Testimony Submitted by

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On behalf of

Opportunity Finance Network

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Good afternoon, Representative Evans and Representative Fitzpatrick. Thank you for holding this hearing on "Small Business Capital Access: Supporting Community and Economic Development." My name is Dafina Williams, and I am Vice President of Public Policy at the Opportunity Finance Network. I am pleased to be here today to not only testify on behalf of the Opportunity Finance Network (OFN), but also as a constituent of the 2nd Congressional District of Pennsylvania.

OFN is a national network of community development financial institutions (CDFIs): mission-driven community development banks, credit unions, loan funds and venture capital funds investing in opportunities that benefit low-income, low-wealth, and other under-resourced communities across America. CDFIs connect communities to capital that creates jobs, supports small businesses, builds affordable housing, cultivates healthy food and energy efficiency, and promotes safe borrowing and lending.

Currently there are more than 1,100 CDFIs certified by the Department of Treasury's Community Development Financial Institutions (CDFI) Fund. CDFIs in OFN's network alone have originated more than $54.9 billion in financing in urban, rural, and Native communities through 2016. With cumulative net charge-off rates of less than 1 percent, CDFIs are able to lend prudently and productively in unconventional markets often overlooked by conventional financial institutions.

Today I would like to provide an overview of some of the challenges facing small businesses in accessing credit, how CDFIs are helping to address those challenges, and the role the federal government can play in providing resources to further stimulate the flow of capital to businesses that need it most.

Although lending conditions have been relatively stable for the past several years, credit standards for loans have remained tight since the Great Recession. Less credit-worthy borrowers – like those in communities disproportionately affected by the financial crisis - face significant challenges to accessing capital to start or grow their businesses. For women-owned and minority-owned small businesses, these challenges are even more pronounced.

However, there are proven solutions to meeting these challenges: specialized, targeted lending, technical assistance, and community partnerships can help to improve capital access, create new markets for small businesses, expand networks, strengthen the borrower-to-traditional lender relationships, and support broader economic development efforts to revitalize distressed rural and urban communities.

Underserved Businesses Lack Access to Credit

Small businesses are important driver of economic growth but face macroeconomic and microeconomic challenges when attempting to access credit. Some of these challenges include: contractions in the banking system and lending to small business; a decline in the availability of small dollar loans; weak or limited credit history; lack of business and financial management skills, access to entrepreneurial training and networks, and limited awareness of lending options. These barriers are particularly high for entrepreneurs who are low- to moderate-income; women; racial or ethnic minorities; and otherwise traditionally disadvantaged populations:

- **Bank Consolidation -** U.S. banks closed 4,821 branches between 2009 and 2014, reducing the total number of branches by about 5 percent.[1] A Harvard Business School report found that:

  > "A decades-long trend toward consolidation of banking assets in fewer institutions is eliminating a key source of capital for small firms. Community banks are being consolidated by bigger banks, with the number of community banks falling to just over 5,000 today, down from over 14,000 in the mid-1980s, while average bank assets continue to rise."[2]

  This decrease in bank branches has created banking deserts, especially in low-income communities, rural communities, and communities of color. The Federal Reserve Bank of New York found that people in low-income census tracts are more than twice as likely to live in a banking desert than their counterparts in higher income tracts.[3] As branches close, access to banking services as well as credit and loans is diminished for the areas served by the branches.

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[1] Morgan, Donald, Maxim Pinkovskiy, and Bryan Yang, "Banking Deserts, Branch Closings, and Soft Information", Liberty Street Economics, Federal Reserve Bank of New York, March 2016.
[2] Mills, Karen Gordon and Brayden McCarthy, "The State of Small Business Lending: Innovation and Technology and the Implications for Regulation Working Paper 17-042, Harvard Business School, http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf.
[3] *Id.* at 1.

