It's Personal: How Consumer Credit Paves the Way for Business Success

A good credit history is a financial asset. Distinct from debt, credit is a measure of financial health and influences lending and business decision making. Far more than just a number, a strong credit score is a prerequisite for everyday financial services like a low-cost credit card or car loan. Renting an apartment, paying for car insurance, signing up for utilities, and even landing a job can all be affected by a person's credit history—or the absence of one. Robust credit is a foundation for building assets, including purchasing a home or starting and growing a small business.

Individuals with a good personal credit history will pay approximately $200,000 less in fees and interest over the course of their lifetime than those with poor or nonexistent credit scores.[1] Entrepreneurs rely on their personal credit profiles not only for their household financial well-being, but also when accessing business financing. Thus, a strong credit history is essential for achieving small business success. This can be a particular challenge for entrepreneurs of color, who are more likely to start off with lower credit scores and less access to capital and affordable credit products than white entrepreneurs. Eliminating credit disparities and increasing access to safe and affordable credit products can help these entrepreneurs leverage credit to build wealth. This brief describes the importance of strong personal credit histories for building resilient businesses. It also highlights the need and promising solutions for increasing consumer credit building opportunities for entrepreneurs and small business owners.

Entrepreneurship and Small Businesses Ownership as a Pathway to Wealth Building

Small business ownership offers a vital pathway to wealth creation, a promising alternative to discriminatory job markets, and a means for achieving agency over employment prospects amid a dearth of living-wage jobs.[2] Business equity is the second largest source of household non-financial assets, after home equity.[3] The median net worth of business owners is almost two and a half times higher than that of non-business owners. For a Black woman who owns a business, the difference in median net worth is more than 10 times than that of her non-business owner counterparts, and for a Latino man, it is five times.[4] For these reasons, it is not surprising that Black Americans and immigrants are almost twice as likely to start a business as white and native-born Americans.[5] In addition, those returning from a period of incarceration, disproportionately people of color, often turn to entrepreneurship when criminal background checks hinder opportunities for employment.[6]

If starting and growing a business is a key means through which many build assets, in particular for entrepreneurs of color, building and protecting credit histories is an essential foundation for that success.

Owning a small business can be a powerful wealth- building strategy and play a role in closing the racial wealth gap. However, with opportunity comes risk. For many entrepreneurs, this risk manifests in the inevitable link between business and personal finances. If starting and growing a business is a key means through which many build assets, in particular for entrepreneurs of color, building and protecting credit histories is an essential foundation for that success.

Credit Access and Racial Disparities

While entrepreneurship is a wealth-building strategy, not all entrepreneurs start on equal ground. Research shows that levels of personal wealth are directly correlated with the creation and sustainability of businesses.[7] With the current racial wealth divide, the Cleveland Federal Reserve calculates that it would take approximately 260 years for the average Black family to achieve 90 percent of the wealth of the average white family.[8] Given low levels of wealth and segregated social networks, entrepreneurs of color have fewer resources to draw upon for startup capital. This leads many to seek a variety of financing options, among them credit, to get a business off the ground.

THE CREDIT INVISIBLES

Individuals with no credit history will not have a credit report or a credit score. An individual with a thin credit file, generally defined as having fewer than three active credit accounts, will have a credit report but may not be able to generate have a credit score due to insufficient credit history. In both cases, these individuals are seen as potential credit risks due to inexperience or lack of recent credit history. More than one in three adults in the United States are credit-challenged. This includes 38 million with credit scores below 600 and 53 million more without a credit score.[15]

While credit score algorithms do not factor in income or wealth, their influence still shows up in credit scores. Lisa Rice, CEO of the National Fair Housing Alliance, refers to this as a "dual credit market," one that is separate and unequal.[9] Historical redlining codified racial discrimination in lending, leaving households of color no option but to turn to predatory products.[10] This practice inhibited and degraded the transfer of generational wealth and persists to this day. Mainstream financial institutions have disinvested in communities of color, causing predatory lenders to disproportionately cluster.[11] As a result, people in lower income neighborhoods are more likely to be excluded from access to traditional credit; instead, they are more likely to enter the credit system because of derogatory debt as compared those with higher incomes.[12] This can lead to credit invisibility—Black and Hispanic people are twice as likely to be credit invisible or have low credit scores.[13] In over 50 of 60 U.S. cities studied by the Urban Institute, residents in predominantly non-white areas had median credit scores that were below prime (<660), and most were subprime (<600).[14]

Discrimination by financial institutions, a mistrust of those financial institutions due to that discrimination, and predatory targeting by fringe lenders correlates with the existence and persistence of low or nonexistent credit scores. For entrepreneurs of color, this results in less information about and access to credit products. For example, in 2017 the Federal Reserve Board found that that banks denied credit to more than half of Black small business owners and nearly 40% of Latinx small business owners.[16] To further understand these racial disparities in lending, the National Community Reinvestment Coalition conducted "secret shopper" tests at banks. It found that Black and Latinx business owners were also given less information about loan products available to them and required to provide more personal information when searching for a small business

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loan.[17] These realities reinforce and perpetuate the racial wealth divide. Entrepreneurs able to tap mainstream financing can continually strengthen their credit; those with poor credit histories or without a credit history at all, are routinely excluded or charged more.

