BREAKING BARRIERS

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to Capital Access for Returning Citizens

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ABOUT RESEARCH AT AEO

As the leading voice of innovation in microbusiness, the Association for Enterprise Opportunity (AEO) has an extensive history of conducting research that aims to understand, support, and promote the interests of underserved nonemployer, small, and microbusinesses (SMBs). For more than 30 years, AEO and its member and partner organizations have helped millions of underserved entrepreneurs in starting, sustaining, and growing their businesses. Together, AEO is working to change the way that capital and services flow to underserved entrepreneurs so that they can create jobs and opportunities for all.

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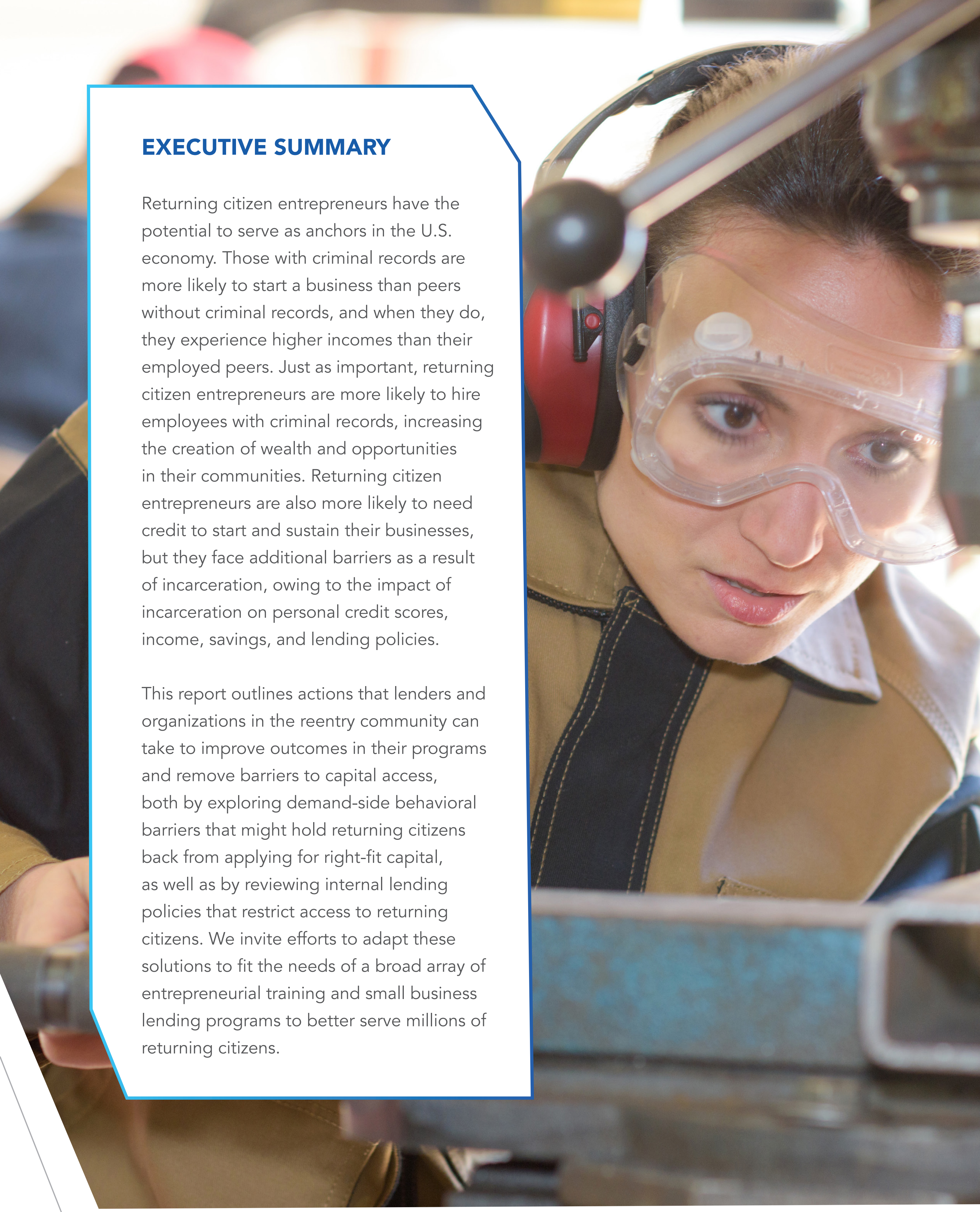

EXECUTIVE SUMMARY

Returning citizen entrepreneurs have the potential to serve as anchors in the U.S. economy. Those with criminal records are more likely to start a business than peers without criminal records, and when they do, they experience higher incomes than their employed peers. Just as important, returning citizen entrepreneurs are more likely to hire employees with criminal records, increasing the creation of wealth and opportunities in their communities. Returning citizen entrepreneurs are also more likely to need credit to start and sustain their businesses, but they face additional barriers as a result of incarceration, owing to the impact of incarceration on personal credit scores, income, savings, and lending policies.

This report outlines actions that lenders and organizations in the reentry community can take to improve outcomes in their programs and remove barriers to capital access, both by exploring demand-side behavioral barriers that might hold returning citizens back from applying for right-fit capital, as well as by reviewing internal lending policies that restrict access to returning citizens. We invite efforts to adapt these solutions to fit the needs of a broad array of entrepreneurial training and small business lending programs to better serve millions of returning citizens.