- **Contractions in lending to small businesses -** A decline in the number of bank branches and community banks impacts the availability of credit to small businesses, who typically rely on relationship lending from their local lenders. After increasing rapidly from 2001-2007, small business lending declined precipitously between 2007 and 2010, then rebounded slowly starting in 2015 according to data reported under the Community Reinvestment Act (CRA).[4] Large bank lending, has in fact been increasing, with loan approval rates at big banks (those with $10 billion or more in assets) improving for the seventh time in the last eight months in September 2016.[5]

  In spite of the increase, large banks approved only 23.4 percent of loan requests by small business owners, meaning more than three quarters of applicants were not able to receive the requested financing.[6] For small businesses with less than $1 million in revenue, access to capital issues are even more pronounced. A report from the Woodstock Institute, Patterns of Disparity, found the number of CRA-reported loans nationally to small businesses with gross revenues under $1 million was just 15 percent higher in 2015 than in 2001, but 41 percent lower than the peak in 2007, while the total dollar amount of those loans in 2015 was down more than 41 percent from the amount in 2007 and down 21 percent since 2001.[7]

- **Decline in availability of small dollar loans** - There has also been a decline in the availability of smaller dollar loans. *Patterns of Disparity* also stated the number of CRA-reported loans under $100,000 nationally in 2015 remained 58 percent lower than in 2007 and two percent lower than in 2001. The total dollar amount of those loans decreased nearly 47 percent from its peak in 2007 but rose by 16 percent, from $67.0 billion to $77.9 billion, between 2001 and 2015.[8] At the same time, the demand for loans of less than $100,000 remains high. The Federal Reserve's 2016 Small Business Credit Survey of employer firms found that 55 percent of applicants sought $100,000 or less in financing. For businesses with less than $1 million in

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[4] "Patterns of Disparity: Small Business Lending in the Detroit and Richmond Regions", The Woodstock Institute, January 2017. Accessed August 24, 2017. http://www.woodstockinst.org/sites/default/files/attachments/Detroit%20and%20Richmond%20Report%20Website.pdf
[5] Biz2Credit Small Business Lending Index, September 2016, https://www.biz2credit.com/small-business-lending-index/september-2016
[6] *Id.* at 4.
[7] *Id.*
[8] *Id.*

revenue, 70 percent of respondents sought financing of $100,000 or less.[9] This results in a significant access to capital gap for business owners.

- **Weak or limited credit history/collateral -** Tight credit markets can have an impact on small business owners who may have weak or limited credit history, lack of collateral, poor financial documentation, and modest business revenues. Many of these small business owners use their personal credit to finance their business. The 2016 Small Business Credit Survey found that 42 percent of small businesses rely exclusively on their owners' personal credit scores to secure debt, and another 45 percent use both the owners' personal scores and business credit scores.[10] Weak credit history makes it more difficult to secure financing from mainstream sources and makes these small business owners more vulnerable to predatory online lenders.

- **Lack of Business Training and Financial Management Skills –** Lack of business training and financial management skills is one of the biggest challenges facing small businesses seeking financing. CDFIs have noted the need to provide specialized training and technical assistance to small business borrowers to identify areas of weakness in the business, develop a strategy for delivering technical assistance to that borrower, and helping build capacity to ensure the business owner is prepared for financing. This hands-on approach to business development is a key component to the success of CDFIs lending to small businesses.

- **Access to business and professional networks –** Small business owners often lack access to business and professional networks and can have a hard time accessing venture capital or other institutional capital. Further, underserved business owners often lack personal capital and do not have a strong friends and family network who may have access to capital. Access to business networks and mentors can build relationships or lead to financial opportunities**.** The greater Philadelphia region has a relatively robust network of organizations that support entrepreneurship, but could benefit from better coordination among those groups so business owners know where to seek resources needed to start or grow their businesses.

- **Limited awareness of lending options** – Often small business owners are not aware that they may have affordable options to finance their businesses, or that responsible lending alternatives like CDFIs are available. It is also important to address the role of online and marketplace lenders in the small

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[9] 2016 Small Business Credit Survey: Report on Employer Firms", Federal Reserve System, April 2017. Accessed August 22, 2017. https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf
[10] *Ibid.*

business lending space. The emergence of online lending has produced a seismic shift in the delivery of capital and financial services to consumers and business owners. As access to traditional brick and mortar institutions continue to retract and reduce their numbers, and credit remains difficult for small businesses to secure, new online lenders have entered the small business marketplace. To an extent, marketplace lenders are filling a gap and providing a financing option to people with limited access to business credit and financial services. However, not enough is known about their business models, underwriting methods, and portfolio quality. There are some lenders providing high-cost loans targeting the most vulnerable small businesses with little transparency about loan pricing and terms upfront. The lack of oversight in the online lending market limits the ability of business owners to make informed decisions.