While nonprofits and other mission-oriented microenterprise and small business development organizations including incubators and lenders might target support to entrepreneurs of color, many don't offer sufficient credit building education. Additionally, some of those that lend may not report their borrowers' loans to the credit bureaus, inhibiting their clients' ability to access affordable credit. This is a missed opportunity.

Importance of Credit for Entrepreneurs and Small Businesses

Strong personal credit plays an essential role in helping a business survive, maintain stability, and thrive. Specifically, personal and business credit allows entrepreneurs to:

- Access financing
- Rent adequate business space
- Acquire or finance the production of inventory
- Purchase necessary equipment, materials, or other goods
- Manage working capital through lines of credit dedicated to payroll or inventory during low business seasons
- Qualify for other business opportunities, such as government contracts

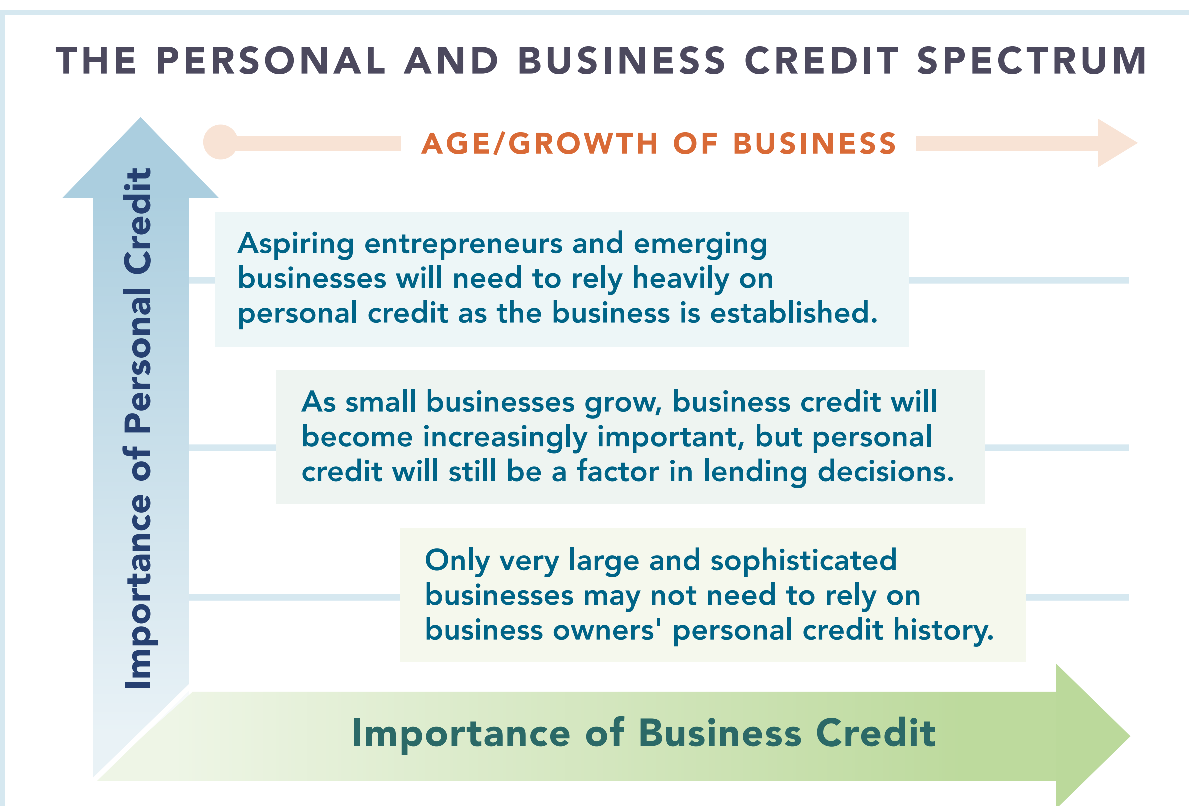
Credit Throughout the Business Life Cycle

As a business goes from start up to maturity, an entrepreneur will lean on credit for different purposes. Over time, an entrepreneur will generally shift from a reliance on personal credit to business credit as their business matures. The exact circumstances of this shift vary depending on the size of the business, cash flow, capital availability, and inventory needs, among other variables.