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Introduction

The U.S. has the highest rate of incarceration in the world, holding nearly a quarter of the world's prisoners but just four percent of the world's population. Nearly one-third of working-age Americans have a criminal record – about the same as the number with college degrees – and every year, hundreds of thousands of people are released from the prison system.[1]

In theory, individuals released from prison face a new beginning filled with hope and opportunity. In practice, they face tremendous barriers to reentry, including exclusion from employment opportunities. While involvement with the criminal legal system has become a routine marker of adulthood in the U.S., measures to protect access to jobs, housing, and financial services for formerly incarcerated individuals, whom we refer to as returning citizens, are limited. As a result, returning citizens face significant income penalties and financial challenges post-release. Compounding matters, the structural racism embedded in every decision point in the criminal legal system also shapes disparate outcomes upon reentry.[2]

In this context, entrepreneurship offers an important path for returning citizens to circumvent labor market discrimination and build wealth. Other things being equal, returning citizens are more likely to start a business than their peers who have never been incarcerated, and when they do, they earn higher incomes and experience lower recidivism than their employed peers.[3] But after years in prison or starting from a context of poverty, many returning citizens have little personal savings, few people to rely on for support, and little or no credit history – placing initial starting capital for businesses far out of reach. Others succeed in establishing their businesses but need injections of capital to introduce efficiencies and scale up, manage cash flow, and more.

So the big question is: How do we increase access to capital for returning citizens to help them benefit from the economic mobility that entrepreneurship can provide? Recent AEO programs have made significant headway in this area with the publication of a toolkit to help entrepreneurial training programs support returning citizens with early credit development, right-fit capital, and trauma-informed care,[4] and by testing an underwriting innovation – the R3 Score – to facilitate underwriting to returning citizens among Community Development Financial Institutions (CDFIs).[5] But, notwithstanding their impact, these programs revealed additional demand- and supply-side barriers to lending that must be addressed in order to scale our support for returning citizens:

1. Barriers responsible for the low uptake of small business loans at institutions that offer right-fit capital to returning citizens,[6] and

2. Supply-side barriers such as the use of criminal background records in lending decisions that restrict capital access for returning citizens.

Over the past year, AEO has conducted in-depth research and launched a pilot program with numerous CDFIs, social justice organizations, online lenders, returning citizen entrepreneurs, and other stakeholders to address these challenges from a behavioral science perspective. This report highlights the lessons we learned and offers some guidelines for best practices. Our solutions are not exhaustive; instead, this report should serve as a conversation starter to develop the behavioral innovations and policy changes needed to reach and serve returning citizen entrepreneurs. Our goal is to complement and expand existing efforts with behavioral insights to support returning citizens at each stage of their entrepreneurial journey.

We begin by introducing the many challenges faced both by entrepreneurs post-release and the organizations that seek to support them. We also outline broad guidelines and sample solutions that follow from these findings and that can be tailored to fit the needs of a wide range of organizations, as well as the entrepreneurs they serve. Here is a summary of the broad guidelines:

Develop clear and actionable communications:

Much of the work needed to connect returning citizens with right-fit capital concerns messaging and communications. While service providers generally never try to deliver information in overwhelming, confusing, or roundabout ways, we often do so unintentionally. We offer broad guidelines for communications, including loan applications, to help us close the gap between intention and action.

Reduce uncertainty:

The search for right-fit capital is too often complex, lengthy, and emotionally difficult. It may take returning citizens months or years to become credit-ready, and entrepreneurs may have already experienced previous declines, making them even less inclined to apply for opportunities when there is not a clear fit. To support returning citizens, we must identify opportunities to reduce uncertainty in the credit-building and application process.

Guide entrepreneurs throughout the process:

Entrepreneurial training programs are critical to raising awareness of mission-based small business lending and credit-building opportunities for returning citizens. While many programs refer their clients to other resources when appropriate, it is often left up to the client to pursue the referral. We found that the most effective way for service providers to encourage action was to make direct connections on behalf of the entrepreneurs they serve and follow up as needed.

Empower returning citizens with peer support:

Returning citizen business owners, like all business owners, face many challenges for which they seek advice, and they typically seek advice from peers. Building a network of peer support can empower returning citizens to take action in pursuit of their business goals.

Provide evidence of social proof:

Providing evidence that "people like us" are able to become successful entrepreneurs can give us a license to do so. Even small changes in the way a message is worded or the priming of particular aspects of our identity can make a difference.

In this report, we also explore supply-side barriers to capital access, particularly the formal legal and policy restrictions that many public and private financial institutions impose on loans of business capital based on a borrower's criminal history. We show how these policies deepen racial inequality and are out of step with the policies of many successful lenders and guidance from the Equal Credit Opportunity Act, and suggest a way forward.

Finally, we close with broad recommendations to better support returning citizen entrepreneurs. For many returning citizens, recovering livelihoods and building wealth starts with owning a business. And those businesses grow and thrive with access to right-fit capital.

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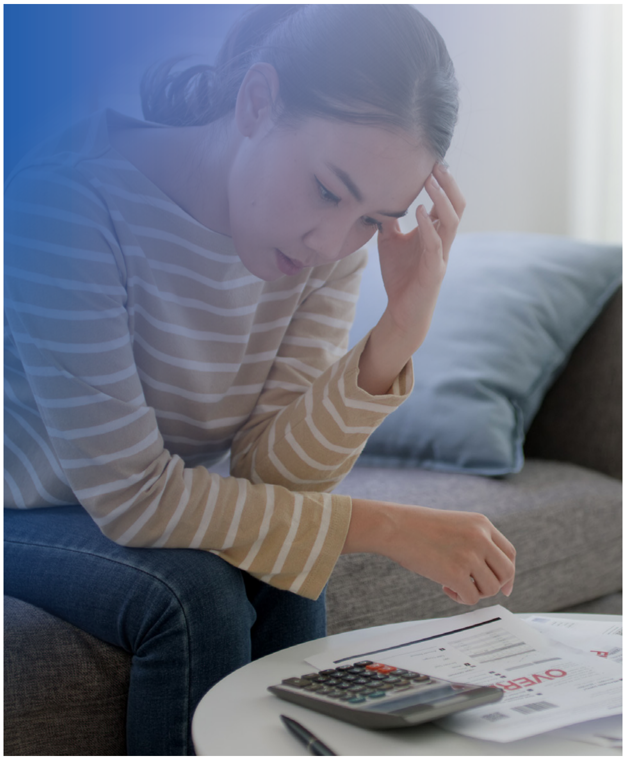
02

