

# A History of Emerging Domestic Markets

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The 2000 U.S. Census dramatically illustrated what many observers already knew — that America’s racial and ethnic make-up is diversifying rapidly. Over the next 40 years, if projections hold, more than 85 percent of U.S. population growth will come from ethnic groups.<sup>1</sup> In fact, the size and share of these ethnic groups is so significant that the combination of America’s African American and Hispanic consumer markets is larger than the GDP of all but nine countries in the world.<sup>2</sup>

With this diversity comes a change in the make-up of business ownership in the country. This is a trend that has been building over time. In the 1960s, as desegregation opened up opportunities for African-Americans and other ethnic minorities, they began to move into new fields of business. Over time, as access to education and employment opened up, the new managers possessed higher levels of training and experience, and stronger professional networks. While it is not yet an even playing field, aspiring entrepreneurs have steadily increased their ability to build companies in a variety of industries. Women have also steadily entered the ranks of business ownership in large numbers.

Between 1997 and 2002 (the most recent comprehensive data on ethnic- and women-owned firms), the number of firms owned by African-Americans, Hispanics, and Asian-Americans grew at nearly three times the rate of all firms (with the number of African-American businesses increasing at almost four times the rate).<sup>3</sup>

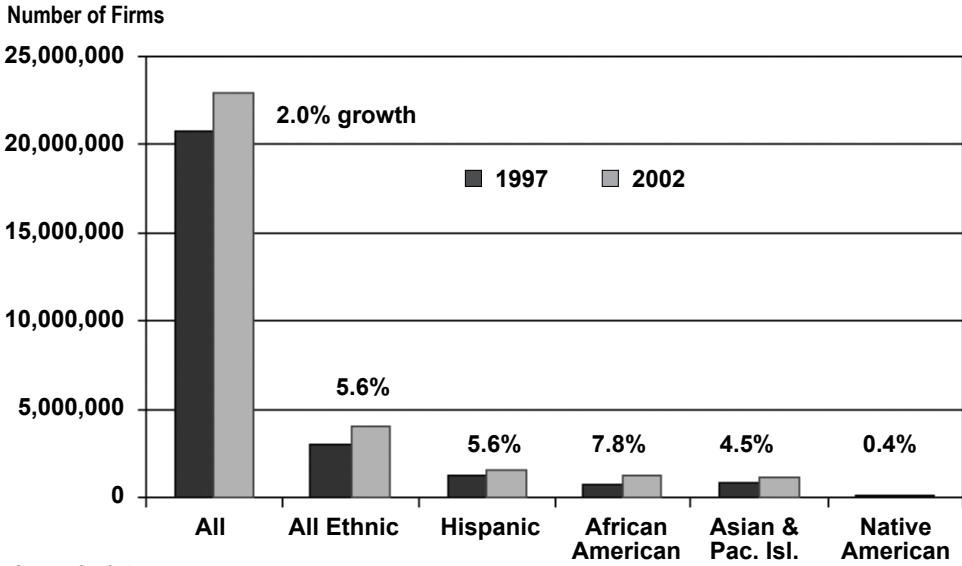
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1 U.S. Department of Commerce Minority Business Development Agency. September 1999. “Minority Population Growth: 1995 to 2050.”

2 Jeffrey M. Humphreys. “The multicultural economy, 2006.” *Georgia Business and Economic Conditions*, 66:6 (2006), 1.

3 U.S. Census Bureau. 1992. “Survey of Minority and Women-Owned Business Enterprises”; and U.S. Census Bureau. 2002. “Survey of Business Owners.”

*Annualized Growth in Number of Ethnic-Owned Firms  
1997-2002*

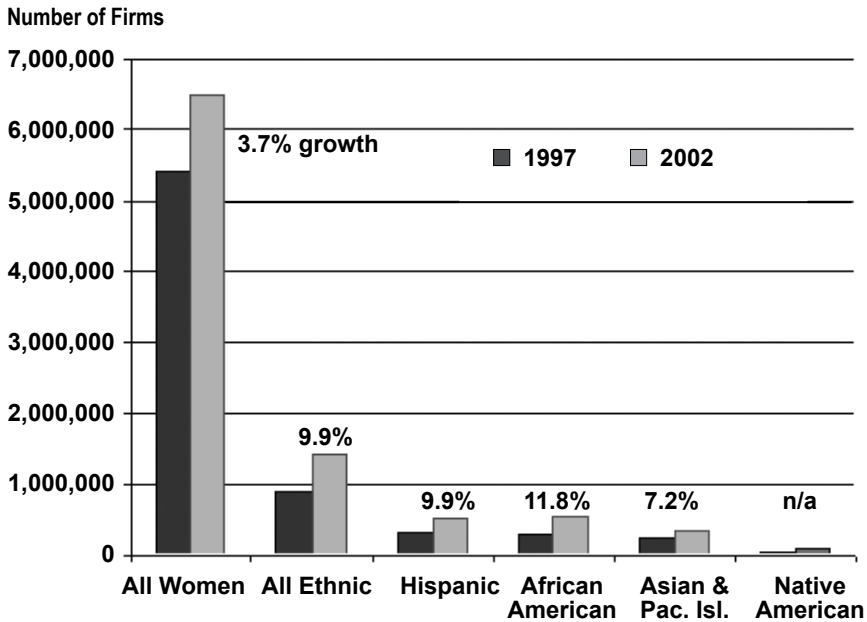


Source: SBO Data, 2002

Women-owned firms also show high growth rates, particularly marked among ethnic women entrepreneurs – increasing at a rate five times that of all firms. The number of firms owned by African American women multiplied even faster, at nearly 12 percent annually, compared to two percent for all firms and just under four percent for all women-owned businesses.<sup>4</sup>

<sup>4</sup> Ibid.