Emerging and Early Stages: When a business is brand new or in its earlier stages, lenders will weigh an entrepreneur's personal credit history as they determine the terms and availability of financing. Lenders view an entrepreneur's personal credit history as an indicator of how well they will manage their business finances, hence, when seeking startup capital or even a lease, personal credit is the most relevant data for underwriting. The business may not exist yet, be incorporated, or be able to demonstrate other factors considered by creditors in extending credit. In the early stages of any business's development, an entrepreneur's personal credit may remain the primary factor in applications for business loans and/or lines of credit, especially until the business grows to a minimum revenue or other size threshold (determined at the discretion of the financial institution). This access has lasting implications: research shows that access to startup capital and financing options in the early stages of the business is one of the most influential factors that dictates long-term success for entrepreneurs of color.[18]

Stabilizing Operations and Weathering Shocks: Over sixty percent of businesses fail within their first five years.[19] While revenue may not be predictable, access to credit can make the difference between navigating unforeseen circumstances or closing doors. Credit can help a business weather economic shocks, manage cash flow, adapt to industry or technological changes, maintain and update equipment, and sustain a period of growth. During this time, establishing a business credit profile and building a positive track record can open doors for businesses small and large. This credit history, along with the business's financials, will supplement the evidence base needed to prove that the business will be able to successfully grow.

Growth and Maturity: Realistically, a business will rotate between the growth and maturity stages throughout its life cycle. As the business becomes more stable, establishing a credit history under the name of the business, through trade relationships with suppliers and/or through a business credit card, becomes more meaningful. Its established relationship with financial institutions and good personal and/or business credit can facilitate ongoing growth. Even so, requirements to personally guarantee and/or cosign a business loan are still common. Underwriters may place greater weight on business credit history for larger, more experienced, and better-resourced businesses, but a business owner's personal credit history remains relevant for most small business financing.



QUAN'S STORY

Quan spent 22 years in and out of prison. When Quan was released, he had no credit at all. Now, just under two years post-release, Quan has established a credit score of 822 and operates a successful business with three employees. Quan attributes his success to his entrepreneurial spirit and to the time that he spent educating himself about credit pre-release.

"I have always been entrepreneurial. Always drawn towards business—though some illegal. I realized [in prison] that I had certain talents that I could translate to business."

In addition to self-study on the topic of credit while incarcerated, Quan opened a secured credit card once released [and made on-time payments]. Quan considered the $500 deposit that he had to put down as collateral for the card an investment towards his personal financial and business goals.

The investment paid off. "I applied for my first business credit card and they ran my personal credit. I was able to grow my business credit. My credit limit went up. My bank will every now and then send me offers. Having larger credit lines helps me know that I can leverage credit to take on bigger contracts."

Call to Action

"Freedom is not enough. You do not take a person who, for years, has been hobbled by chains and liberate him; bring him up to the starting line of a race and then say, 'you are free to compete with all the others,' and still justly believe that you have been completely fair. Thus, it is not enough to just open the gates of opportunity. All our citizens must have the ability to walk through those gates."

—President Lyndon B. Johnson

The socioeconomic barriers that entrepreneurs, especially those of color, face are complex and multi-faceted. The COVID-19 pandemic and resulting economic fallout have hit small businesses across the country particularly hard. Despite this, the accompanying recovery and reaffirmed urgency to address our nation's history of racist policies, present a real opportunity for lasting change. Policy makers, funders, lenders, and practitioners must continue to support responsible credit building programs and policies that combine access to safe and affordable financial products—that are reported to the credit bureaus—with skilled and relevant financial education and coaching. Targeting this support to communities of color will open doors and allow more people to envision themselves as entrepreneurs. To accomplish this, we recommend that funders and policy makers champion the following:

Support and Expand Relevant Credit Education for Entrepreneurs

Culturally relevant credit education is essential to leveling the playing field for consumers and entrepreneurs of color, yet it is far from universally available. Accurate and comprehensive credit education provides entrepreneurs with knowledge about how the system works and safe ways to establish and improve their personal (and business) credit profiles. We recommend that funders invest in building the capacity of nonprofits to provide (or partner with other organizations with the capacity and expertise to provide) credit coaching, including the ability and mandate to pull soft inquiry credit reports for educational purposes. Practitioners should embed credit building education as a staple service to their microenterprise and small business clients. In addition, harnessing lessons from the public health field, adequately resourced consumer-centric public information campaigns can amplify important credit building information at scale. For example, messaging widely about the dangers of disreputable credit repair and other "quick fix" predatory services and products like payday loans, along with raising awareness about viable and safe alternatives could go a long way to countering the negative reach of those services that otherwise interrupt an entrepreneur's business gains.