Applying a Behavioral Perspective to Better Serve Potential Borrowers

Amid the barriers faced by returning citizens, one positive trend stands out: a growing number of reentry programs, social justice organizations, fintech institutions, CDFIs, and other mission-driven lenders are focusing their efforts on serving returning citizen entrepreneurs.

Yet, notwithstanding a well-documented need for capital among returning citizen entrepreneurs, CDFIs consistently cite difficulty reaching these potential borrowers. While no external data exist to demonstrate this gap, nearly all of the lending institutions we partnered with for this research and in the past have reported a challenge in reaching returning citizen borrowers, including potential borrowers who had been referred by fintech lenders with criminal decline policies. If returning citizens are in need of capital to start and grow their businesses, then why the low uptake in lending programs?



One reason concerns the significant structural barriers that restrict the pipeline of returning citizen entrepreneurs in the first place. Reentry programs have emerged in recent decades in response to trends in mass incarceration,[7] but not at the same pace, and the vast majority of programs are (understandably) focused on helping returning citizens meet basic needs post-release. Traditionally, reentry programs have focused on meeting needs for housing, healthcare, transportation, recovering identity documents, and finding employment to begin generating income – often itself a parole requirement.[8] The need for immediate income is all the more pronounced for the average returning citizen, who spends over $13,000 in conviction-related fees. The average incarcerated parent leaves prison with more than $20,000 in unpaid child support, and this debt adds to the barriers returning citizens face and further interferes with their ability to secure housing, employment, and capital.[9] An end to these structural barriers would require sweeping reforms at all levels of the criminal legal system, as well as accessible and affordable healthcare and financial services, an increase in the supply of good jobs with living wages, protection from discrimination, and much more – and is thus beyond the scope of this report.

Another reason concerns underlying behavioral barriers. Many returning citizens overcome the odds and enter the pipeline of entrepreneurs, but may not apply for capital when they need it. Lenders confronted with the challenge of low uptake often assume that the problem is a lack of awareness, and they respond by expanding outreach. As one lender described the challenge, "We have marketed this program, we have gone to reentry programs and financial institutions serving this population to tell them about this opportunity [to refer returning citizens to apply for business loans], and we've been unable to get a mass of people to apply." But exploring lending opportunities and then applying can be a lengthy, complex, and difficult process, and behavioral science suggests that this process itself is often to blame. We believe that underlying the low uptake is a complex set of human behavioral and psychological tendencies and that program outcomes can be improved when we take these human tendencies into account.

In this report, we adopt a behavioral perspective to unpack the full range of cognitive, social, emotional, and contextual factors that might hold returning citizens back, including the role of context in shaping the innovations that are most likely to have an impact, along with a host of other barriers underlying the low uptake. Importantly, this does not imply that we believe returning citizens need to change their behavior. Rather, we follow a tradition in behavioral science that holds that programs and services are most effective when we take universal behavioral tendencies into account. The burden thus falls on organizations and their staff to design programs in ways that consider the psychological, behavioral, and situation-specific forces that shape human decision-making.

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While behavioral innovations cannot address the underlying structural barriers and economic inequities described above, they can help entrepreneurs engage with and benefit from the services available to them. Bringing behavioral innovations to the work of social justice organizations and mission-based community lenders focused on serving returning citizens can help us maximize program impact and create better outcomes for all. Drawing on broad insights from behavioral science, findings from our in-depth research, and the results of our pilot completed in 2022, below we flesh out the most salient behavioral bottlenecks that we observed in our research, followed by related solutions that lenders and organizations in the reentry community may take to improve outcomes for returning citizen entrepreneurs.

Behavioral Considerations for Program Design

Most programs and services require us to make active decisions and follow a series of steps to achieve a desired outcome, from navigating potential lenders to deciding which product is the right fit, to completing forms, to obtaining required documents, to attending meetings or appointments. Program staff typically provide tremendous support along the way, but also assume that we will carefully evaluate options and make the right decision to obtain the right result. Yet, our natural, universal human tendency – both for staff and clients – is to feel overwhelmed by choices, miss important details, lose the ability to recall information over time, and rely on mental shortcuts to make decisions. These tendencies, in turn, often diminish program efficacy and may contribute to low application rates. A large and growing body of evidence shows that insights from behavioral science can improve the design and effectiveness of programs by taking these tendencies into account.[10] A behavioral approach is essential for communications problems and complex processes – problems familiar to lending and training programs operating in the reentry community. Below we outline key barriers to supporting returning citizens that emerged from our research.

Limited Awareness of Options

The journey from reentry to starting a business to raising capital is often long and complex. While most microbusinesses are founded using personal savings as startup capital – typically less than $5,000 – this amount is prohibitive for many returning citizen entrepreneurs facing low wages and high debt as a result of incarceration.[11] Compounding matters, traditional commercial and fintech lenders – as well as many community banks – are not optimized to provide affordable, low-dollar microloans for business startups. And finding the right lenders to turn to for startup capital – and then later for growth capital when they succeed – is far from straightforward. As one program director put it, "[Entrepreneurs] have to randomly knock on whatever lender they happen to first hear about and go through a whole rigamarole only to find out that actually, nah, you're not the target market, even though you never could have been able to tell that from the website." Our research suggests that many returning citizens are unaware of mission-based community lenders in their local communities and the options that might be available to them. When returning citizens are aware of community lenders, they typically learned about these opportunities through referrals from reentry or entrepreneurial training programs.