*Annualized Growth in Women-Owned Firms, 1997–2002*



Source: SBO Data, 2002

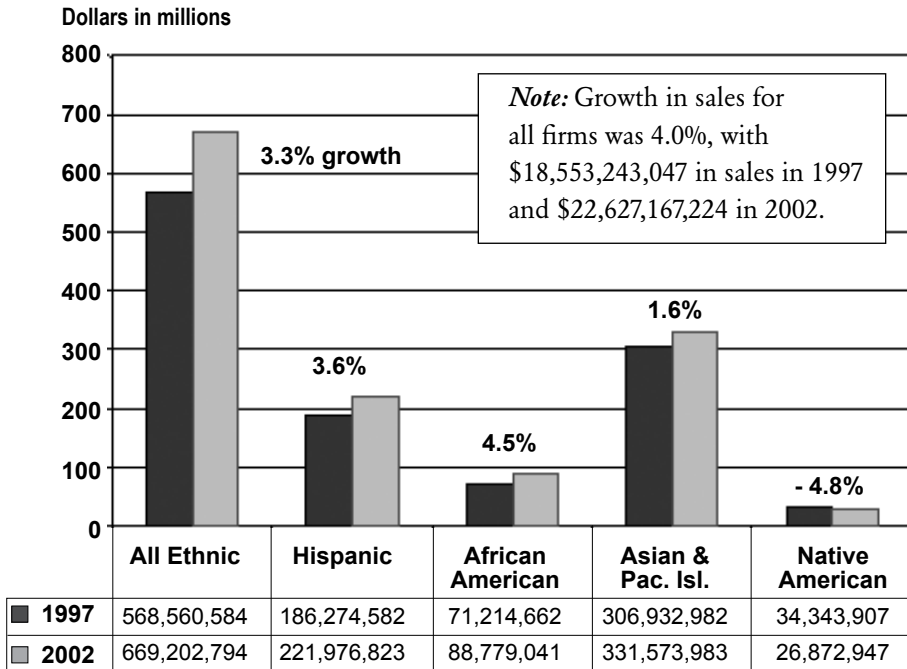
Furthermore, the added diversity has increased the range of places in which the new owners live or locate their businesses, leading to demands for capital in a wider variety of locations. With these changes comes a new investment opportunity, identified as “emerging domestic markets” (EDM). EDM refers to people, places or enterprises with growth potential that face constraints due to systematic undervaluation due to imperfect market information and access to resources. The markets include ethnic- and women-owned firms, urban and rural communities, companies serving low-to-moderate-income populations, and other small- and medium-sized businesses.<sup>5</sup> EDM represents a variety of subsectors including people of color (African Americans, Latinos/Hispanics, Asian Americans/Pacific Islanders and Native Americans), women and low-to-moderate-income communities (LMI) (both businesses located there and firms owned by LMI entrepreneurs).

Despite their growth, the ability of EDM businesses to grow their revenue remains constrained. While still marked, the growth rate of EDM firms’ sales does not match that of their numbers, indicating smaller size. The number of all ethnic firms grew by 5.6 percent

<sup>5</sup> Glenn Yago, Betsy Zeidman, and Bill Schmidt, “Creating Capital, Jobs and Wealth in Emerging Domestic Markets: Financial Technology Transfer to Low-Income Communities,” (Santa Monica, CA: Milken Institute, 2003), 2.

from 1997 through 2002, while sales growth rose only 3.3 percent over the same period. On the other hand, while the number of all U.S. firms increased by just 2 percent, their sales grew 4 percent. It is worth noting, however, that African American-owned firms increased their sales by a greater percentage than did all firms (4.5 percent compared to 4 percent). Hispanic-owned firms showed the greatest growth rate in terms of employment (2.1 percent over the period, compared to 1.4 percent for all firms).<sup>6</sup> Even after controlling for a variety of factors (e.g., education, experience, industry, location), it is clear from research that EDM firms receive less capital and on less advantageous terms. Without equal access to the full array of financial products on the market, EDM businesses will not grow to their potential. And that would hinder the nation’s economic growth.

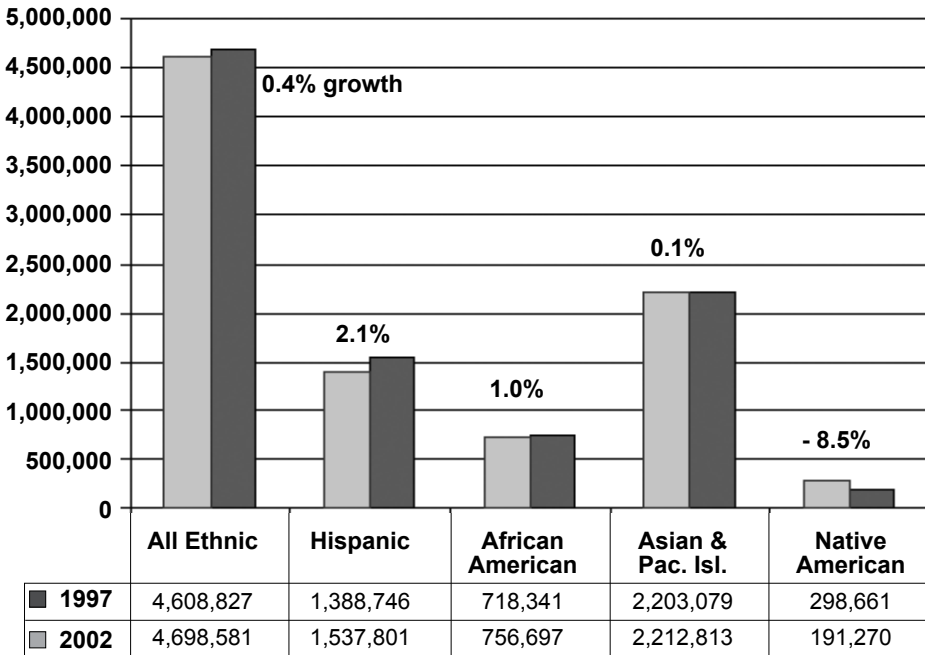
*Annualized Growth in Sales in Ethnic-Owned Firms  
1997-2002*



Source: SBO Data, 2002

6 U.S. Census Bureau. 1992. “Survey of Minority and Women-Owned Business Enterprises”; and U.S. Census Bureau. 2002. “Survey of Business Owners.”

