneurs to receive external financing, even when controlling for risk.

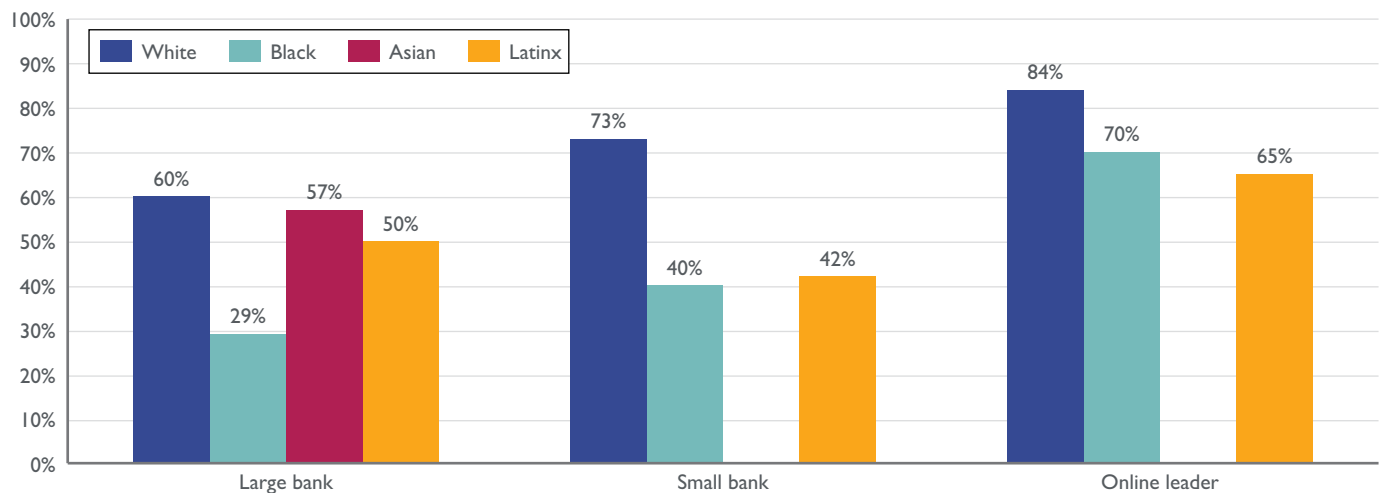
Percentage of financing requested that small employer firms ultimately received, for entrepreneurs of color and White entrepreneurs, by risk level, US, 2018.



Source: Federal Reserve Banks Small Business Credit Survey

Figure 6: Entrepreneurs of color are less likely to receive financing across different types of lenders.

Approval rate for financing by race and ethnicity of small employer firm owner and type of financial institutions, US, 2018.

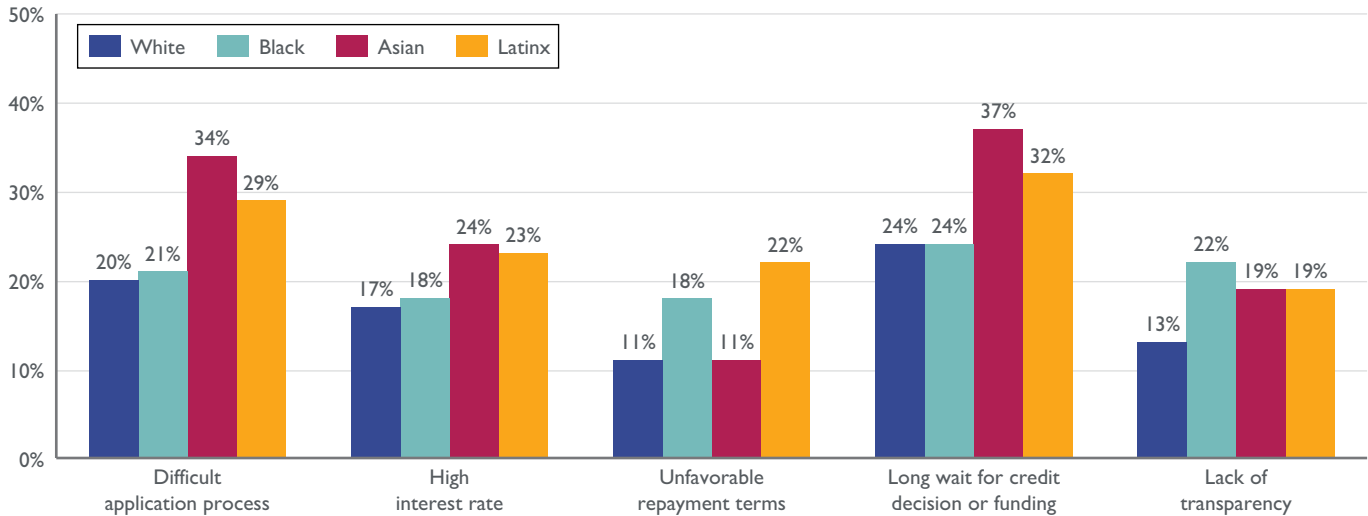


Note: Sample size did not allow for analysis of Asian applicants at small banks and online lenders.

Source: Federal Reserve Banks Small Business Credit Survey

Figure 7: Entrepreneurs of color are more likely to face challenges applying for a loan at a large bank.

Percent of small employer firm owners facing challenges when applying for a loan at a large bank by race and ethnicity, US, 2018.



Source: Federal Reserve Banks Small Business Credit Survey

challenges (Figure 7). A lack of diverse leadership at large banks may be partly driving the divergent experience that business owners of color have as borrowers. Among the banks in the United States with more than \$50 billion in assets, 81 percent of senior executives identified as White, while just 4 percent of executives or senior level staff identified as Black or Latinx.³⁵

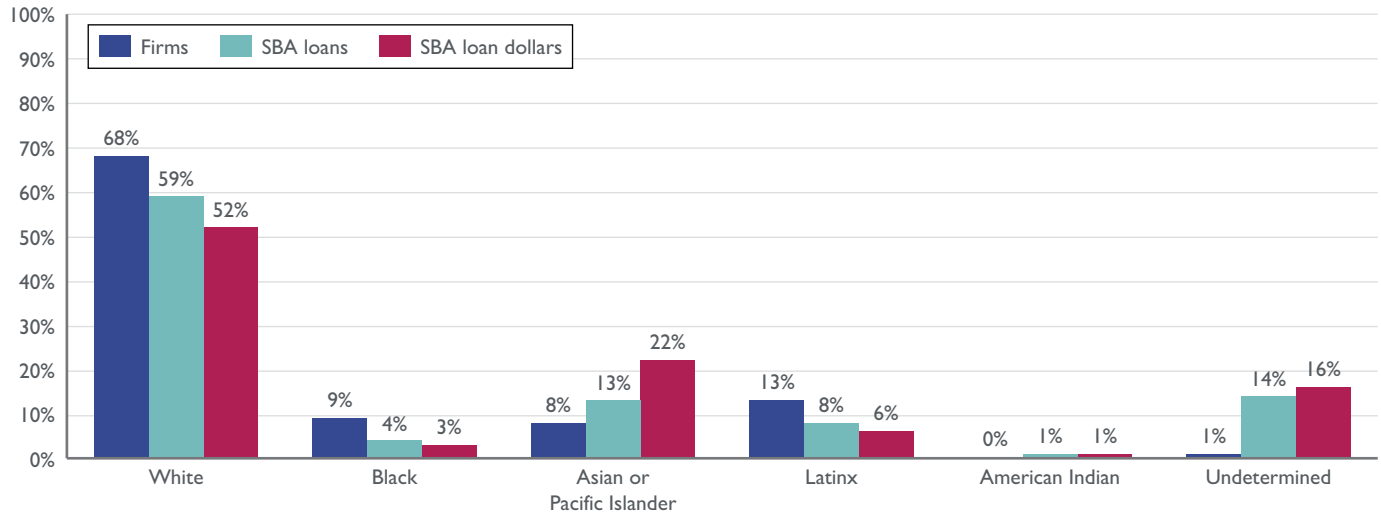
One particular lending program worth looking at is the Small Business Administration (SBA) 7(a) Loan Guarantee Program, because it is specifically designed to expand capital access to underserved groups, including entrepreneurs of color. The SBA guarantees 75 to 85 percent of loans made by its lending partners (mostly banks but also some other financial institutions), which also come at a lower interest rate. Altogether SBA 7(a) loans make up about 7 percent of the small business lending market nationally.

The data available, which capture national trends, suggest that the SBA is not effectively expanding access to capital for underserved groups. Black- and Latinx-owned businesses appear to receive a disproportionately small share of SBA 7(a) loans, which are guaranteed by the SBA but originated by banks. Black and Latinx businesses represent 9 percent and 13 percent of businesses,³⁶ respectively, yet received 3 and 6 percent of SBA 7(a) loan dollars in 2018 (Figure 8).³⁷ Asian-owned firms on the other hand are over-represented in the share of 7(a) loans and loan dollars they receive relative to their share of firms nationally. Overall, the race and ethnicity data of business owners is much more complete than the SBA 7(a) data. The SBA is unable to provide the race or ethnicity of the recipients of 16 percent of

“In Massachusetts, just under 20 percent of entrepreneurs are people of color, but majority people of color neighborhoods received just 10 percent of small business loan dollars in 2018.”

Figure 8: SBA 7(a) loans do not appear to effectively reach Black and Latinx firms, based on the data available.

