



Written Statement of Joyce Klein, Director, Aspen Institute Business Ownership Initiative to the CDFI Fund Advisory Board

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Good afternoon. I'm Joyce Klein, Director of the Business Ownership Initiative at the Aspen Institute. Our program focuses on expanding economic opportunity through business ownership, by working with practitioners, funders, and policymakers to help entrepreneurs with the greatest challenges access the resources they need to start and grow their businesses. We've been doing this work for close to 25 years. In the past five years in particular, we've had a focus on understanding and addressing the needs of entrepreneurs of color. So, my comments today will relate mostly to the experiences and needs of CDFIs working to support business owners of color. While the work of all CDFIs is essential and needed at this time, in the context of both the pandemic and the much-needed current focus on small businesses and racial equity, my comments are, I hope, quite timely.

My remarks today draw on several bodies of work that we've been engaged in. The first is our work over the past seven years to convene and support the Microfinance Impact Collaborative – which is a collaboration among six of the largest CDFI microlenders (Accion East, Justine PETERSEN, Opportunity Fund, LiftFund, Dreamspring, and Accion Chicago). Together they represent a substantial portion of the microlending volume generated by CDFI loan funds; collectively they originate close to ten thousand microloans each year, about 75% of which are to entrepreneurs of color. We have been working with them to support their efforts to grow the scale and impact of their work.

The second is an ongoing research effort that draws on a variety of data sources to understand the experiences and needs of entrepreneurs of color and the strategies that are effective in reaching them. We published research (and a set of policy and programmatic recommendations) on this several years ago; we have also continued to engage with both the Federal Reserve team that is implementing the Small Business Credit Survey and the JPMorgan Chase Institute as they have both constructed their research and examined their findings as they relate to entrepreneurs of color. In this same vein we have been serving as the evaluator for the San Francisco Entrepreneurs of Color Fund, which is a partnership among three Bay Area CDFIs (Working Solutions, Pacific Community Ventures and ICA Fund Good Jobs) that have received funding from JPMorgan Chase Foundation to expand their lending to entrepreneurs of color (EOCs). In this work we've had an opportunity to learn from and with the CDFIs about the practices they've employed in serving entrepreneurs of color.

One other item I would note, as context to my remarks: we were asked to place a particular focus on the needs of urban, rural and Native communities. Because of the nature of our work and our partners, my remarks will have the greatest relevance to urban communities. I will speak a bit to the needs of rural communities. Although I have had the privilege during my career of working with some Native

CDFIs, that is where I have the least experience and where because of the inadequacies and lack of Federal investment in data on Native communities and people there is simply less available research. I will share my thoughts about what might be needed in those communities, but only to the extent that I feel comfortable in making statements. My colleagues on the panel do have stronger experience in those areas.

Why Microlending is both Essential and Challenging to Scale

As my program and I have been called upon to comment on the current situation facing entrepreneurs of color – the challenges with accessing the PPP, and their needs going forward – I'd share the following key points that I can elaborate on in detail:

- Delivery systems matter as much as products. If we want to reach entrepreneurs of color, we need to ensure that programs and products run through the institutions that serve them, and those are CDFIs and MDIs. They are the institutions that have the commitment and have developed the practices and systems to reach and serve entrepreneurs of color. While a focus on loan products is attractive because of scalability, as we saw with the PPP, one size never fits all – and it is typically the most underserved who get left out. To reach them, we need to invest in the financial strength and capacity of organizations that have the mission, commitment and market knowledge to reach these businesses and communities, and give them the flexibility to design programs and practices that meet their needs.
- Loan size matters as well. Entrepreneurs of color are seeking and need smaller-dollar business loans –e.g. microloans. The structural and systemic barriers that have impacted entrepreneurs of color have limited the size of their businesses; therefore, they can only absorb so much debt. The Federal Reserve's Small Business Credit Survey reaffirms the strong demand for loans of less than \$100K; its most recent brief on entrepreneurs of color found that 76% of Black entrepreneurs and 67% of Latinx entrepreneurs were seeking loans of less than \$100k. This compares to 59% of White entrepreneurs and 55% of Asian entrepreneurs.¹ This is an example of where the research does not include data on Native entrepreneurs.
- The economics of micro/small-dollar small business lending have limited its growth, and willingness of lenders to engage – even among CDFIs. CDFI lenders lose money on most microloans – there is simply not enough income from interest and fees to cover the costs to originate and service the loans. This is one of the reasons why banks are also not making loans in these amounts. If we want to reach EOCs, we need to attend to the economics of making these loans. On this front, two points are important to understand:
 - Any relief and recovery programs must be structured to incentivize and support small-dollar loans (e.g., origination fees tied to loan size as with PPP are problematic). Subsidy is needed here.
 - Without a concerted national effort to subsidize this work, new financial and business models are important to achieving greater scale.

