**Addressing the Gap in Consumer Protection for Small Business Consumers Through a Multiple Method Research Program**

CFPB Symposium Report

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## Report Overview

For more than a decade we, as academic researchers, have investigated the experience of small business customers seeking financial products for their businesses. We have employed a variety of research methodologies to explore the "lived" experiences of small business owners seeking financing, including matched-paired mystery shopping, video ethnography, depth-interviews, controlled experiments, and surveys. From this research, we show that with limited financial sophistication, entrepreneurial small-business consumers approach the financial marketplace much more like retail financial consumers than sophisticated, corporate customers. Furthermore, we find that the customer service received by these small business customers seeking small business bank loan products is consistently poor and that the actual treatment of racial minority and women-owned small business banking customers is significantly inferior in critical ways. These findings suggest that the playing field for women and minority-owned small businesses is not level and the business and personal outcomes for these individuals and for the economy as a whole is suboptimal.

## Small Business Entrepreneurs Need Consumer Protection

Small business loan customers often approach the credit marketplace with similar financial acumen as when they pursue retail, consumer banking products. However, unlike consumers seeking mortgages and consumer credit, the current state of consumer financial protection does not extend a protecting hand to small business banking consumers. The current state of public policy continues to make the assumption that small business-borrowers are more financially savvy than consumer-borrowers, and thus do not require as broad-reaching protections (Bone, 2006). To illustrate this erroneous assumption, in 2005 we conducted interviews with state and federal banking regulators and discovered a regulatory and consumer protection gap in the policies protecting small business consumers. For example, a State Supervisor of Consumer Credit and Compliance and a FDIC Senior Compliance Officer revealed how consumer protection regulations were note designed for small business consumers.

> "Like I said, they're called consumer protection regulations for a reason— because they protect consumers…. I have this discussion every day with somebody who has a business account and wants me to go after the bank because they do not like how their business account is being handled and I just tell them, "You know what? You are not a consumer; consumer protection laws do not apply. If you don't like what you got from the bank and if you have a contractual agreement, see if they are violating it. And if they are then sue'em! If they're not and you have agreed to it, you've got a contract. You don't like it, go somewhere else." I am very… I don't mean to sound too harsh or hard-nosed, but consumer protection regulations do not apply." (Female – State Supervisor of Consumer Credit and Compliance)

> "To be honest with you, commercial loans, for our purposes, are not… there's not that many issues with them as far as consumer compliance because they're not consumer loans, so it really mitigates our analysis on commercial products…. In essence, the world has decided that the commercial borrower should be savvy by and large…. They ought to know more of the financial aspects. It's [compliance regulations] really protecting the smaller guys. Now that's not to say fair lending is, when you think about fair lending and what that really means, that's the only real criteria that overrides everything. So if they are being treated fairly then they don't need… let's say for a commercial property they don't need a RESPA and all the other consumer-related documents…. The lowest common denominator is a first-time homebuyer; that is why you have all these documents… whereas in commercial, these people know the market, they don't need disclosures, they [the government] are not as worried about the individual being dooped in what they are doing." (Male – FDIC Senior Compliance Officer)

This gap between marketplace policy protections and the lived reality of the vast majority of small business operators sets the stage for small business banking consumers to fall through the regulatory cracks which allows a greater possibility for exploitation and abuse. We have dedicated years of research to understanding the reality and lived experiences of racial minority and women-minority owned business, and how membership in a protected class makes these minority-owned business customers more vulnerable to differential treatment in the marketplace including the entrepreneurial financial products marketplace (Bone, Christensen, and Williams, 2014; Bone et al. 2019).

**Goal-Directed Journey and Pre-Application Testing**

Think of an entrepreneur deciding to seek funding for her small business. This decision for her is not a discrete or isolated choice but rather an important step necessary to reach other, higher steps within a larger goal-journey. For example, financial goal for her might be to cover production expansion costs in order to serve more customers thus increasing revenues and profitability. These goals in turn are not isolated choices for our exemplar entrepreneur, but are similarly important steps toward building a successful business, providing for her employees and family, giving back to her community, leaving a legacy for her family, living a life of independence, and experiencing a deep sense of accomplishment and contribution. Thus, the choice to seek financing is an important, even crucial step in a longer life-journey—a means to a much larger and self-defining end.