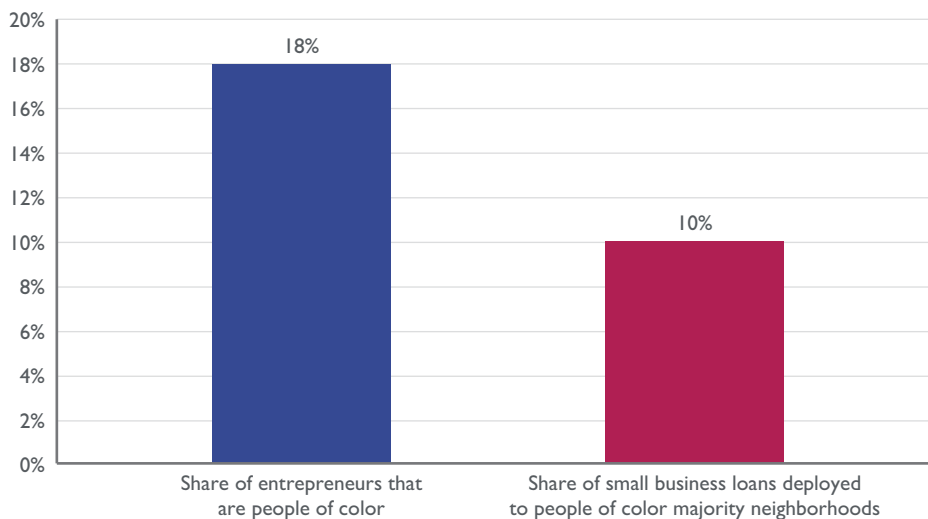
Distribution of firms compared to the distribution of SBA 7(a) loans and loan dollars, by race and ethnicity, US, 2018.



Sources: Small Business Administration; 2018 Annual Business Survey; 2017 Nonemployer Statistics by Demographics

Figure 9: Only one in ten small business loan dollars goes to a diverse neighborhood, even though nearly 20 percent of Massachusetts entrepreneurs are people of color.

Racial/ethnic composition of entrepreneurs (includes employer firms and sole proprietorships) and neighborhoods where small business loans are deployed, Massachusetts, 2018.



Sources: 2018 Annual Business Survey; 2017 Nonemployer Statistics by Demographics; Massachusetts Community Banking Council analysis of Community Reinvestment Act loan transaction data from the Federal Financial Institutions Examination Council

the loan dollars originated under the program, which means the data that are assigned to racial or ethnic groups must be interpreted with caution.

The apparent disparities at the national level documented above seem to be present in Massachusetts too. While data on race and ethnicity of borrowers is not available at state or local levels as it is at the national level, we can compare the percentage of entrepreneurs in an area that are people of color with the percentage of small business loan dollars that go to majority people of color neighborhoods. In Massachusetts, just under 20 percent of entrepreneurs are people of color, but majority people of color neighborhoods received just 10 percent of small business loan dollars in 2018 (Figure 9).^{38,39}

ACCESS TO EQUITY INVESTMENT

Venture capital firms are the largest providers of equity investment to entrepreneurs and small businesses. However, as noted above, only 0.5 percent of startups access venture capital investment for startup capital.

The venture capital industry has wide racial disparities in representation at individual firms and within their portfolios. People of color hold a small share of leadership roles at venture-backed startups and at the venture firms that fund them. According to the National Venture Capital Association's 2020 Human Capital survey, 78 percent of investment partners at VC firms are White and 15 percent are Asian or Pacific Islander. While race and ethnicity data on private venture capital transactions is sparse, by one estimate less than 1 percent of U.S. venture capital investment goes to people of color.⁴⁰ According to another 2020 report by DiversityVC and RateMyInvestor detailing the race and ethnicity of 7,705

venture-backed founders, 2 percent were Black and 1 percent were Latinx, compared with 25 percent Asian and 72 percent White (Figure 10).⁴¹ The fact that entrepreneurs of color are less likely to found companies in professional or technical services industries or finance, for example, may be both a cause and an effect of the exceedingly low equity investment they receive.

Venture capital investment is also highly concentrated by geography. From 2016 to 2020, 67 percent of venture capital investment dollars went to just two states—California and New York. Massachusetts ranks third for venture investment over the same time period, capturing 9.6 percent of total venture investment.⁴²

Individual angel investors and angel investor groups also provide equity to small businesses. Angel investment can be especially important for early-stage firms because it can help them leverage additional funding from venture capital firms or others. Data from the Angel Capital Association's 2020 Angel Funders Report, which represents the angel investing activities of 79 groups and more than \$300 million invested, revealed that among firms that received angel investment, leadership was 73 percent male and 86 percent White. Just 6 percent of business owners that received investment were Black or African American, 3 percent were Asian, and 5 percent fell into an "other" category.⁴³

NEW EVIDENCE OF RACIAL DISPARITIES IN ACCESS TO CAPITAL DURING COVID-19 PANDEMIC

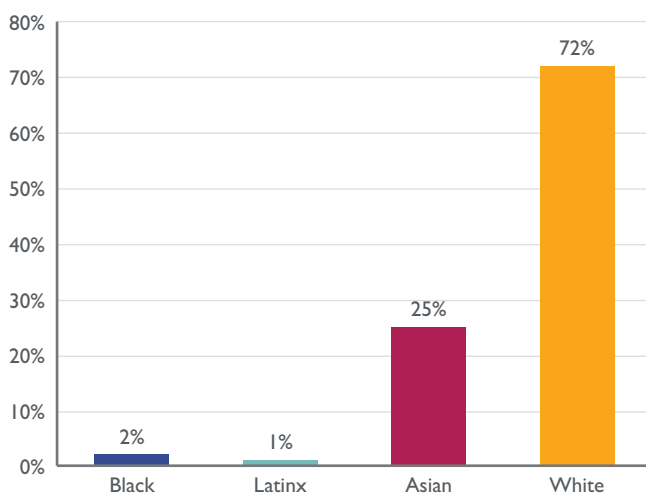
The negative impact of COVID-19 on small businesses nationally has been large and sustained. As of April 28, 2021, national small businesses revenue had declined 29 percent compared to January 2020. Massachusetts small businesses have been hit especially hard. Massachusetts total small business revenue had decreased by 44 percent over the same time period. Leisure and hospitality revenue, an industry with a concentration of entrepreneurs of color, had decreased 61 percent. The number of small businesses open declined by 33 percent nationally and in Massachusetts more than one-third of businesses (40%) are not open compared to January 2020.⁴⁴

Entrepreneurs of color were generally more susceptible to the impact of the pandemic. Service industries, including accommodation and food services, personal and laundry services, and retail, which have the highest share of entrepreneurs of color, have been the most disrupted by the pandemic.⁴⁵ Data from a large national survey of 8,328 business owners showed that entrepreneurs of color have experienced greater loss in revenue and cash on hand. More than half of entrepreneurs of color had moderate revenue declines (25% decline or more) from 2019 to 2020. Severe revenue declines (75% decline or more) were concentrated in Asian- (16%), Black- (15%), and Latinx-owned (13%) businesses (Figure 11). The shares of Black- and Latinx-owned businesses that reported having less than one month of cash on hand were much higher (33% and 21%, respectively) than that of White-owned businesses (12%).⁴⁶

Initial data show that entrepreneurs of color closed at disproportionately high rates. The number of active business owners fell by 22 percent from February to April 2020 (the largest drop ever recorded) and declines were higher for entrepreneurs of color (see Figure 11)—41 percent for Black-owned businesses; 32 percent for Latinx-owned businesses; and

Figure 10: The vast majority of venture capital funding goes to White founders.

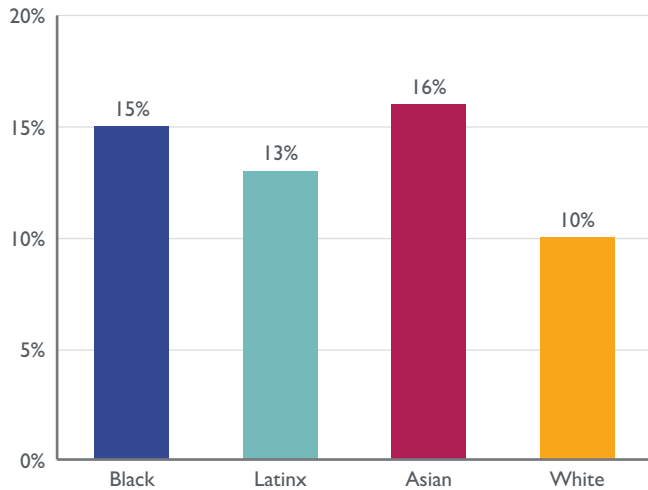
Race and ethnicity of 7,705 founders that received venture capital funding, US, 2018 and 2019.



Sources: DiversityVC and RateMyInvestor

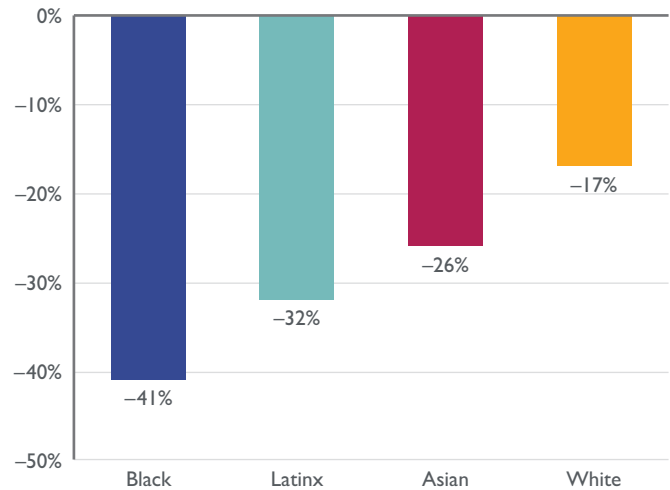
Figure 11: US firms owned by people of color saw steeper revenue declines and more closures during the pandemic.

Share of firms by race/ethnicity of owner that experienced severe revenue decline (>75%) during the pandemic, US, 2020.