*Growth in Employment in Ethnic-Owned Firms*



Source: SBO Data, 2002

The history of investing in these markets – by both the private and public sectors – falls into two broad categories – people and places. On the one hand, initiatives have targeted “minorities,” an obviously anachronistic term, given their growing share of the population and business ownership. On the other hand, there has been a focus on “underserved” geographies – those with large concentrations of LMI census tracts or subject to historic abandonment. Neither of these approaches is sufficient in and of itself.

**Investing in EDM – the History of Federal Policy**

Forty years ago, with the private capital markets ignoring emerging domestic markets, the Federal government stepped in. In 1969, President Nixon initiated his first urban initiative, Project Enterprise, and among the components was the establishment in 1970 of minority enterprise small business investment companies (MESBICs). These privately owned firms had a mandate to invest venture capital and long-term debt in minority-owned businesses (originally African-American, with other ethnic groups added later). The money invested included private capital raised by the MESBICs, leveraged by funds from the Small Business Administration (SBA). The program’s founders envisioned the approach as a way to “remedy the deficiencies of mainstream financial institutions, particularly their uninspiring record of

financing minority-owned firms.”<sup>7</sup>

The MESBIC program eventually was supplanted by the Specialized Small Business Investment Company (SSBIC) program, which was merged into the Small Business Investment Company (SBIC) program in 1995. Despite worthy intentions to fill a clear capital gap, these approaches never achieved their desired outcomes. The reasons were many:

- Too many MESBICs/SSBICs remained too small to effectively cover operating expenses and/or achieve portfolio diversification. As an example, Bates’ analysis of all MESBICs operating in 1993 found that the typical fund had revenues of 7.3 cents per asset dollar against 8.4 cents in expenses.
- Many MESBICs incurred large losses from their venture capital investments, perhaps reflecting an inability to cover the cost of strong due diligence.
- The most stable MESBICs invested greater sums in bank CDs than in minority-owned businesses, hardly the approach envisioned by the program.<sup>8</sup>
- SBA leverage came in the form of debentures, generating a mismatch between the SSBICs source of capital and its use of funds for long-term equity positions.<sup>9</sup>

While the MESBIC/SSBIC program addressed EDM capital needs through a people-based approach, the Community Reinvestment Act (CRA) took a place-based strategy. Enacted by Congress in 1977 in response to concerns over discrimination in lending, CRA directed banks and thrifts to meet the credit needs of all borrowers in their communities, consistent with sound banking practices. It specifically challenges them to reach out to potential customers in LMI areas (as defined by the percent of LMI residents within a census tract). Compliance for larger banks is evaluated via lending, investment and service tests.

Research shows that during its 30 year life, CRA has made an impact on EDM place-based lending. Despite the lack of strong enforcement mechanisms, the prospect of public disclosure of a below-average rating leads many banks to improve.<sup>10</sup> Additionally, consolidation in the banking industry puts CRA on the table in increasing numbers of merger applications.

Perhaps more significantly, bankers found that CRA loans were good business. A 2001 survey of depository institutions reported that 86 percent found CRA small business loans at least as profitable as non-CRA small business loans.<sup>11</sup> More recently, Bostic and Robinson

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7 Timothy Bates, “Financing the Development of Urban Minority Communities: Lessons of History” *Economic Development Quarterly* 14 (2000): 228.

8 Ibid, 222 and 228.

9 Glenn Yago and Michael Harrington, “Mainstreaming Minority Business: Financing Domestic Emerging Markets,” (Santa Monica, CA: Milken Institute, 1999).

10 Kenneth H. Thomas, “CRA’s 25th Anniversary: The Past, Present & Future,” (2002).

11 Board of Governors of the Federal Reserve Board, “Evaluating the Profitability of CRA Loans,” in *Capital Connections* (Board of Governors of the Federal Reserve Board 2001).

studied data reported pursuant to CRA agreements and found that not only did institutions increase their small business lending upon initiation of an agreement, but that the increase continued even after the agreement's expiration.<sup>12</sup>

Despite these findings, there is continued debate about CRA. Issues include the cost burden on smaller banks, the strength of enforcement, and whether to extend its application beyond depository institutions as more small business lending is provided by insurance and securities firms, and other non-bank lenders. The CRA Modernization Act of 2007, introduced in March, addresses some of these concerns. These include extending CRA obligations within a financial holding company, and requiring satisfactory ratings by securities company, mortgage bank, and insurance company affiliates of such holding companies.

Since 1990, several new place-based initiatives have been launched. These include the Community Development Financial Institutions (CDFI) Fund, established by the Riegle Community Development and Regulatory Improvement Act of 1994, as a bipartisan initiative. The CDFI Fund supports community development lenders through direct investments and loans, technical assistance and other financial incentives encouraging capital flow to LMI populations. The Fund also administers the New Markets Tax Credit (NMTC) program, launched in 2000. The NMTC provides taxpayers a credit for investments in designated community development entities (CDEs), designed to enable these entities to raise more long-term capital from the private markets. Since its inception, the Fund has allocated \$12.1 billion of the \$19.5 billion it is authorized to provide during its life.<sup>13</sup>

A January 2007 GAO report concluded that the NMTC appeared to be successful in increasing investment in LMI communities. Banks and individuals accounted for 70% of the investors, and other regulatory considerations (such as CRA compliance for financial institutions) may explain some of the flow of funds into NMTC vehicles. However the GAO survey conducted for the report found that some corporate investors were shifting funds from other assets to NMTC projects, and that some individual investors were tapping new sums to participate in NMTC deals. Of the allocations awarded to date, about 75 percent was used for commercial real estate construction and rehabilitation, with the balance for fixed assets and working capital for businesses.<sup>14</sup>

While the NMTC is currently place-based in its approach to EDM, that strategy may change. The American Jobs Creation Act of 2004 did revise the NMTC guidelines to enable people-based strategies as well, by adding "targeted populations" to those eligible for

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12 Raphael W. Bostic and Breck L. Robinson, "CRA Agreements and Small Business Lending: Is There a "there" There?" (paper presented at the Federal Reserve Bank of Chicago Conference on Bank Structure and Performance, 2006).

