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Abstract

While small businesses represent a significant portion of the economy, there is mounting evidence that the playing field is not level for these firms in access to capital. Based on 10 years of matched-paired mystery shopping tests in banks to investigate bank lending practices and customer experience, the results demonstrate that in almost every instance, minorities were treated more poorly than their White counterparts. However, the authors acknowledge the controversy surrounding this issue, as some question the need for government action to push banks in this direction. Before offering evidence of the impact race can have on the treatment of small business owners who apply for loans, they present two frameworks which support the adoption of race-based criteria in evaluating bank performance, namely, Corporate Social Responsibility and Corporate Social Innovation. They then provide a summary of the results of mystery shopping studies they have conducted, concluding that banks are leaving profits on the table through their discriminatory practices.

Introduction

Small businesses (defined as firms employing fewer than 500 employees) account for 99.9 percent of all U.S. firms and nearly half of private-sector employment.[1] These firms collectively represent a $1.4 trillion market, according to estimates by the Consumer Financial Protection Bureau.[2] A critical question that must be asked is whether the playing field is level for these firms in access to capital. In previous research (based on 10 years of testing), Bone, Christensen, and Williams conducted matched-paired mystery shopping tests in banks to investigate bank lending practices and customer experience.[3,4] Across these studies in multiple U.S. metropolitan areas, the results demonstrate that in almost every instance, minorities were treated more poorly than their White counterparts. This was true even when these minority entrepreneurs should have been treated better because on paper they were more qualified candidates than their White counterparts. This is consistent with other research using matching methods which found that African-American borrowers were rejected at a higher rate (17-33% higher) than similar risk White-owned firms.[5]

Despite this continuing and mounting evidence, there is controversy over the best approach to resolve this problem. Based on our research, banks are losing money as profitable customers are not identified and/or are treated poorly. Based on our research, we also argue that banks that recognize these troubling practices and then take action to resolve this disparate treatment should enjoy greater profitability as they make loans to underserved minority-owned businesses. However, we also recognize that this could be perceived as a controversial approach. For example, some could question the need for government action to push banks in this direction. They could pose the argument that if serving minority-owned businesses is that profitable and good for their bottom line, then many banks already would be "doing the right thing" out of self-interest and other banks would need to mimic them to catch up.

Based on these opposing viewpoints and approaches to resolve this problem, this issue has become a political "hot button". For example, in commenting on the "Promoting Diversity and Inclusion in Banking Act," one major news celebrity stated that it would inject race into the critical financial rating system and would impose a so-called 'diversity mandate' on banks if they want to stay in business.[6] This commentator went further to call the legislation a 'shakedown' and 'dangerous.' In our view, much of the pushback on this legislation stems from not fully understanding or appreciating the frequency and gravity of disparities in the treatment among minority-owned compared to White-owned businesses. In the remainder of this report, we will—based on the results of our many studies—provide concrete evidence of the impact race can have on the treatment of small business owners who apply for loans. However, before considering the results from our studies, we first present two frameworks which support the adoption of race-based criteria in evaluating bank performance.

Frameworks to Support Use of Race in Evaluating Bank Performance: CSR and CSI

Corporate Social Responsibility

The first perspective is Corporate Social Responsibility (CSR), which is another approach that has the potential to suggest some new ways of thinking about racial disparity issues in a manner that is palatable or perhaps even attractive to businesses. A sophisticated and nuanced understanding of CSR is essential to gain new insights. During the past few years, the concept of business' responsibility has evolved from an economic model, to a legal model, to a social model, and now to a stakeholder model, which embodies a richer and more sophisticated understanding of CSR.[7] A stakeholder model focuses not just on customers and shareholders and maximizing their returns but also on a host of other parties that are affected by the firm—e.g., internal parties such as employees and external parties such as local communities, policy makers, activist groups, etc. Underlying this transformation is a different and broader focus on performance and results—a new calculus of the bottom line or a multiple bottom line. The multiple bottom line approach argues that firms should be concerned not only with the traditional, economic/financial bottom line, but also with a social bottom line that focuses on stakeholder relationships, an environmental bottom line that assesses the business's impact on the natural environment, and a cultural bottom line that assesses a firm's influence on the culture or cultures within which it operates.[8] If the banking industry were to calculate overtly not just their financial bottom line, but their social, environmental, and especially their cultural bottom line (which would include their impact on the larger community in which small businesses operate), they would be more likely to view their responsibilities differently and be more receptive to understanding how race is negatively impacting small business lending decisions. All of this suggests that public policy can play an important role.