Zooming in on the life of a consumer who has made the decision to seek financing for her business reveals an involved consumer choice journey which requires a series of behaviors and subchoices that must happen before she can chose to even apply—investigating loan options, finding potential providers and choosing those to include in her final consideration set, evaluating different attributes of loan products and choosing the attributes on which to rely when finalizing choice, identifying loan requirements, collecting relevant information and documentation, and so on.

Thus, experiencing obstacles, roadblocks, or dead ends—even during the early stages of information search for small-business lending—can discourage or derail an entrepreneur's choice-goal to seek funding for business expansion. This in turn may require a painful reworking of her superordinate and self-defining life goals. Given the criticality of early stage preapplication information search, our research has focused on understanding the experiences of entrepreneurs during this important stage of the journey for small business financing.

**Matched-Paired Mystery Shopping Studies**

Data is a required component in combatting institutional and systematic discrimination, but it is not effective in a vacuum. Matched-pair mystery shopper testing is a valuable investigative tool for uncovering systematic and institutional barriers that raw data and surveys alone cannot detect. The U.S. Department of Justice, the CFPB, and HUD have all used mystery shopping testers to uncover institutional discrimination that exists in consumer lending (CFPB, 2016; U.S. Department of Justice, 2016). However, to date, none of these agencies have attempted to use mystery shopping testing to uncover potential discrimination possibly faced by minority small business entrepreneurial consumers.

In Bone, Christensen, and Williams (2014), we report the results of the first independent study published using a matched-paired method with small business consumers. We compare the experience of mystery shopping Hispanic and Black consumers to white consumers as they visit banks for entrepreneurial, small-business loans. The results unfortunately show that even when white and minority consumers are identical "on paper" (for example, all the consumers in the study wore the same clothes, asked for identical loans for identical businesses and had identical backgrounds—other than their race/ethnicity), they were treated differently by bank loan officers and minorities were treated more poorly than their white counterparts. Unfortunately, minorities were given different information, were asked for more financial and other information, were given significantly less encouragement, and were less likely to get offers to help in the loan application process by loan officers.

In Bone et al. (2019), we conduced additional mystery shopping tests of 17 bank locations in two large metropolitan statistical areas (MSAs) in the eastern United States. These markets were selected by first analyzing the regional demographic composition of each bank's location according to the United States' 2010 Census Data tracts categorized as low, moderate, middle, and upper income as classified under Consumer Reinvestment Act (CRA) guidelines using median family income. We then used CRA data collected by the Federal Financial Institutions Examinations Council (FFIEC) to determine the lending patterns of these banks. This data revealed the number and dollar amount of loans originated to each census tract. This study analyzes interactions amongst branches that have high, moderate, and low levels of spending to those of low-moderate income tracts. We conducted a total of 52 tests (or 26 matched-pairs with one Black tester and one white tester).

Six Black and five white male testers came to the banks with nearly identical business profiles and strong credit histories to inquire about a small business loan product ($60,000 – $70,000 loan to expand their business and to possibly hire a part-time employee). The profiles of the test and control groups were sufficiently strong such that on paper, either profile would be very likely to be approved for a loan. We designed the profiles for both the protected and control testers to be well above the threshold of what is acceptable loan requests, however, we purposefully designed the qualifications of Black testers to be superior to the qualifications of the white testers. In other words, on paper the protected, Black, tester was financially better off than the control, white, tester. Thus, one would hope for the experience of Black testers to be more positive, or at the very least, equal to the experience of the white testers. This makes this study a conservative test for the presence, if any, of disparate and discriminatory treatment in the test condition.