The Gap Between Awareness and Action

We often assume that simply being aware of a new lending opportunity is enough to motivate individuals to apply, but a number of barriers prevent business owners from doing so. For example, even when returning citizens are aware of lending opportunities, they may not see credit-seeking as a worthwhile activity because the applications can be onerous and they do not expect a successful outcome. This is most often the case when the entrepreneurs have experienced previous declines. "People are vaguely aware – if not mostly aware – that loans are an option. Whether or not they seem accessible or the right fit, that is where the barriers arise," explained one program director. Similarly, one returning citizen entrepreneur shared his perception of a typical experience with lending programs: "If you're explaining how you can help [returning citizen entrepreneurs], and they really can't understand how they can implement themselves into that help, that may be more of the problem." Both knowing there are options and perceiving fit are key to motivating action.

Cognitive Biases Arising from Informational Complexity

Our capacity to process and recall information is bounded; even when we understand the information given to us, we may not remember it or we may not recall it when we need it. And information regarding starting a business and becoming credit-ready is notoriously complex, with different pieces of information being more or less relevant at different stages. Information regarding a small business lending opportunity may not be relevant until reaching a minimum personal credit score or until the business has been in operation for a minimum period of time. In the words of a director of an entrepreneurial training program, "Getting a loan is often ten steps removed from where a returning citizen entrepreneur is today."

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Identity and Self-Doubt

For entrepreneurs, issues of identity can be particularly salient; the way we think about a business activity can influence the opportunities we pursue. Many self-employed individuals – returning citizens included – confront conflicting identities commonly tied to popular myths and cultural representations. Some may see themselves as "gig workers" or someone with a "side hustle" rather than as an entrepreneur, for example, and several program directors cited this challenge. As one director explained, "There seems to be a mental association of entrepreneurship with Shark Tank and tech startups, with all of this capital. But literally, you just have to just start something, whatever it is right now and you can be a business owner." Often, these identity conflicts can contribute to feelings of self-doubt as entrepreneurs; in the words of another program director, "There is a self-projection onto the situation that there's this world of business out there, and that's for the wealthy or the privileged or the fancy people. And I don't belong there." Both service providers and entrepreneurs also cite a common perception among returning citizens that business ownership is "not for people like me." Context and messaging can influence our identity or framing of a situation and the way we take action.

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Understanding Context

Context shapes the way we evaluate options, form intentions, and take action. While we have been discussing returning citizens as a whole, both their individual situations and the scope of entrepreneurial support available can vary widely. These situational and contextual factors, in turn, shape what messages will be most effective and when. With regard to entrepreneurial support, some programs offer pre-release training inside prison, others offer support post-release or both. Additionally, the services offered vary widely. Among entrepreneurial training programs, some offer credit-building support, microloans, or seek partnerships with local lenders to increase access to capital for the entrepreneurs they serve, while others focus on helping entrepreneurs start their business with a small amount of capital – less than $1,000 – with little to no credit-readiness training. Among small business lenders, many require minimum credit scores for small business loans and may or may not offer technical assistance or support for credit-building. With regard to returning citizen entrepreneurs, the context is equally diverse. The amount of time that has passed post-release, their ability to secure housing, their family obligations, their networks of support, their health and well-being, their ability to generate income through employment (most are employed at the time they start their business), and many other factors will influence their cognitive and emotional biases, as well as what works best and when. Each context presents a unique set of challenges and requires different approaches to messaging and communications.

The considerations outlined above reveal key behavioral barriers that organizations can take into account as they design their products and services to better serve returning citizen entrepreneurs. In the following section, we outline broad guidelines and potential solutions that can support returning citizens in their search for right-fit capital.

Behavioral Design Principles

Building on what we learned regarding behavioral barriers faced by returning citizens through our research and pilot program, this section outlines opportunities to complement service providers' toolkits using behavioral science principles and a series of recommended solutions. These solutions can be tailored to fit the context of a vast array of service providers, from reentry programs to entrepreneurial training programs to community lenders. At first glance, some recommendations may seem commonsense or insignificant. But, we include them because **1)** seemingly unimportant details often shape how we think and act, and **2)** well-designed adjustments to programs, communications, and messaging can have outsized benefits in terms of uptake.

Develop Clear and Actionable Communications

Much of the work needed to connect returning citizens with right-fit capital concerns messaging and communications, an area ripe for behavioral innovation. While service providers generally never try to deliver information in confusing or roundabout ways, we often do so unintentionally. Additionally, we may share a lot of information because we want to help entrepreneurs make informed decisions, but an unintended consequence is that little gets through. When confronted with a flood of information we tend to feel overwhelmed and then we shut down, default to the status quo, or make the decision that seems easiest. General best practices include sharing the most important information first, and then providing additional details at a later stage or on request. The most important information – particularly any calls to action – should be especially salient through any communication's design to make it easy to act. The language should also be familiar in order to resonate even with those with little experience with financial products or legal documents, for example. A good way to test communications is to seek feedback from a member of the target audience.