However, we also recognize that advocating government intervention beyond what is already being implemented is likely to engender further pushback from the banking industry. For example, the Consumer Financial Protection Bureau (CFPB) recently held a forum on how to implement a provision of the Dodd-Frank Act that requires lenders to collect and report certain information about small-business borrowers, including whether the firms are owned by women or minorities, where several members of the banking industry spoke and offered their perspective.[9]

Generally speaking, the CFPB acknowledges that they face pushback from small-business lenders and that many lenders maintain that the CFPB should take a narrow approach to its responsibilities, citing the costs that a broad data-collection requirement would impose, and arguing that those costs would be passed along to borrowers. For example, the American Bankers Association has called the collection and reporting of small-business loan data a "Herculean task" and argued that the bureau's data collection should not go beyond what Dodd-Frank explicitly requires. Similarly, the Innovative Lending Platform Association has argued that a more expansive approach by the CFPB would result in higher lending costs and fewer options for small-business borrowers.[10] We recognize that many politicians and bank executives have major concerns about the impact of adding race into the evaluation of bank performance. Certainly, given the historical performance of the banking industry relative to race, there is legitimate cause for concern. Companies are increasingly evaluated—both within the public sphere and within individual organizations—according to the degree to which they are perceived to simultaneously meet this nexus of demands. As pointed out by Ozanne et al.,[11] the tensions frequently faced by organizations that strive to manage these dimensions will be significantly impacted by the role of public policy. In the case of the banking industry, the role of public policy would include specific actions by government, such as pending legislation to include race in the evaluation of bank performance. While many banking industry executives have resisted the adoption of incorporating race, as noted above, because of its potential negative impact on profits and perceptions, (e.g., increased demands to collect data that indicates how race affects bank performance with small and minority-owned business), this concern may be overstated.

For example, in one study involving the food and beverage industry, firms with higher CSR orientations tended to join pledge programs. An analysis of the annual revenues of pledge companies and non-pledge companies revealed that joining a pledge initiative did not have a negative impact on revenues.[12,13] While the data in this study was reported at the organizational level, rather than the firm level, the authors recognized that these individual firm performances likely also impacted the industry. For example, one of their observations was that there seemed to be a "pull" effect on competitors in joining the pledge programs, e.g., McDonald's joined the CFBAI initiative in 2006, followed by the direct competitor, Burger King in 2007. After Coca Cola joined the initiative in 2006, the direct competitor, Pepsi joined the initiative in 2007. We feel that a similar effect would likely be observed in the banking industry as more and more competitors recognize the value of

CSR in meeting the needs of their small and minority-owned business customers.

Corporate Social Innovation

The second perspective we consider that would support the use of race in analyzing the performance of banks is Corporate Social Innovation (CSI).[14] This second perspective is similar in some senses to CSR; however, CSI can be viewed as a more innovation-seeking approach that is positioned to allow firms to move more aggressively from "checking the boxes" to really trying to gain advantage by understanding more broadly what it means to do the right thing.

CSI integrates a company's full range of capabilities and assets within innovative business models to achieve positive societal impact while advancing the success, profitability, and sustainability of the enterprise. CSI involves deeper collaboration across functions within a firm and with external parties to co-create new and sustainable solutions to remedy social ills. Finally, whereas Corporate Social Responsibility (CSR) can generate goodwill and enhance corporate reputation, CSI also aims to produce new sources of revenue and to generate a more socially relevant innovation system and corporate culture which can be a source of competitive advantage. Essentially, by overlooking the disparities in treatment by race, as evidenced by our mystery shopping studies, banks are "leaving money on the table," given that small business financing is a $1.4 trillion market, according to estimates by the CFPB.[15] Because of disparate and even discriminatory customer service, banks are allowing good minority-owned business customers who are well-qualified for good loans to walk out the door.

In the next section of this report, we will present a summary of the results of mystery shopping studies we have conducted. The evidence we will review below demonstrates that banks are leaving profits on the table through their discriminatory practices. Because they have demonstrated for many years that as an industry they are unable to police themselves or even to act in their own interests, increasingly there are calls for government regulation and intervention. Perhaps a way for banking industry leaders to fix the problem is through pushing broad adoption of CSR, and a way for individual banks to gain a competitive advantage is through CSI.