The results show that Black testers were asked to provide more information about their businesses and personal financials than white testers ($\chi^2 = 17.25$; $p = .01$). Specifically, compared with the white testers, Black testers were more frequently requested to provide the information of their business financial statements (73.1% vs. 50.0), the amount of their accounts receivable (11.5% vs. 0.0), and their personal W-2 forms (30.8% vs. 0.0%). In addition, we identified a troublesome pattern of loan officers inquiring about marital status. Asking about marital status as a determination of credit worthiness is a direct violation of fair lending law (15 USCS § 1691). We found that Black testers were asked if they were married (marital status) (M = 23.1%) significantly more frequently than compared to white testers (M = 3.8%; $\chi^2 = 4.13$; $p = .04$). In addition, Black testers were asked about spousal employment status (M = 11.5%) significantly more frequently than compared to white testers (M = 0.0%; $\chi^2 = 3.18$; $p = .07$). The similar test and control profiles are created in a manner that should result in a loan approval based solely on the income of the tester alone. There would be no reason or need to incorporate a spouse's income into the credit worthiness decision-making process. Furthermore, only the Black testers where asked if their spouse is employed. The results also reveal differences in the level of assistance and encouragement offered to the Black testers ($\chi^2 = 9.43$; $p = .05$). Compared with their white counterparts, Black testers were less frequently offered a future appointment (11.5% vs. 23.1%), offered help to complete an application (11.5% vs. 26.9%), thanked for coming in (80.8% vs. 96.2%), and asked how they can help (92.3% vs. 100%).

**Racial Homophily Test**

A critique and limitation of these results is whether the race and gender of the bank employee influence the treatment that testers experienced, and if so, how? To address this limitation, we recently conducted (in 2018) a matched-paired mystery shopping test in the Los Angeles metropolitan statistical area where we tested whether the racial homophily—or similarity of bank employee race and the tester race—further investigates the differences we encountered in our earlier work. Consistent with the earlier tests we again found differences across the testers, including in the information that was required to make application for a small business product (see Figure 1). Minority customers were statistically more likely to be asked for personal financial information than their white counterparts.