Drawing from this broad, general guideline, we identified two sample solutions that are relevant to both lenders and social justice organizations working with returning citizens:

- **Make the loan application easy and transparent.** Returning citizens should be able to quickly identify evaluation criteria in order to evaluate fit, along with required documents and information, before creating an account or beginning an application. One reason that the top small business fintech lenders are easy to apply to is that they follow this guideline, not simply because they make fast decisions (they do include the time estimate for a decision and funding, however – another important point that we explore further below). In contrast, sites that include vague references to requirements or require the user to begin an application before knowing details are likely to dissuade potential borrowers. While community banks are known to rely on soft information for lending decisions, rules of thumb regarding eligibility – intended to be encouraging for the target audience – can go a long way toward increasing interest. If you aren't certain you meet the requirements, if you aren't certain which loan product is the right fit, if you aren't sure how long it will take, or if you're not certain what will happen once you submit, you may never apply.

- **Develop a guide to small business lending.** The guide should include **1)** rules of thumb for small business lending, and **2)** provide an overview of lending institutions and how to evaluate fit. The messaging can encourage entrepreneurs to take immediate action; for example "Start now – if your business/personal credit score is not ready, we/our partners will help you get there" to help close the gap between action and intention.

Reduce Uncertainty

The search for right-fit capital is too often complex, lengthy, or emotionally difficult. It may take returning citizens months or years to become credit-ready, and entrepreneurs may have already experienced previous declines, making them even less inclined to apply for opportunities when there is not a clear fit. Evaluation criteria and lending requirements should be easy to find and evaluate. When connections are made to lenders or after a process is initiated, expected timelines should also be communicated. If returning citizens do not know how long they will be waiting, the uncertainty may make them more likely to disengage, and unexplained waits seem longer than explained waits. Consistent with guidelines from trauma-informed care, always provide a reference point to help them know what communications to expect, and when.

Drawing from this guideline, we offer three sample solutions that are relevant to both lenders and social justice organizations working with returning citizens:

- **Communicate timelines and progress.** Whether the communication is online or in person, establish timelines and guidelines for next steps and consider using reminders of progress to reduce anxiety. Even if a decision may often take weeks, it is better to be forthcoming about potential wait times. Then, communicate if the next step is taking longer than expected. Again, unexplained waits are longer than explained waits.

- **Develop a curated list of preferred lenders, along with rules of thumb for evaluating options.** With so many lenders online, in local communities, and in different geographies, it can seem overwhelming to consider every single factor and every single lender.

- **Reduce uncertainty about eligibility and normalize the process of building credit.** Create a score/tool that can predict loan readiness, and develop related recommendations for increasing loan readiness and expected timelines.

Guide Entrepreneurs Throughout the Process

Entrepreneurial training programs are critical to raising awareness of mission-based small business lending and credit-building opportunities for returning citizens. While many programs refer their clients to other resources and organizations when appropriate, it is often left up to the client to pursue the referral. We found that the most effective way for service providers to encourage action was to make direct connections on behalf of the entrepreneurs they serve and follow up with other service providers and the entrepreneur as needed.

Here are two sample solutions better to guide entrepreneurs:

- **Establish contacts in community lenders that serve returning citizens.** When the entrepreneur is ready, make direct introductions to lenders and then follow up with the other service provider and with the entrepreneur as needed. Even more ambitious approaches are possible; when the time is right, entrepreneurial training programs can work with entrepreneurs to prepare their entire loan package and then work as their advocate in the process of talking with lenders.
- **Bundle entrepreneurial support and financial services in a one-stop shop.** Establish a progression of services and a smooth, streamlined process that helps entrepreneurs avoid bouncing between institutions. Many successful social justice organizations offer microloans or credit-building services, and conversely, mission-driven lenders may expand their offerings of trusted guidance.

Empower Returning Citizens with Peer Support

Returning citizen business owners, like all business owners, face many challenges for which they seek advice. And when they seek advice it's most likely to be from peers.[12] As one program director put it, "People who get the most done fastest have good support systems. It's a huge benefit to them reaching their business goals more effectively." Additionally, a system of peer support is helpful to ensure relevant advice; in the words of one entrepreneur, "You need to be working with somebody that knows the position you're in, has been there, and has done the thing that you're looking to do." Many successful programs have built-in peer support through the design of workshops, technical assistance, and mentorship. Yet these networks may become less accessible as programs end, and can be limited to specific geographies.

Below are two sample solutions aimed at increasing peer support, along with any conditions for success:

- **Introduce a cohort model.** Create a cohort of peers, driven by peers, to support each other as they all seek individual business loans.

- **Create an active online community that connects returning citizen entrepreneurs for peer support, learning information-sharing, advice, feedback, and problem-solving.** Potential platforms include Facebook Groups, LinkedIn Groups, WhatsApp, GroupApp, Mighty Networks, or a custom platform, and require seeking a balance between accessibility and selecting platforms that are likely to have higher engagement. This is an ambitious solution; to be successful, the platform should help people meet and build relationships when they do not know each other. Effective moderation and oversight can also help to build an active community that contributes important content. To foster active engagement, returning citizens that programs have worked with in the past could be encouraged and potentially compensated to contribute to the community.

Provide Evidence of Social Proof

Programs can encourage desired actions or outcomes by providing evidence of social proof and by drawing on identity priming – for example, by emphasizing an individual's strengths, successes, or identity as an entrepreneur. Even small changes in the way a message is worded or the priming of particular aspects of our identity can make a difference. Additionally, providing evidence that "people like us" are able to become successful entrepreneurs can give us license to do so. Given the ambivalence that some returning citizens expressed concerning their identity or status as entrepreneurs, entrepreneurial training programs – particularly those conducted in prison or shortly after reentry – have a unique opportunity to prime this aspect of identity.