Summary of Empirical Studies: Matched-Pair Mystery Shopping Results

The small business marketplace has been analyzed by different measures, but no previous research has investigated the preliminary, information seeking processes for obtaining a small business loan. These first experiences in the journey to obtain financing are formative and can greatly influence whether or not a business owner decides to apply for a loan. However, these interactions of entrepreneurs and loan officers before application submission are not captured in current official reporting measures. A full analysis of the small-business lending marketplace should evaluate these initial, gate-keeping and stage-setting customer service interactions.

One method to evaluate preliminary loan interactions is matched-paired mystery shopping, where a tester is sent to a bank under the guise of a small-business loan customer and then reports back on how they are treated by the bank and its employees. The matched-paired element of these tests involves sending matched testers that are essentially identical on paper in the loan amount and type of loan requested and are as similar as possible on physical features such as age, attractiveness, body build, clothing worn, and yet are different along the experimental condition of race (Black, Hispanic, and White). We also vary from time to time gender (Male, Female) to test for the possible interaction of race and gender (this is referred to as intersectionality). Comparisons are made by the researchers between racial minority testers and the non-minority, White control group.

Testers are told they are evaluating banks' customer service. They are trained thoroughly and given a profile of "their business" that they rehearse and then share with bank employees as they seek initial information on loan products. Intentionally, all profiles (White or minority) would easily qualify for the loans they are seeking (based on financial ratios and credit scores, etc.). Purposefully, the profiles of the minority testers (income, credit scores, ratios, etc.) are better than the control group to make this a conservative test. If all things were equal, because of their superior profiles, minority testers should receive more favorable treatment during their bank visit. Both testers visit a bank location within a close time proximity of one another and after each test bank visit, the tester reports the specific details of their experience by writing a narrative of the details of their encounter and answering objective measures of experience. Information is captured along critical "moments of truth" of the experience, including the initial greeting, opening conversation, the information the bank employee asks for to understand the business, information provided by the bank regarding loan products, pricing and terms, direction given about completing an application, the encouragement expressed, overall service provided, and finally the closing and next steps asked for or invited by the bank employee. In some instances where it is legally permitted, audio and/or digital video recordings are made to offer an even more objective view into these interactions across race and gender lines.

To date, we have tested three major U.S. metropolitan areas: Los Angles, Washington D.C., and Atlanta. The quantitative survey data and the corroborating narratives, audio transcripts, and video recordings provide a disturbing and financially unfortunate pattern of results for minorities and banks. In nearly every measure we have compared, White male testers received superior service compared to racial minority and women testers. The experience of a Black or Hispanic male is significantly different and poorer across the objective measures we collected. When one includes women racial minority testers, they are treated even more poorly comparatively speaking.

One notable difference in treatment that is commonly uncovered occurs in the first stage of the visit when the White tester is greeted and an initial conversation to get to know the prospective borrowing customer ensues. In these interactions White testers receive a statistically better and more professional greeting and opening conversation than minority testers. This opening often includes the bank employee asking for details about their business, demonstrating sincere and genuine interest in the tester, and then suggesting loan products and solutions that include descriptions of application requirements. Even more egregious and blatant differences are sometimes observed when the matched-pair of testers interact with the same loan officer at the same branch and that officer asks for the minority tester's marital status and spouse's employment and income (all illegal questions), while the White tester is not asked these same illegal questions.

An important finding of our research is that the overall customer service for all testers (White or minority) receive in these encounters is poor and well below an acceptable standard of service. For example, testing exposed inconsistencies across banks—even within the same branch in some cases—in bank representatives' knowledge of loan products and requirements. Potential borrowers from any background will struggle to understand different loan options and requirements as a result of bank representatives' lack of knowledge. Unfortunately, minority testers are treated even more poorly than White testers. All banks would benefit from dramatically improving their customer service for all customers and most especially for minority customers. Our research shows that good customers, good loans, and good money are literally walking out of their doors.

Conclusion and Implications Regarding the Incorporation of Race in Evaluating Bank Performance

Our results indicate a troubling state for the small-business lending marketplace. Some measures of treatment that were significantly different between testers were: greeting, personal information requested from tester, loan information provided by bank representative, and closing interaction and discussion of next steps. The general quality of customer service in all tester interactions was poor, which is concerning since access to capital always begins with these initial interactions. The gaps in treatment we find between the minority and non-minority testers is especially troubling because it shows that minority consumers are denied equal access to financial capital even at the initial stage of the journey.

We propose that these tests of financial institutions are important to understand the lived experiences and inferior treatment that minorities receive. If recognized by financial institutions, this can shed light on both the problems with business practices and policies and the opportunities for banks to take course correction to increase profits by better serving minority customers.

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