13 CDFI Fund. [http://www.cdfifund.gov/who\\_we\\_are/about\\_us.asp](http://www.cdfifund.gov/who_we_are/about_us.asp).

14 US Government Accountability Office, "Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance," ed. GAO (2007).

investment. Such populations include businesses that derive at least 50 percent of its gross income from activity with low-income individuals; at least 40 percent of whose employees are low-income, or at least 50 percent of which is owned by low-income individuals. The regulations have not been finalized.<sup>15</sup>

### Private Capital Finds EDM

While government efforts to foster EDM investing – both the major ones described above and others on the state and local level, by the mid-1990s, the private sector was discovering the EDM opportunity on its own. Ever in search of new sources of returns, the capital markets were seeking unexplored territory. Two publications played a role in validating this interest. Michael Porter’s Harvard Business Review article, “The Competitive Advantage of the Inner City,” identified key strengths of traditionally overlooked urban areas (the “places”) and provided a strong business motive for capturing those strengths.<sup>16</sup> It provided private capital with a rationale for engaging in place-based approaches to EDM. In the late 1990s, the Milken Institute coined the term “emerging domestic markets,” (EDM)<sup>17</sup> identifying the rapidly diversifying base of entrepreneurs (the “people”) as targets for investment just as significant as the international emerging markets that were a staple of institutional investors’ asset allocation. Its later report, *Creating Capital, Jobs & Wealth in Emerging Domestic Markets: Financial Technology Transfer to Low-Income Communities*,<sup>18</sup> explored the role of financial innovation in opening channels of capital to EDM businesses.

It is worth noting an interesting parallel in choosing to describe markets as “emerging.” In the early 1980s, terminology such as “third world” and “less developed countries (LDCs)” was standard. Frequently, and often unnecessarily, that label tainted assets from those markets, yielding undervalued assessments and excessive and arbitrary discounts. Antoine van Agtmael, then serving as division chief for the World Bank’s treasury operations and deputy director of the International Finance Corporation’s Capital Markets Department, coined the term “emerging markets.” Within twenty years of the change in definition and accompanying analysis of investment opportunities, emerging markets internationally came to contribute a majority of the global GDP for the first time since 1820.<sup>18</sup>

Similarly, antiquated language and labels from the 1960s (e.g., “minority business”) dominated and arrested development in thinking and understanding about U.S. ethnic markets. As demographics in a number of states shift, it has become arithmetically incorrect to refer to ethnic markets as having “minority” status. As U. S. cities began to evolve in

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15 Ibid., 11.

16 Michael E. Porter, “The Competitive Advantage of the Inner City,” *Harvard Business Review*, no. May-June (1995).

17 Yago and Harrington, “Mainstreaming Minority Business: Financing Domestic Emerging Markets.”

18 Antoine van Agtmael, *The Emerging Markets Century: How a New Breed of World Class Companies is Overtaking the World* (New York: Free Press, 2007).



spatially polycentric patterns, discussions of “inner cities” (which were increasingly in the suburbs as well) became misleading. Shifting the terminology to more inclusively describe these firms, places and entrepreneurs as emerging domestic markets better captures the range of investment opportunities. It also more accurately captures the dynamics between the emerging asset and sub-asset classes characterized by new entrants into business, real estate and homeownership. In short, the broader base of economic participation in both labor force and capital ownership required clearer, more terminology that mainstreamed, rather than marginalized, the growing investment opportunities. In this journal, Greg Fairchild offers another perspective on the challenges of language.

The exploration of the investment opportunities emerged in a wide variety of innovative private, and public/private, sector efforts to deploy capital in EDM arenas. Several of these are described below. They are by no means a comprehensive list, but they offer an overview of the historical activity laying the groundwork for EDM investing.

Some of the seemingly simplest innovations were the adaptation of practices successful in mainstream finance to EDM firms. As an example, securitization is an approach widely used in the capital markets. The mortgage loan was the first to be widely securitized in the 1970s, but a secondary market has developed for other debt instruments, such as corporate loans and credit card debt. Securitization of the small business loans guaranteed under the Small Business Administration (SBA) 7(a) and 504 programs is a relatively standard practice, but the market is undeveloped for the un-guaranteed portions of small business loans. Virtually the only noticeable effort in securitizing community development loans (those most directly link to EDM firms) is that of the Community Reinvestment Fund (CRF). CRF has been securitizing real estate and small business EDM loans for nearly 20 years, using philanthropic capital as a credit enhancement. Its recoveries against defaults have varied by security type, with loans secured by real estate averaging 97 percent and unsecured loans averaging recovery levels of 27 percent.<sup>19</sup> In 2004 and 2006, CRF offered the first rated community development securitizations, totaling over \$100 million, comprised primarily of small business loans backed by real estate. Importantly, the amount of credit enhancement required for the second offering was less than that of the first, indicating greater market acceptance of the product.

As noted above, the funds launched through the SBA’s MESBIC and SSBIC program were generally too small to reach scale and successfully see returns from EDM investments. However, several evolved into independent venture capital (VC) firms, and met the needs of institutional investors, including public and private pension funds, banks and insurance companies.

The resulting network of funds investing in ethnic-owned businesses is represented today by the National Association of Investment Companies. Most of the funds have no remaining

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19 Standard & Poor’s, “Pre-Sale: CRF USA-18, LLC,” (2006).