Below, we offer three final sample solutions that serve to prime successful identities or establish social proof:

- **Certificate to Entrepreneur.**
  Give returning citizens a license or certificate "to entrepreneur" that states they have the skills and talent necessary to start a business along with a few resources to start them out.

- **Double down on this identity in all communications and interactions.**
  Use intentional language that emphasizes entrepreneurial identities and business ownership whenever possible, no matter the entrepreneurs' current employment situation.

- **Feature personal stories from returning citizen entrepreneurs.**
  The stories may be shared from an array of returning citizen entrepreneurs about their experience with lending institutions, including experiences with credit-building and with unsuccessful credit applications. The stories can highlight experiences of self-doubt and limited resources (in terms of time and money). This solution is only relevant to the extent that it creates trust or helps entrepreneurs feel comfortable.

The Way Forward

The previous solutions offer options for organizations to bolster their communications and services – and consequently increase access to right-fit capital for returning citizens. Again, even adjustments that seem small or perhaps prohibitively costly can create space for returning citizens to make investments in their businesses. Over time and taken together, behavioral designs can help place returning citizen entrepreneurs on a successful pathway for their business, contributing to more equitable opportunities for all. Increasing their access to capital also requires steps to remove supply-side barriers, however. The next section explores considerations for lending requirements to increase access to capital.

WHAT PARTNER ORGANIZATIONS ARE DOING TO SUPPORT FORMERLY INCARCERATED ENTREPRENEURS:

DETERMINATION INCORPORATED

Determination, Incorporated runs in-prison workshops to prepare returning citizens with a business and action plan so they can hit the ground running upon release, as well as business support groups outside of prison to help formerly incarcerated people get started and succeed as entrepreneurs. Determination, Incorporated proactively advocates for the entrepreneurs they serve, both by facilitating connections to support services to ensure a warm referral and by following up with service providers and entrepreneurs as needed.

MARYLAND REENTRY RESOURCE CENTER

Maryland Reentry Resource Center (MDRRC) helps those currently and previously impacted by incarceration to successfully regain entry to their communities by assisting participants with alleviating barriers to a successful reentry. This road to reentry is different for everyone, and MDRRC's approach is holistic, relational, and multi-faceted. Case managers assess the needs of each client and their families; that information is then used to coordinate services, monitor, and evaluate success and advocate where there are gaps in support coverage.

FIRST STEP ALLIANCE

First Step Alliance helps advance successful reentry and sustainable financial independence for justice-involved individuals by improving access to affordable banking services and financial education. Committed to ending systemic discrimination in financial services, First Step Alliance is working on starting a new credit union dedicated to meeting the needs of formerly incarcerated people and their families.

THE FOUNTAIN FUND

The Fountain Fund increases economic opportunities for formerly incarcerated people to improve their lives and remain in their communities. They provide low-interest loans and financial coaching, helping returning citizens build credit and achieve their self-determined goals. The Fountain Fund envisions a nation of hope and opportunity for formerly incarcerated people, their families and their communities.

03

Toward Fair Chance Lending: Rethinking Underwriting Policies for Returning Citizens

Ensuring that returning citizens have the opportunity to finance their businesses requires more than addressing behavioral barriers: it also requires removing systemic bias from the underwriting process, including criminal background checks.

While mission-based community lenders and CDFIs are uniquely suited to serve returning citizens and other underserved entrepreneurs, community banks are not where returning citizens typically turn first. Online lenders and fintech companies, in particular, have gained market share relative to community lenders in the small business lending market in recent years.[13] In 2022, 40% of borrowers with medium or high credit risk – the target population for many community lenders and where most returning citizens fall – applied for loans at fintech lenders, relative to 4% at CDFIs.[14] Thus, it is important to understand underwriting policies among a broader set of lenders – particularly fintech organizations – and their implications for returning citizens.

This section explores how lending requirements and involvement with the criminal legal system shape the availability of affordable credit for entrepreneurs. Drawing from interviews with stakeholders, loan officers, compliance officers, and heads of policy, as well as a vast literature review, we explore patterns in lending requirements, their implications for returning citizens, and the costs of relying on criminal histories to support lending decisions. We also reflect on relevant experiences and potential solutions from the community lending sector, and the broader potential for fintech institutions to increase lending to returning citizens by addressing other gaps in small business financing.

Overall, our findings suggest that lenders have little to gain and much to lose by restricting access to business loans on the basis of criminal histories.

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Approaches to Risk Assessment

Every small business lender has its own unique set of protocols and credit scoring models, but they traditionally draw from an approach based on the 3 C's of credit: personal or business credit scores, collateral, and capacity, which is a measure of borrowers' financial resources. Like most microbusiness owners, returning citizen entrepreneurs are underserved by traditional financial institutions because they typically lack mature credit histories, documented histories of business income, collateral, and other requirements, or simply because they need small loan amounts that mainstream lenders are not optimized to provide.

In recent years, fintech lenders have provided new ways to reach underserved audiences and address gaps in small business financing. By augmenting their credit scoring with cash flow or proprietary data (among lenders with payment platforms), these lenders are able to serve business owners with thin credit files – i.e., those who have few pieces of data on their traditional credit report and hence are frequently assigned low or no composite credit score. And, fintech lenders with payment platforms can leverage alternative sources of collateral, for example, by asking applicants to pledge short-term assets such as accounts receivable.

Importantly, fintech lenders are also shown to lend more in communities with higher business bankruptcy rates and higher rates of unemployment.[15] Notwithstanding widespread attention to the role of algorithmic bias in shaping consumer lending decisions, small business fintech lenders still rely on more or less traditional inputs: personal or business credit scores and financial information.[16] As one stakeholder from the fintech sector put it, "Unlike trends in consumer lending [where alternative digital trace data are often used] the most significant innovation in small business lending has been to ask applicants to link their bank accounts through platforms like Yodlee to analyze cash flow and verify financial information provided in the application."