¹ Mels de Zeeuw, *Small Business Credit Survey: 2019 Report on Minority-Owned Firms*, Federal Reserve Bank of Atlanta, December 2019, p. 10.

- Once we attend to the economics of microlending – which should encourage more CDFIs to do this type of lending – then we need ways to help them build the operational practices required to do microlending at a larger scale. This is partly about technology, but it also about underwriting and risk management practices, staff capacity and other needed investments as a financial institution grows. Again, two points are important here:
 - To be successful in making microloans at larger scale to entrepreneurs of color and other business owners with limited collateral and lower credit scores, lenders need a different approach to sales, underwriting and risk management than for other types of small business lending. This different approach focuses on cash flow and a flexible approach to credit rather than the asset-based focuses on collateral and the ability of the borrower to inject equity at the time of the loan.
 - Entrepreneurs with limited time, pressing capital needs and experience with rejection will turn to those who promise a speedy decision with a high likelihood of a “yes,” regardless of the terms of the available capital. To prevent borrowers from turning to unsustainable or predatory options microlenders need to be able to provide a quick decision. And at the same time achieve operational efficiencies that minimize the need for subsidy. This is where process and technology are critical.

- In the short term, micro and small business lenders face particularly daunting financial challenges. Those that have been most successful in lending pre-crisis are facing high levels of financial stress; both their operating and lending liquidity are highly challenged as they have offered payment deferments to assist their borrowers and as they need to increase reserves to deal with anticipated losses. Those that were most successful in growing their portfolios are most at risk – because they were already at their net asset limits and highly dependent on portfolio income. An effective recovery for entrepreneurs of color requires these lenders to be at their best. As traditional lenders retrench, CDFIs must be prepared to expand. To do this, we need to address their liquidity constraints and provide some form of credit enhancements/risk protection.

[Policies and Resources to Support Entrepreneurs of Color and the Institutions that Reach Them](#)
 As we have engaged with CDFIs to understand their financial and operational challenges, and the needs of the businesses they are working to assist– we have come to the following conclusions with regard to the policies and programs that are needed at this moment. We believe the following:

- While businesses need financial resources and support, not all of them want to or should take on debt. Borrowing in the face of so much uncertainty is a difficult decision. The PPP showed us this; even with potential forgiveness it will not be the right solution for every business. Some will need relief on current debt, and some will need grants to get them through this crisis.

- Many businesses will need fresh capital to adjust their operations to new safety requirements and economic conditions. As we saw in the last recession, banks will tighten their credit criteria and more borrowers will turn to CDFIs and MDIs. That means that CDFIs and MDIs must have the financial strength to be able to participate actively in relief and recovery lending programs.

- One of the most effective ways to address the balance sheet stress facing small and microbusiness CDFIs would be to remove loans made prior to COVID from their balance sheets. These loans –which were prudently made and are stressed due to factors having nothing to do with the business owner or the underlying business – are now challenged. The financial costs of increasing reserves have significant net asset (and therefore debt covenant) implications for these lenders. And providing debt relief to borrowers is also extremely challenging for CDFIs whose financial capacity is also challenged because of the pandemic. We have proposed that the Federal Reserve create a facility to purchase and hold these loans; allowing them to be restructured to also provide debt relief to the businesses. This concept has been part of the Jobs and Neighborhood Investment Act now being considered by Congress; that Act has significant bipartisan support in the Senate.

We have also created a nonprofit that is demonstrating the feasibility of this concept. Called the Entrepreneur Backed Assets (or EBA) Fund, this privately-capitalized nonprofit is working to purchase 25% of the pre-COVID microenterprise portfolios of the six members of the Microfinance Impact Collaborative. EBA Fund has already completed two transactions with initial grant support provided by the Citi Foundation, and will continue to purchase more loans as we raise additional capital. We were able to launch the Fund quickly because it built on work we had already been doing with the collaborative members and the fund manager, Revolve Asset Management, to build a fund that could create a secondary market for CDFI microloans. In the longer term, our intent is to sell the loans purchased by EBA Fund to banks seeking to improve their performance on the CRA lending test. This plan is based on a model developed by Revolve while they were part of the team at Accion Chicago, and which they have replicated with CDFIs and banks in several other markets. Bank willingness to pay a premium for these loans creates a new revenue stream for CDFI microlenders. Loan sales then provide both liquidity and operating subsidy, reducing the amount of debt and grant funding required as the CDFIs scale their microlending portfolios. Given the uncertainty of the bank buyer market, we have adjusted the fund’s model in the start-up phase so that it can also hold the loans it acquires, and allow them to be restructured to more advantageous terms for the borrowers.