SBA affiliation.<sup>20</sup> Bates and Bradford found that these funds (and fund of funds—Fairview Capital) succeeded where the SBA-chartered entities failed by operating differently in several ways. They raised enough capital to diversify their portfolio and contribute additional rounds of financing. (Their median capitalization was \$40 million as compared to \$10 million for the SBA vehicles.) Their average investment size was four times greater than their predecessors. Additionally, as survivors of the MESBIC/SSBIC program, the founding NAIC firms possessed enormous experience to share with their counterparts.<sup>21</sup> Given the relative youth of the industry, few studies have analyzed EDM-targeted fund performance, but Bates and Bradford show EDM funds (as represented by funds targeting minority-owned businesses) have enjoyed strong returns with a mean internal rate of return of 23.9 percent (surpassing the 20.2 percent, ten-year trailing average for the private equity industry). Today NAIC member firms have over \$5 billion under management, with over 50% provided by public pension funds (compared with over 70% from the government in 1990).<sup>22</sup>

In addition to the minority-focused venture capital funds, two other types of funds specifically target EDM communities—Community Development Venture Capital (CDVC) funds and Double Bottom Line (DBL) funds. Both of these place-based EDM strategies make equity investments in distressed areas, with a stated interest in both risk-adjusted market rate financial returns and ancillary benefits to the region, such as job and wealth creations, and overall economic growth. CDVC funds focus on business investment, while approximately 60% of the DBL funds are invested in inner city real estate funds.<sup>23</sup> Within the industry, there is debate over the finer points of difference between CDVC funds and DBL funds, but their goals and target returns are quite similar, and both have raised the profile of EDM as an investment opportunity.

Among one of the strongest factors in raising awareness of EDM has been the activity of public pension funds. The California Public Employees' Retirement System (CalPERS) has been a leader, investing in two minority-focused VC funds as early as 1992 (Fairview Capital in Connecticut and Bastion Capital of Los Angeles).<sup>24</sup> In 2001, CalPERS implemented the California Initiative, a commitment of \$475 million from its alternative assets allocation to "traditionally underserved markets primarily, but not exclusively, in California," and the first major EDM program by a leading public pension fund.<sup>25</sup> The California Initiative was

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20 Timothy Bates and William Bradford, "Minorities and Venture Capital," (Kansas City, MO E. M. Kauffman Foundation, 2003).

21 Timothy Bates, William Bradford, and Julia Sass Rubin, "The Viability of the Minority-Oriented Venture-Capital Industry Under Alternative Financing Arrangements," *Economic Development Quarterly* 20, no. 178 (2006).

22 Bates and Bradford, "Minorities and Venture Capital," 11, and interview with Samuel Boyd, National Association of Investment Companies, May 14, 2007.

23 Strategic Development Solutions, "Double and Triple Bottom Line Fund Consulting." <http://www.strategicds.com/dbl-fund.html>.

24 T. Hellman, "Allied Equity Partners," (Palo Alto, CA: Stanford University Graduate School of Business, 2001).

25 CalPERS Investment Committee, Agenda Item 51, May 14, 2001.

based on the premise that “underserved markets” (fundamentally equivalent to EDM) were less efficient than traditional markets, but held the potential for superior investment opportunity. CalPERS allocated funds to 10 partnerships throughout the state, with allocations ranging in size from \$10 million to \$200 million, and investment stage from seed through buyout. Shortly thereafter, the California State Teachers’ Retirement System (CalSTRS) committed \$300 million to several of the same partnerships. Other funds have implemented similar programs, including Massachusetts Pension Reserves Investment Management (MassPRIM), New York State Common Retirement Fund, and New York City Employee Retirement System. (Former California State Treasurer Phil Angelides, one of the driving forces behind the California Initiative, provides an institutional investor’s perspective in his article in this issue.)

Six years later, CalPERS has deemed its program successful. CalPERS has invested nearly 70 percent of its allocated funds in 131 companies with a one-year net IRR of 5.6 percent, closely tracking the Venture Economics Median for private equity. The EDM companies range in size from three to more than 22,000 employees, with employment having grown seven percent, and LMI employment by 11 percent. The percentage of women or ethnic officers and key managers at the California Initiative companies generally exceeded that of the general California business population.<sup>26</sup> (For a more detailed discussion of pension fund investing, see Lisa Hagerman’s article in this issue.)

Other types of institutional investors are increasingly looking at EDM investment options. Insurance companies have invested capital through such vehicles as Impact Community Capital, an LLC owned by the eight major insurance companies active in California (representing more than \$22 billion in annual premiums), makes and manages EDM investments, often through pooling and securitization. The California Organized Investment Network (COIN) posts notices of EDM opportunities to facilitate connections with interested insurers. Additionally, insurance companies appear as investors in CDVC and DBL funds and other EDM-targeted vehicles.

## Outstanding Issues – A Review of the Literature

The above sections of this laid out the current demographics and the history of activity in providing capital to EDM firms. Despite the upward trend and the array of new vehicles, there is still a capital gap. What follows is a review of some of the key literature on this topic.

### *The Capital Gap*

It has been widely shown that ethnic, female, and low-income entrepreneurs have less access to equity and debt capital than do white, male, and more affluent business owners.<sup>27</sup> Canner analyzes Community Reinvestment Act (CRA) data from 1996 and 1997, and finds

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26 CalPERS and Pacific Community Ventures, “Impacting California’s Underserved Communities: Taking a Second Look,” (2007).