Mission-driven community lenders, for their part, have long reached business owners with low credit and no collateral but with high business potential. Because racial disparities pervade traditional credit indicators – owing to a long history of structural discrimination that systematically excluded communities of color from opportunities to build wealth and access financial markets – these lenders look beyond legacy lending criteria to guide the underwriting process. Still, these lenders often need additional information to fill in the gaps for loan committees and demonstrate the ability to repay.

Ultimately, the use of credit scores continues to be widespread among small business lenders, although fintech lenders and community lenders have found ways to facilitate underwriting to traditionally underserved borrowers. Fintech lenders are able to supplement financial information with cash flow data to facilitate underwriting to borrowers with relatively low credit scores, while community lenders have traditionally relied on soft information regarding business potential and potential to repay. In both cases, alternative scoring methods designed to take into account the impact of incarceration on our credit history may offer an opportunity to push these efforts further, as we explore further below. Next, we explore how criminal records are used by financial institutions in the underwriting process.

The Use of Criminal Records

While many lenders find that the best approach to underwriting business loans involves evaluating each business and applicant on their own merits – or on the merits of their credit scoring models – other institutions use criminal histories to inform lending decisions.

Financial institutions are not required to disclose whether they consider criminal histories, but our research found that some nonbank lenders do restrict access to small business lending on the basis of criminal histories.[17] Notably, these restrictions are not published online, nor do the applications ask about prior convictions or arrests (this would cause discouragement, a form of discrimination under the Equal Credit Opportunity Act).[18] Instead, background checks are conducted as part of the underwriting process and used to inform a decision in these institutions. This finding was surprising, given that small business fintech lenders are generally assumed to predict risk most accurately based on supplementary financial data, and given the emphasis on quick decisions: notably, some institutions that do not rely on criminal background checks advertise decisions in less than five minutes.

Of the nine fintech lenders surveyed for our research, four institutions had some form of a decline policy based on criminal record checks, owing to an assumption that criminal histories imply greater credit risk or reputational risk. One institution categorically denies credit to any applicant with a criminal conviction, another denies credit to applicants convicted of "egregious" crimes in the last seven years, another denies credit to those convicted of financial crimes, and yet another evaluates criminal histories on a case-by-case basis and may decline applicants with charges or convictions for financial crimes or for felony convictions at any time in the past.[19]

The U.S. Small Business Administration (SBA) also restricts eligibility for lending programs on the basis of criminal histories, including the 7(a) and 504 loan programs, but with little publicly-available guidance as to its evaluation criteria or the relevance to creditworthiness. Questions surrounding the use of criminal background checks by the SBA gained momentum in the wake of the Paycheck Protection Program (PPP) and COVID-19 Economic Injury Disaster Loan funds, however, which adopted broad criminal history restrictions that are not required by statute and disproportionately affected Black and Hispanic communities.[20] Returning citizens with certain criminal histories were ineligible to apply for PPP loans during the initial rollout, but when several of these restrictions were lifted after a series of executive decisions, over 200,000 more businesses with over 340,000 employees became eligible for funding.[21] SBA loans represent a critical source of funding for microbusinesses, and making their loan programs available to underserved entrepreneurs – including returning citizens – is critical to building a more just and inclusive economy.

Many observers in the fair lending ecosystem – including the Consumer Financial Protection Bureau – have pointed to the role of public institutions in setting a standard for small business lenders and influencing broader public perceptions regarding the creditworthiness of returning citizens.[22] Recent steps suggest that the SBA also wants to reduce criminal history restrictions to make credit more accessible to returning citizen entrepreneurs and to help them succeed.[23] And beyond government programs, banks generally do not conduct criminal background checks for small business credit applicants.[24] Instead, decisions are based on credit history, ability to repay, and business potential. Next, we consider how criminal history screening policies may cause disparate impacts based on race and risk violating fair lending laws.

How the Use of Criminal Histories Amplifies Historic Inequities and Discrimination

Mass incarceration and overcriminalization have disproportionately affected communities of color. Owing to structural inequality and systemic racism, Black and Hispanic individuals are more likely to be arrested, fined, charged with court fees, convicted, and face harsher sentences than their White peers for the same offenses. And after reentry, poor people – particularly Black and Hispanic people – face greater debt as a result of arrests and incarceration, greater labor market discrimination, and lower wages when they do find employment.[25] Today, people of color make up 67% of the incarcerated population and just 39% of the U.S. population, and the rate of imprisonment for Black men is six times that of White men.[26] As a result, policies that restrict lending to returning citizens disproportionately impact applicants of color.

The systemic racism of the carceral system, taken together with the lack of evidence of a link between criminal history and creditworthiness, can put lenders with broad criminal decline policies at risk of violating fair lending laws, given that these policies will likely have a disparate impact on applicants of color. Disparate impact occurs when a seemingly neutral policy has a disproportionately negative effect on a protected class and does not serve a legitimate business interest. Disparate impact considerations have increased fair housing, employment, and small business lending opportunities by limiting undue reliance on criminal history.[27] Guidance from previous cases suggests that the decisions made on the basis of criminal history screening should not be speculative and should not be based on generalizations or stereotypes.[28] Next, we consider the empirical evidence for a link between criminal convictions and creditworthiness, drawing from the literature and our program experience.