Increase Access to Relevant, Responsible Microenterprise and Small Business Credit Products

Knowledge about credit alone is insufficient if entrepreneurs cannot act on it. However, mainstream financial institutions offer limited options for smaller dollar credit due to lack of profitability, and many are unwilling to take the risk of working with startup or newer microenterprises or small businesses. From 2007 to 2015, one study found that the number of banks offering business loans under $100,000 declined by 58 percent. Entrepreneurs in the startup phase or small business owners in general may not qualify for a loan at all, let alone one over $100,000. Furthermore, some do not need that much money to get their business up and running. Fortunately, many nonprofit lenders fill in the gaps to provide smaller, accessible loans. To further address a dearth of relevant, responsible microenterprise and small business credit products, investors can continue to capitalize Community Development Financial Institutions (CDFIs) to offer right sized and accessible credit products that meet the needs of entrepreneurs, particularly those of color. In addition, policy makers and advocates can ensure that the Community Reinvestment Act holds financial institutions accountable to making capital available and investing in diverse communities.

Promote a Fair Regulatory Environment that Centers Racial Equity

While safe, affordable, and accessible products provided by nonprofits and mainstream financial institutions will help abate the need for "alternative" lenders, there is still a need to regulate predatory actors and deceitful lending practices. Increasingly of alarm is a growing industry of usurious and unregulated small business lenders. A 2017 poll for the Small Business Majority found that 78 percent of small business owner respondents feel that high interest, high fee products being offered to small businesses are a problem. And, according to the Federal Reserve, Black and Latinx entrepreneurs are at least two times more likely to seek "alternative" high-cost financing compared to white entrepreneurs. To ensure a fair lending environment, policy makers can cap rates on small dollar installment loans and do more to regulate small business lending. For instance, Congress can create a Truth in Lending Act (TILA) for Small Business that ensures transparency in pricing and terms (a parallel to the consumer lending TILA). In addition, the Consumer Financial Protection Bureau can better monitor and regulate online business lending platforms that currently operate in what nonprofit lender Opportunity Fund calls a "regulatory void."

Lastly, lenders and financial institutions don't need to wait for regulation to adopt fair lending practices that lead to expanded and safe capital options for entrepreneurs of color. Lenders can sign on to the Small Business Borrowers' Bill of Rights (SBBBR) which commits them to a higher standard of lending than required by law. SBBBR identifies fundamental financing rights to help protect small businesses and outlines set of specific practices that should be required of lenders and brokers to comply with these rights.[20]

Promote Responsible Use of Nontraditional Credit Inclusion Strategies

The use of alternative data in credit scoring and underwriting has the potential to help the vast number of credit invisible consumers, who are disproportionately BIPOC, become scored and hence, eligible for financial products. Policies that scale evidence-based strategies such as rent reporting, and the use of cash flow data for underwriting would enable entrepreneurs to use predictive alternatives to credit scores to access financing. However, alternative data is not a panacea. Its use should be carefully tested and regulated to mitigate unintended consequences for vulnerable consumers and entrepreneurs.

Conclusion

While credit building is not a stand-alone solution, it is an essential strategy that must be deliberately and broadly levered to build strong businesses and wealth in communities of color. Good credit building products must be paired with credit education that is self-affirming of those it targets, and offered within a regulatory environment that supports innovation, curbs usurious practices, and centers vulnerable and BIPOC communities. A financial ecosystem that nurtures credit building among consumers will inherently galvanize a healthier and more diverse base of entrepreneurs and small business owners.

About Credit Builders Alliance

CBA was created in 2007 by and for our nonprofit members in response to a serious gap in the modern credit reporting system that locks millions of individuals with poor or no credit out of the mainstream financial system. CBA's core services provide our 580+ members with the ability and support needed to report loan data to the credit reporting agencies and to pull client credit reports for financial education, outcome tracking, and underwriting. Our Training Institute provides robust trainings, tools, and up-to-date industry information that equips practitioners to help clients build credit and reach financial goals. Through this support, CBA helps people and small businesses who are outside of or underrepresented in the financial mainstream build credit to achieve their goals and enjoy financial resiliency. For more on CBA, go to **www.creditbuildersalliance.org** and follow us on Twitter at **@Credit_is_Asset.**

This brief was developed with support from Kaiser Permanente.

Founded in 1945, Kaiser Permanente is recognized as one of America's leading health care providers and not-for-profit health plans. Kaiser Permanente currently serves 12.4 million members in 8 states and the District of Columbia. Since its founding, Kaiser Permanente has invested in community health through a variety of means. Among those investments are the charitable contributions they make to nonprofit, community-based organizations to meet the shared objectives around community health access and equity.

Notes

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