27 Bates, Timothy and William Bradford. 2003. “Minorities and Venture Capital: A New Wave in American Business,” Kauffman Foundation.

that “for all ethnic groups, the number of small-business loans falls with increases in neighborhood racial composition.”<sup>28</sup> Bostic and Lampani looks specifically at African-American-owned firms. After controlling for “loan, firm, owner, and local market characteristics,” the authors conclude there is a statistically significant difference in loan approval rates between white- and African American-owned firms.<sup>29</sup> Even when African-American entrepreneurs successfully secure financing, the amount of the bank loan is, on average, less than that of white borrowers with identical financial characteristics.<sup>30</sup> This gap is also evident for Latino-owned firms.<sup>31</sup>

Research findings by the Federal Reserve Bank of Chicago seem to reaffirm those of the above. By looking at the geographic distribution of CRA-related small-business lending, it finds that “the number and dollar value of loans are greater in upper-income neighborhoods than in low-income neighborhoods.”<sup>32</sup> Furthermore, it has been demonstrated in several U.S. cities that the share of loans to upper-income areas exceeds that of the lower-income neighborhoods. This has been proved nationwide, as well as in Milwaukee and Washington, D.C.<sup>33</sup> Immergluck takes additional steps to account for firm density, firm size, and industrial mix in the Chicago metropolitan area.<sup>34</sup> Holding those variables constant, lower-income neighborhoods are still found to receive fewer loans. These findings are mirrored in a study by Cavaluzzo and Wolken on small business loan rejections, personal wealth, and discrimination.<sup>35</sup> By examining the impact of personal wealth (home ownership, home equity, personal net wealth) combined with personal credit history of the principal owner, the business credit history of the firm, and additional explanatory variables, the authors find that greater personal wealth is inversely correlated with loan denial. More interestingly, they discovered substantial “unexplained differences in denial rates between African American-

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28 Canner, Glenn B. 1999. “Evaluation of CRA Data on Small-Business Lending,” Business Access to Capital and Credit, Federal Reserve Bank of Chicago.

29 Bostic, Raphael W. and K. Patrick Lampani. March 1999. “Racial Differences in Patterns of Small-Business Finance: The Importance of Local Geography,” Proceedings of the Federal Reserve Bank of Chicago.

30 Bates, Timothy. 1991. “Commercial Bank Financing of White- and Black-Owned Small-Business Start-Ups.” *Quarterly Review of Economics and Business*. 31(1); Bates, Timothy. 1997. “Unequal Access: Financial Institution Lending to Black- and White-Owned Small-business Start-Ups,” *Journal of Urban Affairs*, 19.

31 Morales, Angel and Javier Saade. Fall 2000. “Hispanic-American Venture Capital: Financing the Growth of the Latino Market,” *Journal of Private Equity*.

32 Federal Reserve Bank of Chicago. November 2001. “2000 CRA Small-Business Lending Profile.”

33 Squires, Gregory and Sally O’Conner. 1999. “Access to Capital: Milwaukee’s Small-Business Lending Gap,” Woodstock Institute Research Paper Series; and National Community Reinvestment Coalition. December 2000. “United States Small-business Lending Trends, 1996 to 1999.”

34 Immergluck, Daniel. 1999. “Intraurban Patterns of Small-Business Lending: Findings from the New Community Reinvestment Act Data,” Business Access to Capital and Credit, Federal Reserve Bank of Chicago.

35 Ken Cavalluzzo and John Wolken, “Small Business Loan Turndowns, Personal Wealth and Discrimination,” (Federal Reserve Board, 2002).

Hispanic-, Asian-, and white-owned firms.”<sup>36</sup> This observation inevitably brings up the issue of discrimination.

Blanchard, Zhao, and Yinger finds similar results in a study of black-owned and Hispanic-owned businesses. The authors found “substantial, statistically significant evidence of discrimination” against such firms despite factoring in additional control variables and accounting for possible endogeneity.<sup>37</sup> They also find that “discrimination in small business lending may take the form of statistical discrimination, driven by lenders’ stereotypes about the ability of black- and Hispanic-owned businesses to succeed under some circumstances.”<sup>38</sup> In addition, black-owned businesses face discrimination in interest rates with some types of lenders.

### *Challenges Facing EDM Business*

This particular challenge could be one of the major reasons why the differences between African-American business ownership rates and white business ownership rates are striking. In a comprehensive study on access to financial capital among African-American businesses, Robb and Fairlie finds that lower rates of business ownership among blacks are due to lower levels of net worth, lower levels of start-up capital (which limits growth potential), and higher levels of loan rejection. These all contribute to lower rates of business success compared with their white and Asian counterparts, lower sales and profits, and less employment among black-owned businesses.<sup>39</sup> The authors state that “these constraints not only hurt economic progress among blacks, but also create more general efficiency loss in the economy”. Finally, they reiterate Blanchard, Zhao, and Yinger’s call for more oversight of the lending community to prevent discrimination, in addition to technical assistance programs for financial literacy and training.<sup>40</sup>

In an earlier study, Fairlie and Robb focuses on success and why black-owned businesses do not fare as well as white-owned businesses. Using data from the Characteristics of Business Owners Survey, the authors try to determine whether the role of families, inheritances, and business human capital can help explain the lower rates of business success among African-Americans. They found that black business owners are at a disadvantage because they are “less likely to have had a self-employed family member owner prior to starting their business and are less likely to have worked in that family member’s business”.<sup>41</sup> Given the

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36 Ibid.

37 Lloyd Blanchard, Bo Zhao, and John Yinger, “Do Credit Market Barriers Exist for Minority and Woman Entrepreneurs?,” in Center for Policy Research Working Paper No. 74 (Syracuse, New York: Center for Policy Research Maxwell School of Citizenship and Public Affairs, 2005).

38 Ibid.

39 Alicia Robb and Robert W. Fairlie, “Access to Financial Capital Among U.S. Businesses: The Case of African-American Firms,” in CES Discussion Papers, ed. Sang V. Nguyen (Washington, DC: Center for Economic Studies, 2006).

40 Ibid.

41 Robert W. Fairlie and Alicia Robb, “Why Are Black Businesses Less Successful Than White-Owned Businesses? The Role of Families, Inheritances, and Business Human Capital,” in CES Discussion Papers, ed. Sang V. Nguyen (Washington, DC: Center for Economic Studies, 2005).

lack of direct work experience, black business owners do not acquire the general and specific business know-how, which leads to less successful business outcomes.