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The (Missing) Empirical Link Between Criminal History and Creditworthiness

The use of criminal records in lending decisions seems to carry few benefits and considerable costs for small business lenders. While recent decades have seen a rise in mass incarceration and the parallel rise of organizations dedicated to providing background reports, to date, no empirical evidence seems to exist that establishes an empirical link between involvement with the criminal legal system and creditworthiness.[29] Instead, the use of criminal records to support lending decisions appears increasingly out of step with the social justice movement for the reasons outlined above, as well as guidance established in the Equal Credit Opportunity Act.

Results from the overwhelmingly successful experiences of CDFIs in lending to returning citizens also suggest that we should evaluate small business loan applications on their own merit, not on the basis of past involvement with the criminal legal system. Over the last 2 years, AEO has partnered with CDFIs to facilitate underwriting to returning citizens, as well as with fintech lenders to refer their applicants that were denied credit on the basis of past convictions to CDFI partners for underwriting. Altogether, returning citizens have been connected with $240,000 in funding through these initiatives, and as one partner has shared, "Every single one of our borrowers is paying and paying on time."[30] The success of these programs casts further doubt on the link between past convictions and creditworthiness, and has already motivated compliance officers at one lending institution to take steps to eliminate their decline policy. Next, we take stock of these findings and develop broad recommendations for the way forward.

Where We Go from Here: Opportunities and Recommendations

We encourage financial institutions to review their underwriting process to increase access for those with criminal histories, but this is only part of the solution. We also recommend that financial institutions consider how their credit scoring methods could bias decisions against applicants who have been previously incarcerated and seek opportunities to amplify opportunities for returning citizens entrepreneurs. We suggest two paths forward.

1 Adopting Alternative Scores to Facilitate Underwriting

Credit scoring models, like all quantitative models, are by nature simplifications. Despite their reputation for relative certainty and impartiality, they reflect and encode human prejudice and bias. Even when lenders do not use criminal histories to inform lending decisions, a history of incarceration negatively impacts personal credit scores, lifetime earnings, and wealth, which in turn impact all of the major inputs into any underwriting decision. To account for the impact of incarceration and to provide a more holistic evaluation of credit applications, some CDFIs have turned to alternative scoring methods, including the system developed by R3 Score. R3 Score is a platform that provides prospective lenders with an alternative method to assess the potential risk of applicants with a criminal record. The system provides two unique scores that contextualize a person beyond a standard credit score and background check. The first score interprets the contents of a criminal background screening report and provides a risk assessment score on a scale of 1 to 10. The second and more robust score is a FICO-like score ranging from 300-850 that indicates the stability of the loan seeker so that a lender can better understand where a person is in their reentry process. The score is derived from examining alternative data sources, as well as data across several categories, and enables decision-makers to assess risk without filtering out otherwise qualified candidates. Our CDFI partners have report that this tool is particularly helpful in underwriting loans to borrowers with no credit history or with low incomes as a result of incarceration. For institutions interested in mitigating potential concerns on part of funders and loan committees, this tool offers an important solution.

> " Even when lenders do not use criminal histories to inform lending decisions, a history of incarceration negatively impacts personal credit scores, lifetime earnings, and wealth, which in turn impact all of the major inputs into any underwriting decision.

2 Identifying Opportunities in the Financial Technology Sector

Fintech lenders have the opportunity to influence underwriting policies in ways that can increase capital access for returning citizens, as well as for Black and minority entrepreneurs more broadly. An increasing number of fintech institutions of all sizes are seeking to build relationships with clients that have been involved with the criminal legal system, and to partner with mission-based community lenders to do so.[31] These opportunities have largely included efforts and platforms to help returning citizens access financial services, build savings, manage and pay off debt, and pursue homeownership. There is also an important responsibility and opportunity for small business fintech lenders to support access to capital for returning citizens, as an important path to creating opportunities for all. Partnerships with AEO suggest a way forward. First, R3 Score – or a proprietary alternative credit scoring algorithm – could bolster efforts to serve this population among small business fintech lenders. Alternatively, institutions reluctant to remove restrictions for applicants with criminal histories can partner with AEO to refer their applicants to CDFI partners.

For many returning citizens, recovering livelihoods and building wealth starts with entrepreneurship. Solutions from the fintech sector – including R3 Score – can help businesses grow and thrive with access to right-fit capital.

"Solutions from the fintech sector – including R3 Score – can help businesses grow and thrive with access to right-fit capital.

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04

Conclusions

Returning citizen entrepreneurs have the potential to serve as anchors in the U.S. economy. Those with criminal records are 22% more likely than their non-justice-involved peers to start a business, and when they do, they experience higher incomes.[32]

Just as important, returning citizen entrepreneurs are more likely to hire employees with criminal records, increasing the creation of wealth and opportunities in their communities. Employment opportunities and living wages significantly reduce the risk of recidivism, but beyond recidivism, areas with high densities of microbusiness enjoy greater economic mobility and higher quality of public health.[33] Small businesses are not only a path to generational wealth, but they're also a vital part of any healthy and successful community, particularly in communities disproportionately impacted by the inequities of the carceral system. Returning citizen entrepreneurs are also more likely to need credit to start and sustain their businesses, but they face additional barriers as a result of incarceration, owing to the impact of incarceration on personal credit, income, savings, and more.

This study outlines actions that lenders and organizations in the reentry community can take to improve outcomes in their programs and remove barriers to access, both by exploring demand-side behavioral barriers that might hold returning citizens back from applying for right-fit capital, as well as by reviewing internal lending policies that restrict access to returning citizens. We invite ongoing efforts and collaboration to adapt these solutions to fit the needs of a broad array of entrepreneurial training and small business lending programs to better serve millions of returning citizens.

ENDNOTES

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[13] "Fintech lenders" refer to nonbank online lenders/fintech companies that operate online. Examples include Bizz2Credit, Funding Circle, Lendio, OnDeck, and Square

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