Sources: Reimagine Main Street and Public Private Strategies

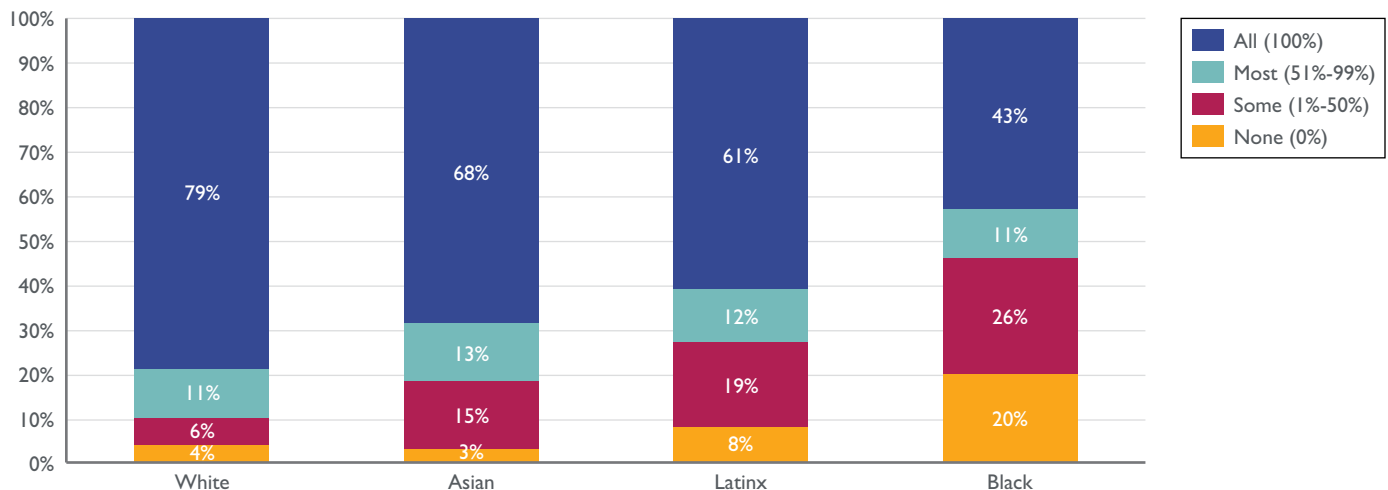
Percent change in the total number of active businesses by race and ethnicity in the US from February to April, 2020.



Source: Federal Reserve Bank of New York

Figure 12: White-owned firms were much more likely to get all of the PPP funding they applied for.

Percentage of PPP loan amount requested that small employer firms ultimately received by race and ethnicity of firm owner, US, 2020.



Source: Federal Reserve Banks Small Business Credit Survey

26 percent for Asian-owned businesses (compared to 17 % for White-owned businesses).⁴⁷

In response to the economic devastation wrought by the pandemic, Congress created the Paycheck Protection Program (PPP) through the CARES Act. The program included an unprecedented \$659 billion for forgivable loans across two rounds of funding to aid small businesses impacted by the crisis. PPP loans created an incentive for businesses to stay open and keep workers on the payroll. The funds received through this program were entirely forgivable if at least 60 percent of the money was used for payroll, rent, mortgage interest, or utilities.

Despite the lack of comprehensive transaction-level data on PPP loans—data that legislators and advocates alike demanded from the SBA—nationally representative survey data indicate that there were racial disparities in access to the program. The Federal Reserve’s Small Business Credit Survey collected data from small businesses during September and October of 2020, shortly after the end of the second round of PPP loans. Survey findings show that Asian and White business owners were similarly likely to apply for PPP loans, with over 80 percent of respondents in both groups reporting that they applied. By contrast, just 73 percent of Latinx-owned firms and 61 percent of Black-owned firms applied for PPP loans.⁴⁸

Racial disparities in the outcomes of PPP applications are even more pronounced (Figure 12). The share of Black-owned firms that received the full PPP loan amount they applied for is roughly half the share of White-owned firms that received the full amount requested (43% versus 79%, respectively). Meanwhile, the share of Latinx-owned firms that were denied PPP altogether is double that of White- and Asian-owned firms. Among Black-owned firms, one in five were denied PPP loans outright, a figure five times that of White- or Asian-owned firms. It is worth noting that although Asian-owned firms received more of the PPP funding they requested than Black or Latinx firms, they were significantly less likely than White-owned firms to have received all that they requested (even as they had a higher application rate than White-owned firms). There are a variety of factors that could impact the outcomes of PPP applications, but statistical experiments conducted by the National Community Reinvestment Coalition have shown evidence of racial discrimination in PPP loan applications, as well as violations of the Equal Credit Opportunity Act.⁴⁹

In Massachusetts, data from a MassINC statewide survey of 1,868 small businesses revealed similar disparities, although overall application rates were lower and approval rates were higher in Massachusetts than across the country (when comparing across the Fed and MassINC survey results). White- and Asian-owned firms in the Commonwealth applied for PPP at higher rates than Black and Latinx-owned firms (72% and 70%, versus 62% and 64%, respectively).

Outcomes for Massachusetts firms owned by people of color were much better than their counterparts nationally, according to the MassINC survey. This may have to do with the support many small businesses received from local organizations when applying for PPP (e.g., the Massachusetts Equitable PPP Access Initiative). Among Black and Latinx small businesses, 71 percent reported receiving the full amount of PPP funding requested. Asian-owned firms had the lowest full amount approval rate, at 69 percent, while 81 percent of White-owned firms saw full approval of their PPP requests, according to the survey.⁵⁰

“The share of Black-owned firms that received the full PPP loan amount they applied for is roughly half the share of White-owned firms that received the full amount requested.”

PART 3: Local Solutions to Close Racial Gaps in Access to Capital

Closing the more than half billion-dollar annual gap in access to capital for entrepreneurs of color in Massachusetts will require intentionality, innovation, sustained investment, and cross-sector collaboration. We need to ensure that access to conventional capital sources (e.g., bank loans, venture capital) is fair and equitable, scale the activity of local mission-driven funds that have proven to fill gaps for entrepreneurs of color, and create new structures to better meet the unique needs of entrepreneurs of color and break down structural barriers.

This work comes at a unique moment in history, as local and federal government policy leaders have mounted extraordinary small business relief programs in response to the COVID pandemic. While much of this funding has been deployed (e.g., PPP loans), there are tens of millions of dollars targeted at small business that local advocates still have an opportunity to shape. And if these small business relief efforts go well, they can help strengthen the case for higher levels of public support over the longer term.

The Commonwealth of Massachusetts has provided significant funding to support COVID-19 small business recovery efforts, including \$20 million in COVID Relief Loans,⁵¹ \$682 million in direct small business relief grants,⁵² and \$17.5 million in grants to community lenders (CDFIs and CDCs) for small business grant and loan programs. Some of this support has prioritized underserved communities, including entrepreneurs of color. This intentionality is a step in the right direction toward equitable distribution of resources, and moving forward we encourage the state to be even more intentional and targeted in its support for entrepreneurs of color.

The federal government has also provided large scale direct relief through the SBA (e.g., PPP and Economic Injury Disaster Loan programs) and has created significant opportunities for states and municipalities to invest in their small business ecosystems and to prioritize an equitable economic recovery. Over the last 12 months, the federal government has provided nearly \$1 trillion in small business loans and advances, the largest amount of such spending in history.⁵³ The American Rescue Plan Act (ARP), passed in March 2021, includes an additional \$63 billion for small business, including a \$10 billion reauthorization of the State Small Business Credit Initiative (“SSBCI”).⁵⁴ The ARP also includes \$350 billion in flexible fiscal aid to state and municipal governments that can be used in part to support small business recovery.

Given the sheer size of the program and its intentional focus on underserved communities, the SSBCI is a once-in-a-generation opportunity to fill gaps in access to capital for entrepreneurs of color. Massachusetts’ allocation of \$22 million⁵⁵ from the original SSBCI program in 2010 (“SSBCI 1.0”) was primarily used to capitalize Mass Growth Capital Corporation’s loan fund and the Massachusetts Capital Access Program. State officials have acknowledged that reaching underserved communities broadly, and specifically entrepreneurs of color, was not a priority of this funding. Massachusetts has an opportunity to lead the nation by focusing SSBCI 2.0 programs on underserved communities and entrepreneurs of

color, specifically. The total federal allocation of \$10 billion for SSBCI 2.0 is seven times larger than SSBCI 1.0 and Massachusetts’ initial allocation is \$136 million.⁵⁶ Furthermore, the Biden administration is working to embed a focus on underserved communities and microbusinesses in the program. States must submit their proposals to the U.S. Treasury by December 2021. State officials should work closely with community leaders who represent entrepreneurs of color to craft proposals and consider the solutions below as relevant based on SSBCI’s criteria.

Non-governmental actors have critical roles to play as well. Foundations, corporations, and individuals can target their grants, donations, and impact investments to mission-driven funds. Large financial institutions, including banks and other lenders, can also design their products, practices, and policies with a greater focus on access and equity.

There is no silver bullet solution to eliminating racial disparities in capital access given the size of the gap, the complexity of root causes, and the wide array of private and public actors in the capital markets. Therefore, local advocates will have to work on multiple fronts simultaneously to make a meaningful difference. With this in mind, we organize the following local solutions into four broad domains, with specific action recommendations flowing from each of them.

INCREASE ACCESS TO SMALL BUSINESS LOANS

There are a number of ways our state could work to increase access to small business loans for entrepreneurs of color. Providing credit enhancements can help entrepreneurs that lack assets to pledge as collateral or strong credit histories. For mission-driven financing providers that already focus most of their resources on entrepreneurs of color, providing them with substantially more funding can significantly boost capacity and increase lending volume. Establishing a state public bank would offer a variety of strategies to increase small business lending volume to entrepreneurs of color, such as loan guarantees, participation loans with other local financial institutions, and more.

Action: Establish a \$100 million Small Business Credit Enhancement Fund with \$50 million prioritized for entrepreneurs of color.