Despite the serious obstacles facing African-American entrepreneurs, evidence suggests that African-Americans continue to be optimistic about their business environment and in fact are almost twice as likely as whites to start a business, according to a study by Phillip Kollinger and Maria Minniti. In other words, “the under-representation of black Americans among established entrepreneurs is not due to lack of trying but may instead be due to stronger barriers to entry and higher failure rates” as discussed earlier.<sup>42</sup> Kollinger and Minniti’s findings have obvious significance in that they strengthen the argument for eliminating discrimination in lending and improving access to capital, financial services, and technical assistance among black entrepreneurs.

Hispanics, the fastest growing ethnic group in the US, exhibit business ownership trends and characteristics similar to those of their African-American counterparts. Lofstrom and Wang perform an analysis of the self-employed gap between Hispanics (of Mexican descent and other Latin-American descent) whites, and discover that “while Mexican-Hispanics are less likely to enter self-employment relative to whites, other Hispanics are more likely to start a business”.<sup>43</sup> Even though Mexicans in their home country have high self-employment rates, this is not reflected in the Mexican immigrant population, with only six percent of Mexican immigrants self-employed in the U.S.<sup>44</sup>

Not unlike the case with African-Americans, there are large differences in business survival rates between Hispanic-owned and white-owned businesses, also seemingly due to differences in education and financial wealth. Fairlie and Woodruff find that self-employment rates among Mexican immigrants improve with legal status, fluency in English, and for men, living in ethnic enclaves.<sup>45</sup>

Cavaluzzo and Cavaluzzo state that the capital gap for female entrepreneurs is not as clear as for minority and low-income business owners. They also fail to identify loan approval bias against female entrepreneurs.<sup>46</sup> Nevertheless, women-owned firms are less likely to apply for and use external financing.<sup>47</sup> Women-owned firms, furthermore, pay a higher interest rate on

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42 Ibid.

43 Magnus Lofstrom and Chunbei Wang, “Hispanic Self-Employment: A Dynamic Analysis of Business Ownership,” in IZA Discussion Paper No. 2101 (Bonn: IZA, 2006).

44 Robert W. Fairlie and Christopher Woodruff, “Mexican Entrepreneurship: A Comparison of Self-Employment in Mexico and the United States,” in IZA Discussion Paper Series No. 2039 (Bonn: Institute for the Study of Labor, 2006).

45 Ibid.

46 Cavaluzzo, Ken and Lind Cavaluzzo. 1998. “Market Structure and Discrimination: The Case of Small-businesses,” *Journal of Money Credit and Banking*, 30(4).

47 National Women’s Business Council. September 2002. “Getting to Success: Helping Women Business Owners Gain Access to Capital.”

average than comparable male-owned businesses.<sup>48</sup> Although women own approximately 40 percent of all businesses in the United States, they receive less than 5 percent of all venture capital investment.<sup>49</sup>

### *The Data Gap*

As noted at the outset, one of the key reasons that EDM firms face capital constraints is information asymmetries—the lack of robust data on the markets. Without comprehensive, reliable demographic and financial information, financial decision makers, business leaders and public policy officials are unable to price risk and evaluate opportunities effectively.

Research continually reinforces the view that systems for capturing and sharing market data on lower-income populations remain undeveloped.<sup>50</sup> This in turn prevents financial institutions from developing innovative investment products. Clark and Gaillard find that the greatest barrier to growth and success of the emerging financial market is the lack of reliable financial-return data.<sup>51</sup>

Sabety and Carlson argue that new information sources are needed to expose potential investment opportunities in urban locations. In comparison to middle-class and wealthier locales outside inner cities, “urban areas may be currently experiencing a shortage of investment and market activity because their investment potential is not well-captured by current information resources.”<sup>52</sup> The development of new data sources would improve urban market activity and reveal new investment opportunities.

In instances when information is collected, the data are not generally in a format useful to investors. For example, the Office of Advocacy of the U.S. Small Business Administration reviews bank lending activities in 2002–2003 as recorded in CRA reports.<sup>53</sup> The focus of the SBA report is an analysis of the level of lending to small businesses, but this is measured only in aggregate. Characteristics of individual loans are missing, and there is no loan performance data. In addition, there is no race or gender data reported under CRA (see the National

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48 Coleman, S. 2000. “Access to Capital and Terms of Credit: A Comparison of Men and Women-Owned Businesses,” *Journal of Small Business Management*, 38.

49 Brush, Candida, Nancy Carter, Elizabeth Gatewood, Patricia Greene, and Myra Hart. “Gatekeepers of Venture Growth: A Diana Project Report on the Role and Participation of Women in the Venture Capital Industry,” Kauffman Foundation, 2004.

50 Weissbourd, Robert. June 2002. “Banking on Technology: Expanding Financial Markets and Economic Opportunity,” The Brookings Institution; Ou, Charles. 2004. “Statistical Databases for Economic Research on the Financing of Small Firms in the United States.” Working Paper, SBA Office of Advocacy.

51 Clark, Catherine H. and Josie Taylor Gaillard. August 2003. “RISE Capital Market Report: The Double Bottom Line Private Equity Landscape in 2002–2003.” Research Initiative on Social Enterprise.

52 Sabety, J. Pari and Virginia L. Carlson. July 2004. “Using Information to Drive Change: New Ways to Move Urban Markets,” The Brookings Institution Urban Markets Initiative.

53 U.S. Small Business Administration, Office of Advocacy. March 2005. “Small Business and Micro Business Lending in the United States, for Data Years 2002–2003.”