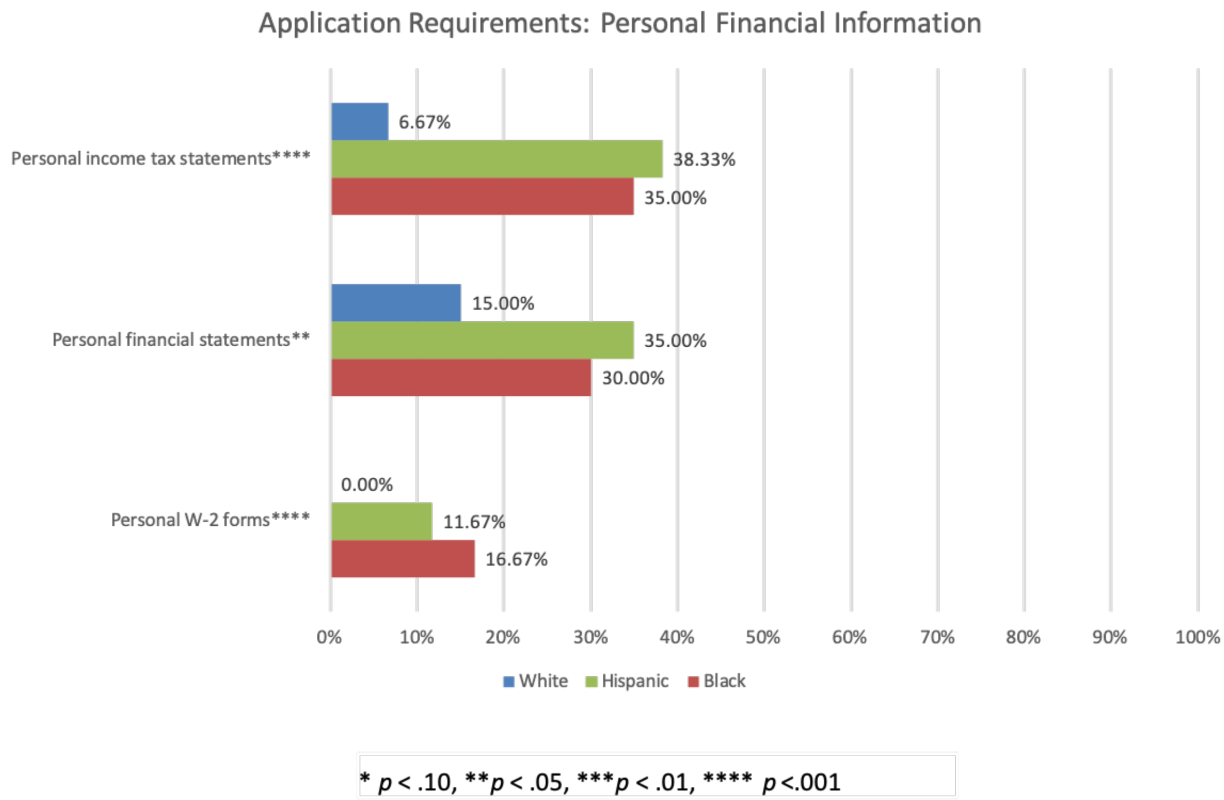
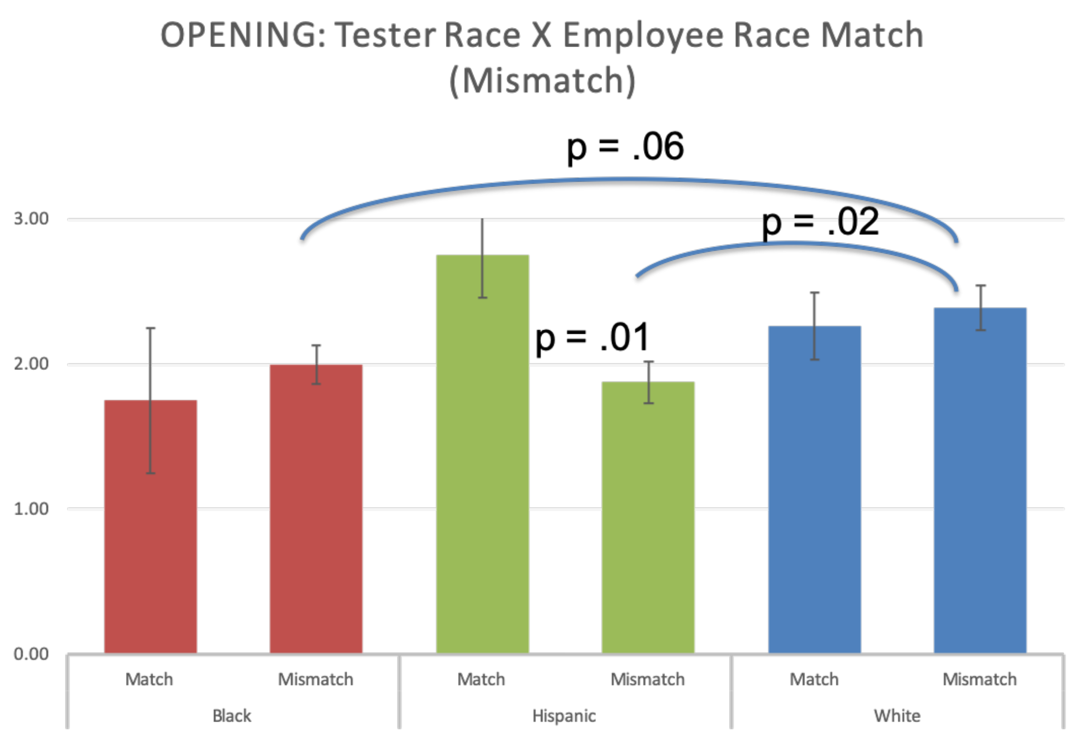



Figure 1: Application Requirements - Personal Financial Information (LA 2018)

To expand understanding regarding the impact of racial homophily, we compared interactions where tester and employee race matched or was unmatched and found significant differences in two experiences, the opening of the encounter (e.g. asking and using the name of the tester) and the closing of the encounter (e.g., offering the tester an application). Consistent with racial homophily, Hispanic testers received a better opening experience when they were served by a Hispanic bank employee (see Figure 2). When Hispanic and Black testers were served by someone that was of a different racial background from them, each received a poorer opening experience than when White testers were served by someone that was non-White.