One key barrier that would-be and early-stage entrepreneurs face is insufficient wealth and assets—both personal and from friends and family—to fund early business formation and growth. As noted above, some entrepreneurs of color tend to have lower levels of wealth and fewer assets. As a result, lack of collateral is often a major barrier in their attempts to borrow capital. Additionally, entrepreneurs of color tend to operate in industries (e.g., service, retail) that have fewer assets and/or lower profit margins that prompt lenders to require additional collateral when securing a loan. Banks view small businesses without assets that can serve as collateral to be much riskier investments.

Credit enhancements are a powerful tool to mitigate these barriers. Put simply, a credit enhancement is a strategy for improving the credit risk profile of a business to increase loan accessibility and to obtain better terms for repaying debt. Credit enhancement structures include providing additional collateral, obtaining loan payment insurance, or a third-party guarantee.

The largest and most well-known application of loan guarantees is the SBA's 7(a) Loan Guarantee Program mentioned above, which guarantees 85 percent of eligible loans under \$150,000 made by SBA-approved lenders (and up to 75 percent for loans over \$150,000). As noted above, entrepreneurs of color receive a disproportionately low share of SBA loan guarantees.

During the first round of the State Small Business Credit Initiative (SSBCI) ("SSBCI 1.0" noted above), several states designed credit enhancement programs that were explicitly focused on entrepreneurs of color. Massachusetts can learn from those early efforts as we plan to deploy the new round of funds coming through the American Recovery Act.

Case Study: State Small Business Credit Initiative

The Small Business Credit Initiative (SSBCI) was authorized by the Small Business Jobs Act of 2010. Through SSBCI, the U.S. Treasury allocated \$1.5 billion to states to support small business financing programs. The state programs provided public funds to leverage private sector lending and equity investment. SSBCI gave the states the flexibility to design and implement their own set of small business finance programs based on basic requirements laid out in the statute.

SSBCI-funded state agencies either administered credit support and investment programs directly or partnered with other organizations as program administrators. States designed their own program, or portfolio of programs, and developed their own underwriting and operating procedures. SSBCI rules required states to target small businesses, develop a plan to target underserved communities, and design programs that leverage private sector lending and investing. A key SSBCI criteria driving state program design was the expectation that states leverage at least \$10 of new small business lending or investing for every \$1 of public funds during the life of the program.

Four of the five program types were credit enhancement structures:

- Capital access programs provide a portfolio loan loss reserve for which the lender and borrower contribute a share of the loan value (up to 7%) that is matched on a dollar-for-dollar basis with SSBCI funds.
- Loan guarantee programs provide an assurance to lenders of partial repayment if a loan goes into default once the lender makes every reasonable effort to liquidate available collateral and collect on personal guarantees.
- Collateral support programs provide cash to lenders to boost the value of available collateral.
- Loan participation programs purchase a portion of a loan that a lender makes or make a direct loan from the state in conjunction with a private loan (companion loan). The state often subordinates to the lender's senior loan.

Eleven states targeted their SSBCI funding to underserved communities and entrepreneurs of color. For example, New York funded a guarantee program (The New York State Surety Bond Assistance Program, or NYSBAP) targeting minority contractors that bid on public construction projects. NYSBAP provided contractors of color

a guarantee of up to 30 percent to secure a surety bond line, a bid bond, or a performance and payment bond on state and city projects. The NYSBAP was managed by Empire State Development and was provided at no cost to businesses.

The philanthropic community has also begun using loan guarantees to support community investments including small business lending. The Global Impact Investing Network (GIIN) studied the use of guarantees in community investing in 2016. GIIN identified 58 guarantees in U.S. community investing. The most common impact theme was affordable housing and other real estate and they identified six guarantees focused on small business lending. The guarantors were mostly foundations (40%) and government (22%) but also included high-net-worth individuals, banks, and others. Guarantee recipients were mostly banks (35%) and CDFIs (27%).⁵⁷

Case Study: Community Investment Guarantee Pool⁵⁸

The Kresge Foundation has been a champion of guarantees since it began using them in 2011. Kresge first made guarantees in 2011 and since that time has made \$70 million in guarantees over 23 transactions. Based upon this experience, Kresge estimates expected loss rates on its separate guarantees to range between 7 and 10 percent, with up to 27 percent for very risky guarantees.

Kresge joined with others to create the Community Investment Guarantee Pool (CIGP) in December 2019. The CIGP combines resources from the 11 current members into \$33 million in available guarantees but anticipates that amount growing up to \$75 million—which it plans to award in six rounds of applications over the next three years. CIGP seeks to guarantee funds/loans in affordable housing development or preservation, small business investment, or addressing climate change.

The initial participants in the CIGP include The Kresge Foundation, The Annie E. Casey Foundation, The California Endowment, Chan Zuckerberg Initiative, CommonSpirit Health, Gary Community Investments, Jessie Ball duPont Fund, Phillips Foundation, Seattle Foundation, Virginia Community Capital, and Weingart Foundation.

The CIGP has deployed \$7.1 million to three organizations, including \$3.6 million to Local Initiatives Support Corporation (LISC) for its \$36 million Diverse Developer Loan Fund to provide loans for minority-owned or led developers with limited balance sheets. These loans will help them conduct pre-development, acquisition, and construction of affordable housing projects throughout the United States.

The state should establish a \$100 million Small Business Credit Enhancement Fund with \$50 million prioritized for entrepreneurs of color. The Fund could partner with banks, credit unions, and mission-driven lenders to provide loan guarantees and cash collateral grants for business loans that meet specific eligibility criteria, including size, credit profile, and demographics of the business owners. The program could be managed by Massachusetts Growth Capital Corporation, MassDevelopment, or a non-profit corporation.

Action: Establish a \$50 million fund to provide grants to mission-driven small business funds.

Mission-driven small business funds, including Community Development Finance Institutions (CDFIs), Community Development Corporations (CDCs), and other social impact funds, have social missions to fill gaps in access to capital for businesses by providing low cost, flexible financing solutions and support programs for entrepreneurs.

CDFIs are specialized financial institutions that provide financial services to low-income communities across the United States. In 1994, the Riegle Community Development and Regulatory Improvement Act of 1994 established the Community Development Financial Institutions Fund to promote economic revitalization and community development in low-income communities.⁵⁹ The CDFI Fund issues CDFI certifications and provides funds to support CDFIs' activities. CDFIs include a variety of institutions like banks, credit unions, and loan funds, and follow a long tradition of alternative financial institutions created to serve low-income areas and communities of color, including minority-owned banks, credit unions, and community development corporations. CDFIs finance real estate projects (affordable housing, community facilities), small businesses, and consumers. There are more than 1,200 certified CDFIs in the U.S. and most of the loans that they make go to high unemployment, high poverty, low income, or majority people of color neighborhoods.^{60,61}

CDFIs are a critical resource for entrepreneurs of color, especially Black-owned businesses. Many CDFIs either have missions that explicitly focus on serving entrepreneurs of color or on low-income communities, which

yields a prominent focus on entrepreneurs of color. Nearly two-thirds of borrowers of CDFIs that serve small businesses are people of color.⁶² Nationally, a relatively large share of Black-owned firms apply to CDFIs for financing. Seventeen percent of Black-owned firm applicants applied at CDFIs, compared to 5 percent of White-owned, 4 percent of Asian-owned, and 3 percent of Latinx-owned applicants.⁶³

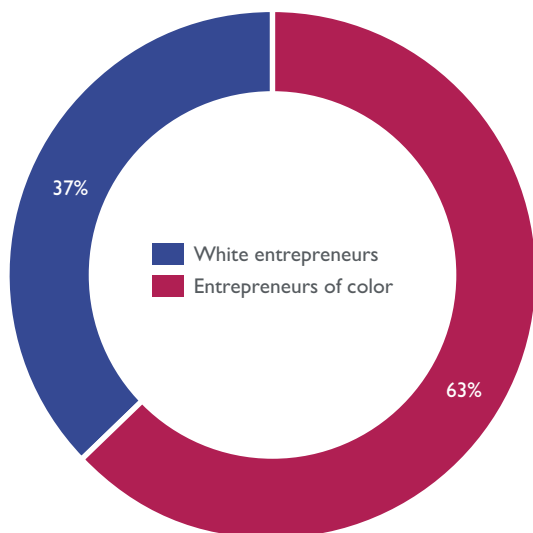
CDFIs, CDCs, and other mission-driven funds tend to have more flexible underwriting criteria, such as less strict collateral requirements and lower credit score thresholds. They are also more likely to make small-dollar loans, or "microloans" to smaller firms.⁶⁴ These features are important because, as noted earlier, people of color tend to have lower levels of personal wealth (e.g., cash savings, home equity) to pledge as collateral and tend to have lower credit scores. Mission-driven funds are impelled to take more financial risk to achieve their social impact missions and the increased risk is made possible by grant subsidies and entrepreneur support programs that mitigate risk. Funding for mission-driven funds' entrepreneurial training, advising and technical assistance programs in healthy proportion to their lending (20-40% of every dollar of financing that they deploy) is critical to effectively scaling their activity.

There are 13 CDFIs in Massachusetts that provide small business financing. During the five years from 2013 to 2017, CDFIs made 859 small business loans totaling \$45.8 million in Massachusetts, an annual average of 172 loans totaling \$9.2 million.⁶⁵ Statewide, 39 percent of CDFI business borrowers were entrepreneurs of color and in Suffolk County nearly two thirds (63%) of CDFI business borrowers were entrepreneurs of color (Figure 13).⁶⁶

Massachusetts is also home to Community Development Corporations

Figure 13: Local CDFIs focus nearly two thirds of their lending on entrepreneurs of color.