Community Reinvestment Coalition analysis of CRA lending from 1996 to 1999).<sup>54</sup>

Several papers argue that improving the quantity and quality of EDM data could increase the supply of capital to emerging small businesses. Carr and Schuetz along with Brush contend that an expanded collection of transaction data tracking investment performance by gender, ethnicity, and geographic location would improve the financial services environment for lower-income and minority households.<sup>55</sup>

### *Improving Granularity, and Usefulness of Data*

Enhanced information would allow banks to conduct data mining (the analysis of large datasets) to uncover investment opportunities across markets and industries.<sup>56</sup> One very promising application of data mining is credit scoring, a form of statistical analysis used to predict the probability that a loan applicant will default. Small-business credit scoring is relatively new the first model was introduced by Fair, Isaac in 1995 and differs from traditional credit scoring in that it combines limited information on the firm with consumer data about the small-business owner.<sup>57</sup>

The personal credit history of a business owner has been shown to be an accurate predictor of a small business's repayment performance. In many cases, credit scoring has helped to increase small business lending by simplifying the approval process and reducing the need for a strong relationship between the bank and the loan applicant.<sup>58</sup> "Research strongly suggests that small-business credit scoring has increased small-business credit availability in a number of dimensions, including: increasing the quantity of credit extended; increasing lending to relatively opaque, risky borrowers; increasing lending within low-income areas; [increasing] lending over greater distances; and increasing loan maturity."<sup>59</sup> The rise in lending has been most noticeable in the number of loans under \$100,000 extended by large banks,<sup>60</sup> which are

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54 National Community Reinvestment Coalition. December 2000. "United States Small Business Lending Trends, 1996 to 1999."

55 Carr, James H. and Jenny Schuetz. August 2001. "Financial Services in Distressed Communities: Issues and Answers," Fannie Mae Foundation; Brush, Candida G., Nancy Carter, Elizabeth Gatewood, Patricia G. Greene, and Myra M. Hart. October 2001. "An Investigation of Women-led Firms and Venture Capital Investment," CB Associates.

56 Wasserman, Miriam. "Mining Data." Spring 2000. Federal Reserve Bank of Boston. See <http://www.bos.frb.org/economic/nerr/rr2000/q3/mining.htm>

57 Berger W., Allen N., Scott Frame, and Nathan H. Miller. 2002. "Credit Scoring and the Availability, Price, and Risk of Small-Business Credit," Finance and Economics Discussion Series 2002-26, Board of Governors of the Federal Reserve System.

58 Fair, Isaac. May 2006. "Leveraging Fair, Isaac Analytics and Decision Technology to Improve Profitability in Small-Business Lending Markets," Fair, Isaac Guide for Using Predictive Small-business Analytic Models.

59 Berger, Allen N. and W. Scott Frame. May 2005. "Small-Business Credit Scoring and Credit Availability," Federal Reserve Bank of Atlanta Working Paper Series.

60 Akhavein, Jalal, W. Scott Frame, and Lawrence J. White. May 2001. "The Diffusion of Financial Innovations: An Examination of the Adoption of Small-Business Credit Scoring by Large Banking Organizations," Proceedings, Federal Reserve Bank of Chicago; Peek, Joe and Eric S. Rosengren. March/April 1998. "The Evolution of Banking Lending to Small Business," *New England Economic Review*; and Berger, Frame, and Miller 2002.



using credit scoring as a means to expand into the small-business lending market.<sup>61</sup>

Frame, Srinivasan and Woosley examine a sample of large U.S. banks and find that credit scoring leads to an 8.4 percent increase in the portfolio share of small-business loans: on average \$4 billion per institution.<sup>62</sup> In the Federal Reserve Bank of Atlanta's district, the use of credit scoring increased small-business lending by \$16.4 million per low- or moderate-income area served and the probability that a large banking organization would make small-business loans in the area by 3.8 percent.<sup>63</sup> Peterson and Rajan find that increased availability of credit scoring data allows banks to lend to more distant small-business borrowers.<sup>64</sup> Further, credit scoring mitigates the potential harmful default effects of distance lending because it improves the ability of lenders to assess and price default risks.<sup>65</sup>

Both government agencies and independent researchers suggest that government, nonprofit organizations and the private lenders and investors collaborate to improve EDM data. Hawke recommends joining data from the U.S. Census, private marketing and "non traditional" sources (e.g., utility bills) to better understand the economic importance of EDM.<sup>66</sup> Yago, Zeidman, Magula & Sederstrom categorize the wide array of EDM-related data (from financial institutions, government agencies, trade associations, nonprofits and information management companies; using different units of measurement, including business owner, business type, financing type and financial performance) and recommend forming a consortium to build a relational database to pool diverse data, masked to preserve confidentiality.<sup>67</sup>

As we note in *Emerging Domestic Markets: Increasing Capital by Improving Data*, "no new financial market or asset class has emerged over the past thirty years without considerable investment in building the informational infrastructure about firm and project finance characteristics, financial and economic performance, and the relationship between these and macroeconomic and institutional dynamics."<sup>68</sup>

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61 Loretta J. Mester. September 1997. "What's the Point of Credit Scoring?" *Business Review*, Federal Reserve Bank of Philadelphia.

62 Frame, W. Scott, Aruna Srinivasan, and Lynn Woosley. 2001. "The Effect of Credit Scoring on Small-Business Lending," *Journal of Money, Credit and Banking*, 33(3).

63 Frame, W. Scott, Michael Padhi, and Lynn Woosley. April 2001. "The Effect of Credit Scoring on Small-Business Lending in Low- and Moderate-Income Areas," Federal Reserve Bank of Atlanta.

64 Peterson, Mitchell A. and Raghuram G. Rajan. October 2000. "Does Distance Still Matter? The Information Revolution in Small-business Lending," Northwestern University.

65 DeYoung, Robert, Dennis Glennon, and Peter Nigro. March 2006. "Borrower-Lender Distance, Credit Scoring, and the Performance of Small-Business Loans," FDIC Center for Financial Research, Working Paper No. 2006-04.

66 John Hawke, "Growing Diverse Banking Markets: Going Beyond Traditional Measures," Comptroller of the Currency Administrator of National Banks Community Development Newsletter (2001).

67 Yago, Glenn, Betsy Zeidman et al., "Emerging Domestic Markets: Increasing Capital by Improving Data," (Santa Monica, CA: 2007).

68 Ibid.

The history of emerging domestic markets is rich and ripe with potential for continuing growth. Yet challenges remain to obtaining capital, and the full variety of capital products. If business, government, the social sector and philanthropy, do not access all available information, EDM businesses will not be able to achieve their potential, investors will not reach their target returns, and the country's economic growth will be constrained.

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