Turning to the closing experience and comparing within race, Hispanic testers received a better closing experience when served by a Hispanic bank employee (homophily) than when they experienced a race mismatch. Finally, during the closing experience, Hispanic testers served by Hispanic bank officers received a better closing compared to Black testers *and* White testers served by a bank employee that was of their same race.

Figure 2: Opening - Racial Homophily (LA 2018)




**Narrative Analysis**

In addition to analyzing the data using empirical quantitative methods, we collected detailed narratives from each test. In these narratives the tester was asked to describe each of the actors (e.g. bank employees) involved, the detailed events of their interaction and the conversation and discourse they experienced during their time in the bank. Comparing the narratives of the Black testers to the white narratives revealed that Black testers experienced micro-aggressions along with the disparate treatment they received. Victims of consumer discrimination bear a psychological burden as a result of overt and subconscious discrimination. Because consumer discrimination occurs in everyday situations, it constitutes the kind of micro-aggressions that can have cumulative debilitating effects over the course of a person's lifetime. For example, we found that on multiple occasions the loan officer during their visit with Black testers went to a government website listing all registered businesses to verify if the minority tester's business was registered and in good standing. This did not occur for any white tester.

Analyzing the narratives of matched-paired tests to the same bank location revealed other types of micro-aggressions experienced and reported by Black testers. For example, while both testers lived about an hour from the bank branch, it was suggested to the Black tester to visit a bank branch closer to his home, while the white tester was told that the business specialist is not in and offered to set up a meeting for the next time the business specialist is available. Another example that occurred is of a matched-pair where the tester met with the same loan officer on the same day. Both testers were asked about the location of their business which—according to the scenario they were trained on—about an hour away from the bank. In this incident, the Black tester was then asked why he was in area and he responded, as directed, by saying that he was in the area to meet with a potential client. On the other hand, the white tester was not asked this question.

**Conclusion and Recommendations**

Access to capital for a small business is critical for growing and accumulating wealth for all consumer groups, regardless of race. However, access can be hindered or frustrated in the early steps of a consumer's journey seeking small business banking products. The availability of data and information along the consumer's journey to access capital is of paramount importance if markets are to improve for all consumers. Based on this research, we conclude and give our support for Section 1071 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) (Pub. L. 111-203, H.R. 4173) which requires financial intuitions that engage in small business lending to report their lending activities with the same transparency already required of home mortgage lending sector.

We are convinced of the power of data to enlighten and illuminate. The data we have personally gathered and published demonstrates the power of data to highlight inequities and disparate customer treatment in the small business lending marketplace. Our findings have shown that for all entrepreneurs, it is difficult journey to obtain financing for their ventures. For minority entrepreneurs especially, this journey is not across a level playing field. Rather it is an uphill journey where they encounter obstacles in their path that their white counterparts simply do not experience as often—if they experience them at all. Even when in our data collection, we "tilted the scale" in favor of minority testers, the data showed that better financially qualified, minority small-business applicants encountered difficulties not experienced by majority testers. These data show that in the small-business lending marketplace, we are simply not there yet.

For these reasons, we support greater data gathering among policy-makers to create increased transparency in the marketplace. Transparent markets allow light to highlight and expose inequities and areas of disparate treatment among marketplace participants. In our view, the potential costs of reporting the data called for in Section 1071 are far outweighed by the illumination and marketplace transparency those data have the power to provide. At the same time, there is a cost to not collecting and reporting these data. That cost, currently incurred, is an unclear and uninformed understanding of the full width and breadth of the small-business lending landscape. In our view, greater access to data will allow citizens and policy-makers increased insight to make informed, data-driven decisions as to policy in this economically vital marketplace.

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