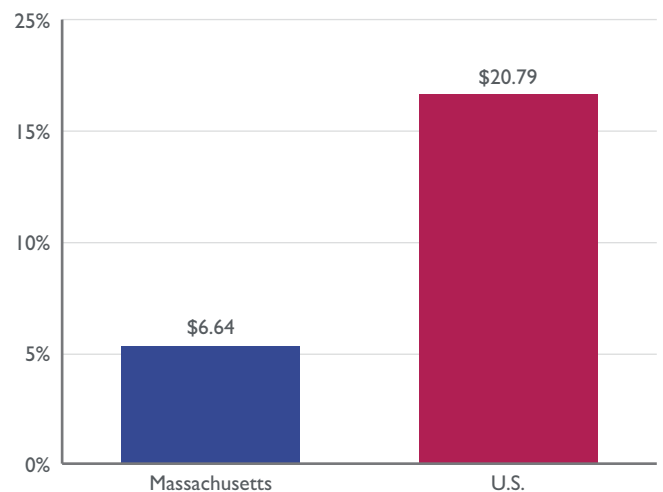
CDFI Small Business Loans by borrower Race/Ethnicity, Suffolk County, 2013-2017.



Source: CDFI Fund

Figure 14: CDFI small business lending per capita is much lower in Massachusetts than it is nationally.

CDFI small business lending per capita, US and Massachusetts, 2013-2017.



Source: CDFI Fund

(CDCs), which are state certified nonprofits that are committed to expanding economic opportunities for low- and moderate-income people in specific neighborhoods or municipalities.⁶⁷ CDCs pursue a wide range of community economic development activities and 11 CDCs in Massachusetts provide small business financing. Some CDCs are also certified CDFIs.

In total, there are 22 mission-driven funds in Massachusetts that finance small businesses (Table 1).⁶⁸ Several of these serve predominantly communities of color, including the Business Equity Fund, Boston Impact Initiative, Local Enterprise Assistance Fund, and Mill Cities Community Investments, plus neighborhood-based organizations and others.

While mission-driven funds play an important role in serving the needs of entrepreneurs of color, the industry overall and market in Massachusetts is small relative to the needs. For example, CDFI lending to small businesses represent less than 1 percent of the overall small business lending market nationally and in Massachusetts.⁶⁹ Massachusetts CDFI small business lending is less than one-third the national average. From 2013 to 2017 CDFI small business lending per capita in Massachusetts was \$6.64 compared with the national average of \$20.79 (Figure 14).⁷⁰

The sector's small scale is the result of limited funding, low operational

capacity including technology, and anecdotally low awareness among the small business community. Substantially increasing financing by mission-driven funds can help meet the unmet capital demand of entrepreneurs of color in Massachusetts. One primary constraint is that CDFIs simply do not have enough money to increase their lending. Approximately 45 percent of CDFIs' lending capital is borrowed,⁷¹ and the main source of borrowed capital is banks who get CRA credit for lending to CDFIs. This means that CDFIs must operate on the "spread" between the interest that they pay their creditors and the interest they charge borrowers. Grants and lower-cost, longer-term loans for loan capital are critically important for mission-driven funds. It allows them to take more risk, charge lower interest rates to small business borrowers, and build their financial position to ensure long-term organizational sustainability. Funding for loan operations is important because mission-driven funds often deploy microloans, even though many of these smaller loans are not profitable (this is one of the main reasons that banks typically do not make small-dollar loans). Operational support for training and technical assistance programs (essential components of [MassINC's Blueprint for Inclusive Entrepreneurial Ecosystems](#)) is also critically important to provide pre-loan support for businesses to get them ready to successfully use loan capital.

Table 1: Mission-Driven Funds in Massachusetts that Finance Small Businesses

Mission-driven Fund	Location	Geography Served	Certifications	MA Business Portfolio	% clients of color
Ascendus Lending (FKA Accion East)	Boston	Massachusetts	CDFI	\$3.0M	66%
Boston Impact Initiative	Boston	Eastern Massachusetts	n/a	\$3.2M	76%
Boston Ujima Fund	Boston	Boston	n/a	\$0.2M	50%
Business Equity Fund	Boston	Greater Boston	n/a	\$2.3M	100%
Coastal Community Capital	Centerville	Cape Cod	CDFI	n/a	n/a
Common Capital	Springfield	Berkshire, Franklin, Hampden, and Hampshire Counties	CDFI	\$5.4M	24%
Community Development Partnership	Eastham	Eight Lower Cape towns	CDC	\$0.2M	5%
Community Teamwork	Lowell	Lowell	CDC	n/a	n/a
Coop Fund of New England	Watertown	New England and Upstate New York	CDFI	\$6.7M	20%
Dorchester Bay CDC	Dorchester	Dorchester, Roxbury, Mattapan, Hyde Park, Jamaica Plain, Roslindale	CDFI, CDC	\$0.3M	92%
Franklin County CDC	Greenfield	Franklin County	CDC	\$4.5M	7%
Jamaica Plain Neighborhood Development Corp.	Jamaica Plain	Greater Boston	CDC	\$3.0M	98%
LISC Boston	Boston	Massachusetts	CDFI	\$3.7M	69%
Local Enterprise Assistance Fund	Boston	Massachusetts*	CDFI	\$4.6M	72%
Massachusetts Growth Capital Corp.	Charlestown	Massachusetts	n/a	\$34.4M	18%
Mill Cities Community Investments	Lawrence	Massachusetts	CDFI, CDC	\$3.3M	92%
New Bedford Economic Development Council	New Bedford	New Bedford	CDFI	n/a	n/a
North Central Mass. Development Corp.	Fitchburg	Worcester and Middlesex Counties	CDFI	\$2.2M	23%
Pittsfield Economic Revitalization Corp.	Pittsfield	Pittsfield	CDC	n/a	n/a
Quaboag Valley CDC	Ware	Quaboag Region and Southern Worcester County	CDFI, CDC	\$1.0M	3%
South Eastern Economic Development Corp.	Taunton	Southeastern MA, all of RI	CDFI	\$10.0M	18%
South Middlesex Opportunity Council	Framingham	Framingham	CDFI, CDC	n/a	n/a

* Local Enterprise Assistance Fund's target market for minority-owned businesses is Massachusetts, but for cooperatives, it is all of the U.S..

National Case Study: Expanding Black Business Credit Initiative (EBBC)⁷²

Formed in January 2016, EBBC’s mission is to create thriving business ecosystems that strengthen Black-owned small businesses, Black-led nonprofits and the seven Black-led/focused CDFIs that help them succeed. EBBC leverages its collective power to reduce systemic barriers and scale access to critical resources—money, management education, and markets—needed to accelerate Black business growth and development. The network of seven CDFIs includes Black Business Investment Fund, City First Bank, Community First Fund Pennsylvania, Hope Enterprise Corporation/Credit Union, Metropolitan Economic Development Association, National Community Investment Fund and Texas Mezzanine Fund.

In 2018, the EBBC launched the Black Vision Fund (“Fund”). The Fund is raising \$78 million from banks and private foundations. The Fund disburses loans and grants to CDFIs (a “fund of funds” approach) to fund their lending and supportive services to Black businesses. The fund’s current focus is on Black-owned businesses in the Mid-Atlantic, Southeast, Deep South, and Midwest regions that are distressed due to the coronavirus pandemic.

The Black Vision Fund is an example of a structure that could be used to aggregate capital at scale to support CDFIs and other mission-driven lenders.

The public (the state, municipalities) and private sector (banks, foundations, corporations, and individuals) can support mission-driven lenders with grants and loans. To focus on reducing barriers for entrepreneurs of color, funders should focus their funding on organizations that disproportionately serve these communities and target funding at specific demographic groups such as Black and Latinx businesses. To catalyze this activity, and building on the state Microlending Program and recent \$17.5 million CDFI/CDC Matching Grant Program, the state should work with the private sector to establish a fund to provide \$50 million in grants over the next five years to mission-driven small business funds (CDFIs, CDCs, and others) with a focus on those that serve entrepreneurs of color. The funding could be used for loan or equity⁷³ investment capital, loan loss reserves, training and technical assistance programs, and operations. This funding could attract as much as \$500 million in additional loan or investment capital over its first years, including bank CRA loans and foundation impact investments (recoverable grants and/or program-related investments, and other impact investments).⁷⁴

Action: Establish a public bank that could partner with other lenders to expand access to capital.

The state of Massachusetts could create a public bank that would be able to leverage many different strategies, in partnership with other financial institutions, to expand access to small business credit. A public bank is a banking institution owned by the people of a state, city or community through their government. By putting a portion of the state’s assets in a public bank, the government could avoid transaction costs at private banks and leverage public funds to make affordable loans to individuals or businesses, or municipalities. By doing this the public bank could substantially

expand the supply of credit in Massachusetts, do so with a very low cost of lending, and set an objective to prioritize lending to entrepreneurs of color.

Public banks make credit more widely available, more accessible, and more affordable, lend in the interest of local residents, and reinvest profits locally. Specifically, public banks can help new and existing businesses to obtain loans by partnering with other lenders to make loans that would pose more risk than a private lender (or even an alternative or nonprofit lender) could normally allow for. The public bank could also participate with other lenders to expand affordable credit access in other ways, such as: offering lower interest rates, buying down loan interest,⁷⁵ or making loan guarantees. A public bank could also purchase loans from other financial institutions to increase their liquidity and negotiate reduced interest rates for struggling borrowers. In sum, by partnering with other financial institutions, a public bank could collaborate with and expand the capacity of local banks, rather than compete directly with them.

National Case Study: The Bank of North Dakota

The state of North Dakota established a public bank in 1919 to increase access to farm loans. At the time, price manipulation by grain dealers and farm suppliers drove up interest rates on farm loans, threatening the state’s agriculture-based economy. So, the state legislature appropriated \$2 million to open the bank, which today has an operational budget of \$270 million. Since 1945, the bank has transferred profits annually to the state’s General Fund (now totaling \$555 million).⁷⁶

The Bank of North Dakota (BND) partners with more than 100 other local financial institutions to fulfill its mission as an economic development bank. BND lending services fall under two categories: direct lending, and participation loans. Direct lending services are quite limited; all other lending programs depend on partnership with a lead financial institution, which can be any qualified financial institution in the state.