- We also believe that the Federal Reserve could substantially significantly improve the balance sheet strength, and long-term viability, of all CDFI loan funds by purchasing substantial portions of EQ2s made by banks and other investors. This would significantly reduce the risk for investors who provide the long-term, low-cost subordinated debt that CDFIs with highly impacted balance sheets are likely to require as they emerge from this crisis. This provision was also included in the current version of the Jobs and Neighborhood Investment Act.

With regard to this idea, and the previous one of providing liquidity through loan sales – I’d note that the rapid growth of microfinance in emerging markets was enabled in large part by innovations that provided microfinance institutions with access to capital markets. But in the United States, most CDFIs have been limited to a fairly simple financial model: raise grant funds to create an equity or net asset base, and then leverage that through low-cost, largely CRA-motivated debt. We need more creative financial tools, and we believe that the Federal Reserve, federal government, and philanthropy should partner together to create them.

- To position CDFIs to weather the financial impact of the COVID crisis and to provide capital to communities and entrepreneurs that have been and will be deeply impacted, the CDFI Fund's core program should be expanded, and continue to fill its important role of providing grant funding that enables institutions to invest in new products, new operating processes and efficiencies, and the organizational costs associated with growth. Challenges with implementing the PPP increased the already-existing calls for CDFIs to make use of technology to improve their products and processes. But the effective use of technology requires ongoing investment – in diagnosing the processes that most need strengthening, selecting and purchasing the right technology, ensuring that the team has the skills and time necessary to successfully master and use the technology to best effect, and supporting and maintaining the technology over time.² Given their current financial models, most CDFIs lack the financial wherewithal to invest significantly in technology. This is particularly the case for CDFIs in rural and other markets where the capacity of local and regional philanthropy and governments is limited. Furthermore, as technology supports portfolio growth, there will be other associated organizational costs – to support capital raising, servicing, financial and risk management, human resources, etc. Organizations that cannot access grant financing to support the initial investments in these capacities will often struggle to grow. We strongly support the substantial increases in the CDFI Fund's budget that have been proposed in the Jobs and Neighborhood Investment Act and several other proposals now before Congress. We also believe that the CDFI Fund should make lenders with strong track records in serving entrepreneurs of color a priority in funding decisions, and that it should recognize the essential role that microloans place in meeting their needs.
- CDFI small and microbusiness lenders will need access to credit enhancements, guarantees and other forms of loss protection to be lending during the pandemic, and in the recession that will follow. During the Great Recession, many CDFIs made good use of the State Small Business Credit Initiative to expand their lending. The RELIEF for Main Street Act that has received strong bipartisan support (as well as support from more than 100 mayors across the United States) is another potential important tool here.
- The Community Reinvestment Act has been critical to the track record that CDFIs have built in serving entrepreneurs and communities of color – as well as other low- and moderate-income communities and residents, both urban and rural. Any revisions to the CRA must strengthen, not weaken, incentives to invest in low- and moderate-income communities and the financial institutions (CDFIs and MDIs) that serve them. Proposed changes to CRA threaten to deeply undermine the availability of concessionary capital to CDFIs from banks. Past CDFI Fund allocations, or even 2x or 3x increases, will be sufficient to overcome a loss of this capital.

² I would also note that while technology is a critical tool to improving scale and efficiency, increasing the use of technology alone will not enable lenders to reach entrepreneurs of color; other changes in products and practices such as outreach and underwriting will be necessary.

- CDFIs also provide critical nonfinancial supports to businesses and need resources to be able to do so. Many entrepreneurs need support to develop the financial and other management knowledge and systems necessary to start and grow their businesses. This is often particularly true in the case of entrepreneurs in rural and less vibrant urban communities, where firms may need a more complex and diversified business models. Grant funding to support the coaching, technical assistance and other nonfinancial resources provided by CDFIs is also important.
- Finally, while our goal is to extend access to capital (and other resources) to entrepreneurs who have to date been excluded and underserved, it is essential that we also balance access with consumer (or in this case, business) protections. As bank lending contracted after the last recession, we saw the entry and growth of many new players in the small business credit and financing market. Some of these brought responsible products and needed innovation and access to small businesses. Others brought products that lacked transparent costs and terms, misalignment of interests, problematic collections practices, and do not report to credit bureaus. At the Business Ownership Initiative and the Aspen Institute we've been proud to be part of the Responsible Business Lending Coalition, an effort among CDFIs (including OFN, Opportunity Fund and Accion), leading responsible fintech lenders, investors, and small business advocates to define and work to advance responsible small business lending. We applaud the CDFI Fund's decision to require responsible financing practices as part of the CDFI certification process.

Thank you for the opportunity to join you today. I look forward to your questions.