BND’s business financing programs use various mechanisms to increase access to credit and make it more affordable for firms. Partnering with local banks, BND lends to small businesses that present more risk than the lead lender prefers. For early-stage entrepreneurs, the state bank provides a loan guarantee of 85 percent up to \$100,000 to help new firms obtain startup capital. To support new job development, the Partnership in Assisting Community Expansion (PACE) Fund at BND partners with a local lender to offer a low interest rate. The PACE Fund’s Flex program buys down the interest of borrowers that are highly valued by the community they operate within (e.g., child-care facilities). For faster-growing firms, BND provides debt or equity funding through the New Venture Capital Program. The state bank can also purchase SBA loans, which helps to lower interest rates for borrowers and increase the liquidity of lenders. Overall, BND has a loan portfolio of \$4.5 billion, of which roughly \$2 billion is in commercial lending.⁷⁶

In 2010, Massachusetts passed legislation establishing a commission to study the feasibility of creating a state public bank (albeit largely for the purposes of infrastructure investment).⁷⁷ Citing several reasons from a report the Federal Reserve Bank of Boston produced for the commission, the group recommended the state not set up a public bank.

The Boston Fed report, a key input for the commission, analyzed whether the Bank of North Dakota (BND) model should be implemented in Massachusetts.⁷⁸ It was principally concerned with the economic challenges following the Great Recession, such as whether a state public bank could stabilize the economy or mitigate the credit crunch. The report found that BND served as an important lending partner with many other smaller local banks, but also concluded that BND did not offer much capacity to address a credit crunch and also did not have an important stabilizing effect on the local economy. The local debate around a public bank in the 2010s did not focus on the market failure the present report is most concerned with: racial disparities in access to small business capital. Although the state commission did report that access to credit for very small businesses in the Commonwealth was a persistent problem.

In light of the persistent gaps in access to small business capital, advocates have again begun to call for a public bank. With input from Massachusetts Public Banking advocates, State Representatives Byron Rushing and Mike Connolly sponsored a public bank bill in the 2017–2018 session (H.3543),⁷⁹ and again in the 2019–2020 session (H.935).⁸⁰ In the face of the COVID-19 pandemic and related recession, Massachusetts Public Banking and state legislators drafted a new public bank bill, which State Senator Jamie Eldridge filed in the senate (SD.1712),⁸¹ and state Representatives Mike Connolly and Nika Elugardo filed in the house (HD.3247).⁸² Among the bills' many provisions are to:

- Help businesses and municipalities in recovering from the COVID recession.
- Expand affordable financing.
- Deposit a significant portion of state public revenues, which could help finance economic activity in the Commonwealth.
- Strengthen state-chartered banks through participatory loan programs.
- Support public, quasi-public, and nonprofit agencies/organizations, including CDFIs, CDCs, and economic development corporations.
- Support small and medium-sized businesses in underserved communities.
- Address historic and contemporary economic inequities that people of color and their businesses face by providing them with affordable financing.
- Make long-term and flexible financing, including debt and equity (in some cases) available directly or through partnership with CDFIs in order to fill a capital gap.

To establish a public bank, the state legislature would need to pass legislation that would determine the capitalization and deposits of state revenues and stipulate independent oversight and audits. The recently filed public bank legislation calls for an equity investment from the state of \$200 million (either from an appropriation or the rainy-day fund) in \$50 million annual increments from 2022-2025. The state would then transfer \$1.4 billion from the Massachusetts Municipal Depository Trust (a fraction of the roughly \$8 billion held at the MMDT). Oversight rules would require the state treasurer to produce annual financial reports available to the public, which would be audited by an external reviewer.

While Massachusetts has a number of public and quasi-public agencies that work with CDFIs and other alternative lenders to increase access to

credit for small businesses and firms owned by people of color, the sum total of their lending capacity does not meet demand. A Massachusetts state bank, such as the one outlined in recently filed legislation, could lend roughly \$1.4 billion (based on a \$200 million capitalization) and thus significantly increase access to credit for cash-strapped small businesses around the state.

INCREASE ACCESS TO EQUITY, GRANTS, AND ALTERNATIVE FINANCING STRUCTURES

While loans are important, there is also a need to develop and scale alternative and innovative structures that better meet the demand for equity capital. Many early-stage businesses do not have the cash flow to support regular loan payments that begin right after they receive capital. Some lenders provide balloon payment loans that are due at the end of the loan term (typically five to seven years), but many businesses are understandably hesitant to commit to a specific repayment date when their growth trajectory is not entirely certain. Early-stage entrepreneurs of color are especially vulnerable given that their owners, friends, and families tend to have much less wealth available to fund the business before it generates revenue and profit.

Equity investment funds that are focused on entrepreneurs of color and the industries that they most commonly operate in can contribute to filling the gap in equity capital. Private social impact funds work by raising money from institutional and individual investors, including impact investors (foundations, financial institutions, and individuals) that are seeking financial returns and positive social impact.

National Case Study: Backstage Capital⁸³

Frustrated by an inability to convince existing venture capital firms to invest in companies led by women, people of color, and LGBT founders, Arlan Hamilton started her own firm, Backstage Capital, in 2015. Hamilton understood the untapped potential of companies run by underrepresented founders, a group historically excluded from venture capital funding, and was eager to demonstrate the significant returns on investment in such companies. Hamilton has raised over \$5 million across three funds and invested in 119 companies across the United States, with concentrations in NYC, LA, San Francisco, Chicago, and Detroit. Most of the companies' founders are people of color (66%), including 54 percent Black founders and 9 percent Latinx founders. Backstage estimates that these companies have created more than 1,000 jobs and raised an additional \$500 million.

Action: Establish a new \$50 million venture development fund with \$25 million in state funds and \$25 million in private funds to focus on high growth firms owned by people of color.

Public-private partnership structures can leverage public dollars to fund entrepreneurs of color. Venture Development Organizations (VDOs) are regional nonprofit organizations that provide business assistance to and capital investment in entrepreneurs and early-stage businesses with high

growth and/or employment potential. VDOs are often seeded by state grants that leverage private matching investments.

National Case Study: JumpStart Focus Fund⁸⁴

JumpStart Evergreen Fund is a nonprofit seed fund operated by JumpStart, a VDO created in 2003. JumpStart was capitalized by a mix of state and private philanthropic capital. The state of Ohio granted \$28 million from 2009 to 2011 and local foundations have contributed more than \$70 million in grants and investments (e.g., KeyBank Foundation granted \$24 million in 2016). JumpStart's funds invest in technology businesses in the 21 counties of northeast Ohio. The financial returns from the fund are "recycled" to make more investments in additional companies. JumpStart manages four funds with different deployment strategies. JumpStart's Focus Fund invests in companies that are minority and/or female-owned/-led and either located in Ohio or willing to relocate to Ohio. The fund invests \$250,000+ in early-stage technology-enabled companies. JumpStart's funds have generated strong economic outcomes for Northeast Ohio: 3,211 jobs created, \$443 million of annual economic output, and \$22 million in annual state and local taxes.⁸⁵

MassVentures has similar characteristics to traditional VDOs. Founded in 1978 by the Commonwealth of Massachusetts, MassVentures is a quasi-public corporation with a mission to address the capital gap for startup companies and to encourage the growth of early-stage technology firms. Initially structured as a revolving loan fund, MassVentures evolved into an equity fund in the 1980s with state funding. The Commonwealth of Massachusetts has granted \$11.7 million to MassVentures since 1982.⁸⁶

The state and private funders should support the establishment of a VDO focused on supporting entrepreneurs of color across the state that operate in high-employment sectors (e.g., life sciences, cannabis, financial technology). The state could seed such a fund with \$25 million and leverage private sector matching funds 1:1 to reach \$50 million for initial capitalization. The Fund could make direct investments in business of color and invest in private funds (i.e., a fund of funds approach) with specific sector strategies. The fund could be managed by MassVentures or a *de novo* nonprofit VDO.

National Case Study: New York State Minority- and Women-Owned Business Fund⁸⁷

In 2015, Empire State Development (New York State's Economic Development Agency) committed \$147 million to create two equity investment funds: The Innovation Fund and the Minority- and Women-Owned Business Fund (MWBE Fund). The MWBE Fund was created to support innovation, job creation, and high-growth entrepreneurship throughout New York State (NYS) by investing in early-stage certified Minority and/or Women-Owned Business Enterprises ("MWBEs") in emerging technologies with a proprietary or differentiated product or service. Through a competitive process, NYS selected a private venture capital firm, Excell Partners, to manage MWBE Fund. From 2016 to 2018 the Fund invested in six seed-stage certified minority and women-owned business enterprises across NYS.

Action: Establish a \$30 million Local Economy Preservation Fund to provide flexible equity funding to viable firms struggling with the effects of the pandemic.

There are also creative structures emerging in the context of the COVID-19 pandemic. The Democracy Collaborative, a national nonprofit focused on democratic economic practices, has developed a concept for Local Economy Preservation Funds (LEPF) that would invest in struggling businesses that were viable pre-COVID and will be viable again post-COVID.⁸⁸ Once investments stabilize, LEPFs would sell their stakes in companies to employees to increase employee ownership. LEPFs are an innovative application of equity financing that can help preserve local business ownership and jobs.

Small businesses would apply to receive equity investments from the LEPF to remain in operation and be held in the LEPF until they are viable and ready to exit. To ensure firms remain locally owned and in the public interest, LEPFs would only exit small businesses to local owners, prohibiting flipping to absentee investors or corporate acquisitions. Preference could be given to employee owners via worker cooperatives or Employee Stock Ownership Plans, which enjoy tax advantages. Some firms, especially those providing critical public goods and services, could be retained long-term in public ownership, or passed to community-based non-profits to be run as social enterprises. There is some historical precedent for the LEPF model. During the Great Depression, the Reconstruction Finance Corporation became the nation's single largest investor, owning thousands of firms.⁸⁹

The state should establish a \$30 million Local Economy Preservation Fund to provide flexible equity funding to viable firms struggling with the effects of the pandemic. The Fund should focus on the sectors that are hardest hit by the pandemic (e.g., food service, retail, personal care). The fund could be managed by Massachusetts Growth Capital Corporation, MassDevelopment, or a nonprofit corporation.

Action: Establish a \$25 million crowdfunding matching program.

People of color are generally underrepresented as investors of capital. Crowdfunding and Community Investment Funds are recent developments that hold promise to diversify capital allocation decision-making and democratize access to local investment. Equity crowd funding in the United States is a small and growing market. Until 2012, only accredited (i.e., wealthy) investors could make direct equity investments. The 2012 Jumpstart Our Business Startups (JOBS) Act broadened eligibility of equity investors and has given rise to equity crowdfunding platforms for the average American,⁹⁰ including Salem, Mass.-based Mainvest, a platform that allows local community members to invest in local main street businesses. The U.S. crowdfunding market is growing rapidly but is still very small. Between 2016 and 2018, the annual number of crowdfunding offerings nationally increased from 292 to 502, and occurred alongside a rise in total investment and total number of investors.⁹¹

There are also a growing number of Community Investment Funds (CIFs) nationally that are focused on local investors and community-based decision-making. CIFs have three defining characteristics: they are

capitalized by local investors; they invest in local companies; and local stakeholders make investment decisions. Massachusetts is home to several thought-leading CIFs, including Boston Impact Initiative, the Boston Ujima Fund, and Pioneer Valley Grows Investment Fund.

Local investing is a powerful inclusive economic development tool. Just as spending with local businesses is shown to generate 3 times more local economic activity,⁹² local investors keep more money circulating in Massachusetts communities while allowing local stakeholders to benefit from the success of businesses that they support.

The state and local philanthropies should establish a \$25 million program to match individual crowdfunding investment in entrepreneurs of color dollar for dollar. Such a program would increase access to capital for local businesses and catalyze the growth of the nascent sector. The fund should be managed by Massachusetts Growth Capital Corporation given its experience and capabilities from deploying COVID-19 relief grants.

Action: Establish a \$10 million Capital Innovation Fund to support the development and growth of alternative financing structures.

Equity investment is mostly relevant to a small portion of businesses that are high-growth and have potential to return equity to investors through a sale of the business (e.g., to a strategic acquirer or to the public markets via initial public offering). Many low- and moderate-growth businesses and those that are unlikely to be sold are not a good fit for equity investors' (venture capitalists, angel investors) return expectations. However, many of these businesses still need initial equity capitalization at startup and growth phases and face a gap in access to capital known as the "valley of death"—the phase of business development before revenues or profits are sufficient to cover expenses. The valley of death phenomenon is a greater problem for entrepreneurs of color because, on average, their owners have lower levels of personal wealth and investment from friends and family to bridge to the other side. Entrepreneurs of color are also more concentrated in low- and moderate-growth industries (e.g., social services, food services).

Innovation in capital structures is required to fill this gap. Several such structures, including contingent payment instruments and structured exits, have potential to close the gap.

Revenue-based financing (RBF) and demand dividends are the primary types of contingent payment instruments. In revenue-based financing (RBF) structures, investees commit to paying back a percentage of revenue (usually 1 to 3 percent) for three to five years, until a multiple of the original investment is paid off. In the end, investors may receive as much as three times the original amount invested.⁹³ Similarly, demand dividends are contingent payment instruments that dedicate a percentage of free cash flow as the source of returns to investors.⁹⁴ Contingent payment instruments adjust with the performance of the firm, unlike traditional loan payments. Firms that receive RBF agree to pay a fixed percentage of revenues, often around 5 percent. So, if business slows, the required payment to investors declines proportionately. By contrast, small business loan payments do not account for business cycles. Flexibility in payments associated with RBF can be beneficial for businesses whose cash flow varies over time, which is often the case among smaller firms. There is, however, a risk that businesses who experience dramatic growth in revenue complete payments to

investors in a short period of time, which can drive up the cost of capital significantly.

Structured exits are investment structures designed to achieve liquidity without reliance on a traditional exit. This commonly includes owner and/or employee stock purchases whereby the business essentially buys back the ownership share of the investor at a pre-determined stock price at a specific time. In addition to providing an avenue to equity financing for businesses, structured exits allow the business owner to keep more of the upside in the case of outperformance. Some structured exits also have flexible buyback timing and therefore offer the same benefits as contingent payment instruments.

One of the most significant advantages of these alternative structures for small business owners is that investors do not require them to provide collateral, but rather focus exclusively on the business' viability and its revenue and profit potential. This is an important distinction between traditional debt financing, as small business loans usually require firm owners to have home equity (or other real estate holdings) and other personal assets that can serve as collateral in case of default on loan repayment. Because many smaller firms and their owners lack the necessary assets to provide sufficient collateral, they often do not qualify for business loans. This disproportionately affects business owners of color, who tend to have fewer wealth assets, due in large part to historic racial discrimination in mortgage lending. Investors' exclusive focus on business potential and future performance is a good alternative for smaller businesses and those owned by people of color.

National Case Study: Founders First⁹⁵

One leading revenue-based financing company is Founder First Capital Partners, which focuses on connecting investors to firms owned by women, people of color, and other less advantaged groups. Seeking to fill funding gaps outside of Silicon Valley and New York City, which receive the largest share of investor funds, Founders First directs capital to service-based small businesses, which often do not have the collateral or predictable revenue to help them qualify for debt finance. Business owners also receive advice and access to training programs. More than 80 percent of companies that receive funding from Founders First experience revenue growth within the first year, and more than half see a 25 percent increase during the first six months. To date, Founders First has raised more than \$100 million and plans to fund roughly 500 companies with an average investment of \$250,000.

The state and private funders should establish a \$10 million Capital Innovation Fund to support the development of alternative financing products by Massachusetts mission-driven funds. The Fund could provide grants, loans, and investments to existing and new mission-driven funds that focus on directing capital to entrepreneurs of color. The fund could be managed by Massachusetts Growth Capital Corporation, MassDevelopment, or a nonprofit corporation.

Action: Establish a \$10 million annual state grant program for entrepreneurs of color.

The state of Massachusetts could provide matching cash grants with preference for idea and early-stage entrepreneurs of color to help put equity on the balance sheets of those firms and close the racial gap in access to seed capital from personal, friends and family resources. The state could distribute grants through intermediary partners such as CDFIs and nonprofit business service organizations (e.g., The Black Economic Council of Massachusetts).

National Case Study: Small Business Innovation Research and Small Business Technology Transfer Programs

The Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs are competitive federal programs that encourage domestic small businesses to engage in Federal Research/Research and Development (R/R&D) with the potential for commercialization. Through a competitive awards-based program, SBIR and STTR enable small businesses to explore their technological potential and provide the incentive to profit from its commercialization. By including qualified small businesses in the nation's R&D arena, high-tech innovation is stimulated, and the United States gains entrepreneurial spirit as it meets its specific research and development needs.

However, the program appears to award a disproportionately low share of grants to entrepreneurs of color. The share of the Massachusetts population made up by people of color was nearly five times larger than the share of SBIR-SSTR grants to minority-owned firms—only 6 percent of Massachusetts SBIR/STTR grants went to people of color in 2019.⁹⁶

In the context of COVID relief, the state of Massachusetts—through the Massachusetts Growth Capital Corporation—has provided a significant amount of grant capital directly to small businesses with fewer than 50 employees, with a preference for underserved small business owners. The state reports that it funded 100 percent of the completed applications from entrepreneurs of color and that 39 percent of all grants went to entrepreneurs of color. This intervention could serve as an example for a new grant program going forward.

The state should create an annual \$10 million state small business matching grant program that prioritizes entrepreneurs of color in sectors aligned with the state's economic development goals (e.g., life sciences, technology) and high-employment sectors (e.g., food service, hospitality, construction). The state could distribute grants through intermediary partners such as the mission-driven funds mentioned above and nonprofit business service organizations that are focused on entrepreneurs of color (e.g., Amplify Latinx, The Black Economic Council of Massachusetts, The Foundation for Business Equity). The fund could be managed by Massachusetts Growth Capital Corporation given its experience and capabilities from deploying COVID-19 relief grants, or another nonprofit entity. The grants could also be distributed as part of incubators and accelerator programs focused on entrepreneurs of color.

REGULATE THE SMALL BUSINESS FINANCING SECTOR

Most rigorous analyses of racial differences in credit market experiences point to creditworthiness as the key explanatory variable, but this does not fully explain observed disparities. Prior research demonstrated, for example, that Black-owned firms have more difficulty obtaining capital than other firms do, even when accounting for lots of owner and firm attributes (e.g., owner's wealth).⁹⁷ More recent analysis of restricted-access data from the Kauffman Firm Survey reaffirmed this: While differences in credit scores frequently explain much of racial difference in small business financing outcomes, large disparities in loan approvals between Black and White business owners surfaced, even when only considering those with credit scores at or above the 75th percentile.⁹⁸

Action: Combat direct racial discrimination through matched-pair “mystery shopping” experiments and penalties administered by the state Attorney General's office.

Identifying direct racial discrimination in the small business capital market can be difficult, but where possible, it must be detected and eliminated. “Mystery shopping” for small business loans is a proven way to discover discriminatory lending practices and could be used to root them out here in Massachusetts.

Matched-pair mystery shopping experiments are designed to detect racial discrimination in small business lending practices before an approval decision is made. By sending two individuals out to seek the same service, one White and one Black, having comparable credit histories and business profiles, researchers can evaluate differences in information received, information required, and customer service provided. Past experiments have revealed (with statistical significance) that bank officers asked Black individuals to provide more business and personal financial information (including questions about marital status and spousal income, which violates fair lending laws), and offered less assistance and encouragement compared to interactions with White individuals. A more recent experiment uncovered similar divergences in small business lending practices related to the federal PPP program.⁹⁹ Massachusetts could use this type of experiment to evaluate local banks and censure those that violate fair lending laws.

Action: Under the leadership of the Massachusetts Division of Banks, expand Community Reinvestment Act performance evaluations and mandatory data reporting in Massachusetts to include race and ethnicity.

The Community Reinvestment Act (CRA) is a federal law meant to address “persistent systemic inequity in the financial system for low- and moderate-income and minority individuals and communities.”¹⁰⁰ However, the law and regulators do not explicitly consider race or ethnicity of customers in their bank performance evaluations, nor do they require reporting of race or ethnicity in loan transactions data. Thorough consideration of race and ethnicity by bank regulators would cause banks to be more proactive in their efforts to meet the needs of entrepreneurs of color.

National Context: Overview of CRA

The Community Reinvestment Act (CRA) is a federal law that was enacted in 1977 and requires banks to extend credit in their location of charter and in areas where they receive deposits. CRA was enacted to combat redlining, many financial institutions' practice of systematically denying mortgages, loans, and other financial services to applicants from low-income, minority-populated regions. Nationally and state-chartered banking institutions and savings associations are covered by the act, while credit unions, insurance companies, securities companies, and other nonbank institutions do not fall under its purview.

Banks can receive CRA credit for a wide range of activities. Major categories of qualifying investments include consumer, business, and mortgage loans; low-cost education loans; and investments in infrastructure or projects that otherwise have a community-oriented purpose. Banks also receive credit for providing other services to their communities, including financial literacy education and consulting, discounted transaction processing, and physical facilities for disadvantaged categories of businesses.

The CRA tasks banking regulators, including the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, with tracking the extent to which chartered banks provide financial services to their local communities. When assigning CRA credits, bank regulators examine banks' levels of CRA-credited activity in proportion to their size and issue banks one of four overall performance ratings: Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance. From 2007 to 2018, about 2–4 percent of banks were rated Noncompliant or Needs to Improve, about 86–90 percent Satisfactory, and about 8–10 percent Outstanding. Section 804 of the CRA requires federal banking regulators to consider these ratings when banks apply for charters, new branches, mergers, or other actions. Although the CRA does not specify how regulators should weigh CRA ratings, banks rated below "Satisfactory" may be barred from merging or opening new branches altogether. When banks receive a rating below "Satisfactory," regulators expect them to address their deficiencies immediately and may reexamine such banks within 12 months.

Federal regulators and advocacy organizations are working to reform CRA regulations. Many reformers are focused on strengthening CRA rules related to banks' CRA credit for investments to low-income and communities of color. The Federal Reserve acknowledges these challenges and has asked for public comments on how to reduce racial inequities: "What modifications and approaches would strengthen CRA regulatory implementation in addressing ongoing systemic inequity in credit access for minority individuals and communities."¹⁰¹ The National Community Reinvestment Coalition (NCRC) has responded by proposing that race and ethnicity be more explicitly considered in bank performance evaluation.¹⁰²

"CRA exams should and must include analyses on bank lending, investments and services to people and communities of color because these are the communities that were originally redlined and are often exploited by predatory lending. The legacy of discrimination includes colorful maps with glaring red lines, drawn around black and brown communities. Therefore, we cannot keep color out of CRA."¹⁰³

State regulators work closely with federal regulators in the enforcement of CRA and Massachusetts has been a leader on CRA innovation, including expanding CRA evaluation to non-bank lenders and insurance companies.¹⁰⁴ Massachusetts Division of Banks could continue its CRA innovation by incorporating race and ethnicity in CRA performance evaluations. This could include affirmatively considering race in the delineation of CRA assessment areas; considering racial demographics in the lending benchmarks; considering lending to individuals and communities of color as part of CRA ratings. Additional regulation could also force disclosure of the race and ethnicity of loan recipients in Massachusetts under the CRA.

Action: Create new state regulations based on the Truth in Lending Act for financial technology firms.

Fintech firms make up a growing segment of the small business lending market and have the potential to aid in closing racial gaps in access to capital. This is because entrepreneurs of color are less likely to have formal banking relationships and more likely to seek and obtain credit through online platforms. However, fintech lenders are also more likely to lend to higher risk customers and charge borrowers exorbitant interest rates and fees. While fintech applicants report greater success obtaining credit than traditional-lender-only applicants despite having lower credit scores, satisfaction levels were lower at online lenders as compared to levels at both large and small banks.¹⁰⁵ This is largely due to opaque or confusing loan terms and high costs of borrowing. In the absence of appropriate regulatory protections, small businesses can fall prey to predatory fintech lenders. State regulations designed to protect borrowers from predatory fintech lending could increase access to safe and affordable small business loans, harnessing the power of new lending platforms for entrepreneurs of color.

At present, fintech lending to individual borrowers is regulated by federal consumer protection law, but lending to small businesses lacks similar protections. At the federal level, Congress could move to include small business lending in the purview of the Consumer Financial Protection Bureau. In particular, the Truth in Lending Act (TILA) could be adjusted to protect all borrowers under a certain lending threshold (including small businesses).¹⁰⁶ Even while federal regulations do not currently protect commercial borrowers as they do individual consumers, individual states could extend TILA-like rules for small businesses lending.

State regulators are well-positioned to regulate the activities of finance firms that are not depository institutions, such as fintech lending companies; they have a great deal of experience overseeing the licensure of consumer lenders and regulating local banking activities to ensure they adhere to strict consumer protections. Expanding these types of protections to small businesses would make it so that fintech companies would be required to detail loan costs and terms and end the use of misleading advertising strategies. The state could also impose limits on interest rates and require licensing of nonbank lenders to small businesses, much as New York State recently did.

National Case Study: New York’s S.B. 5470¹⁰⁷

In December 2020, the state of New York passed a law designed to significantly increase oversight of commercial lending practices. The new law includes provisions much like the Truth in Lending Act, such as disclosure of transaction terms and requiring lenders to obtain the borrower’s signature before finalizing the transaction. Regulations will cover an array of institutions and financial products, like loans, factoring transactions, closed-end and open-end financing, direct providers, third-party solicitors, and others. It will affect a variety of nonbank financial technology firms, including platforms that solicit and present offers on behalf of a third party, even if they do not provide financing directly. The state’s Department of Financial Services will be able to track transactions and impose penalties of between \$2,000 and \$10,000 for each willful violation of the law.

In 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which recognized that Minority Depository Institutions (MDI) banks play an important role in serving the financial needs of historically underserved communities, including entrepreneurs of color. Compared to other banks, MDIs originate a greater share of loans to minorities. Within small business, from 2011 to 2016, MDIs originated a greater share of SBA 7(a) loans in low to moderate-income census tracts than non-MDIs and they originated a greater share of SBA 7(a) loans in census tracts with larger shares of minority populations than non-MDIs.¹¹⁰ Despite the clear benefits of MDIs, a recent FDIC study found that from 2001 to 2018, the number of MDIs declined by 9.1 percent and that the decline has accelerated since the Great Recession: from 2008 to 2018, the number of MDIs declined 31 percent. MDIs and particularly small MDIs still have much higher expenses in terms of the cost to bring in a dollar of revenue. Massachusetts is home to only two FDIC-insured MDIs (One United Bank, Leader Bank)¹¹¹ and two MDI credit unions (New England Bee and Messiah Baptist-Jubilee).¹¹²

MDIs could benefit from more deposits and more individuals using their services, but they really need equity investment to significantly expand their impact. To that end, private investors and philanthropic organizations should make \$100 million in equity investments in MDIs that serve Massachusetts.



We have dual economic and moral imperatives to eliminate racial gaps in access to small business capital. Narrowing the half billion-dollar annual gap in Massachusetts will support a more equitable economic recovery from the COVID-19 recession and boost long-term economic growth. As communities of color continue to grow in Massachusetts, all Bay Staters share in their economic destiny. Supporting entrepreneurs of color can help us close the racial wealth gap while boosting local economic activity. McKinsey estimates that if the racial wealth gap were closed, GDP nationwide would grow by 4 to 6 percent.¹¹³ In Massachusetts, this could mean adding another \$24 to \$36 billion to the state’s annual economic activity. Morally, as a Commonwealth we need to continue to strive for racial justice in all parts of our society. The merit of entrepreneurs’ ideas and business plans should be the primary determinants of their success. Many entrepreneurs of color in Massachusetts have succeeded despite the varied challenges in accessing capital, and have grown impressive businesses, provided quality jobs for their neighbors, and served as pillars of their communities. Imagine how much stronger we would be as a Commonwealth if we rebuilt our economy so that all entrepreneurs of color could prosper.

INCREASE DIVERSITY IN CAPITAL ALLOCATION ROLES AND INCREASE FUNDING FOR CAPITAL PROVIDERS OWNED AND/OR OPERATED BY PEOPLE OF COLOR.

Increasing the participation of people of color in capital allocation decisions can result in more equitable outcomes. As noted above, venture capitalists and senior bank executives are overwhelmingly White and male. The national literature and our local interviews suggest that institutions owned and operated by people of color better serve communities of color.¹⁰⁸ Capital providers should strive to diversify the staff who make financing decisions and specifically target proportionality with the demographics of the communities they are seeking to serve. Investors and grantmakers (and other capital allocators) should work to increase their support for small business capital providers (e.g., banks, mission-driven funds, venture capital firms) owned and/or operated by people of color.

Action: Empower state agencies to gather and share demographic data of financial institutions.

The Massachusetts Executive Office of Labor and Workforce Development, Division of Banks, or another state agency could collect and publish, among other information, the racial demographics of leadership at financial institutions, including banks, credit unions, venture capitalists, and private equity firms. This transparency can serve as the basis for community and employee advocacy to increase the diversity of these firms to ideally reach proportionality with the communities in which they operate.

Action: Capitalize financial institutions owned and/or operated by people of color with \$100 million in equity investment.

Financial institutions that are owned and operated by people of color are proven to better serve communities of color, including entrepreneurs of color.¹⁰⁹

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