- **Discrimination** - Racial and gender biases can also prevent small businesses from entering mainstream lending. Studies show that diverse small businesses are less likely to apply for a loan due to fear of rejection. A 2015 Independent Business Survey conducted by the Institute for Local Self Reliance reported that of the business owners of color who applied for a bank loan in the last two years, 54 percent were rejected. The SBA's research shows minority business owners are disproportionately denied financing even when controlling for factors such as business credit scores and personal wealth.[11]

  The Minority Business Development Agency's (MBDA) research finds that minority business owners are denied loans at nearly three times the rate of non-minority owners.[12] Even when controlling for credit and collateral differences, when diverse small business owners do access capital, they often receive lower loan amounts and pay higher rates.

  Women-owned businesses also face access to capital challenges. Women account for only 16 percent of conventional small business loans and 17 percent of SBA loans even though they represent 30 percent of all small

[11] Kymn, Christine, "Access to Capital for Women- and Minority-owned Businesses: Revisiting Key Variables by Advocacy", Issue Brief 3: Access to Capital, Small Business Administration, Office of Advocacy January 2014. Accessed January 11, 2017. https://www.sba.gov/sites/default/files/Issue%20Brief%203%20Access%20to%20Capital.pdf.
[12] Fairlie, Robert, Ph. D. and Alicia M. Robb, Ph.D., "Disparities in Capital Access between Minority and Non-Minority-Owned Businesses: The Troubling Reality of Capital Limitations Faced by MBEs", U.S. Department of Commerce, Minority Business Development Agency, January 2010. Accessed January 11, 2017. http://www.mbda.gov/sites/default/files/DisparitiesinCapitalAccessReport.pdf.

companies.[13] Of conventional small business loans, just $1 of every $23 in conventional small business loans goes to a woman-owned business. These access to capital gaps start from the startup of the business. On average, men start their businesses with nearly twice as much capital as women ($135,000 vs. $75,000).[14] Similar to business owners of color, women are more likely to be turned down for loans or receive loans with less favorable terms than their male counterparts.[15]

Despite these challenges, underserved businesses continue to grow and create jobs. Nationally, in recent years, businesses owned by people of color have grown rapidly, with data showing the increase in Black and Latino business ownership outpaced population growth from 2007 to 2012, when the black population increased by 6 percent but black business ownership increased by 34 percent, and the Latino population increased by 17 percent while Latino-owned businesses increased by 46 percent.[16] This national growth in businesses owned by people of color indicates enormous untapped potential for entrepreneurial growth in a city like Philadelphia, where 41 percent of the population is Black or African-American and 14 percent is Hispanic or Latino.

A boost in local small business ownership could also have a positive impact on the economic development of our region, and make the region more competitive with other large metropolitan areas of the country. Analysis of U.S. Census data by American City Business Journals found that the Greater Philadelphia area lagged behind the metro regions of Boston, New York, Baltimore and Washington, D.C., in small business growth rates.[17] Additional investments in proven solutions and programs like those that support the work of CDFIs will stimulate the flow of capital to business owners, generating economic activity that can catalyze community

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[13] "21st Century Barriers to Women's Entrepreneurship", US Senate Small Business Committee, July 23, 2014, Accessed August 29, 2017. https://www.sbc.senate.gov/public/_cache/files/3/f/3f954386-f16b-48d2-86ad-698a75e33cc4/F74C2CA266014842F8A3D86C3AB619BA.21st-century-barriers-to-women-s-entrepreneurship-revised-ed.-v.1.pdf

[14] Coleman, Susan, and Alicia Robb, Ph.D., "Access to Capital by High-Growth Women-Owned Businesses SBAHQ-13-Q-0A63," National Women's Business Council, April 3rd, 2014. Accessed August 27, 2017. https://www.nwbc.gov/research/high-growth-women-owned-businesses-access-capital

[15] Economics and Statistics Administration, "Women-Owned Businesses in the 21st Century," U.S. Department of Commerce for White House Council on Women and Girls, Issued October 2010. Accessed August 22, 2017. http://www.dol.gov/wb/media/Women-Owned_Businesses_in_The_21st_Century.pdf.

[16] McManus, Michael, "Minority Business Ownership: Data from the 2012 Survey of Business Owners", Issue Brief Number 12, September 14, 2016.

[17] G. Scott Thomas and Alison Burdo, "Phila. Small Business Growth Rate Lags Behind Other Major East Coast Cities", Philadelphia Business Journal, Nov 21, 2016. https://www.bizjournals.com/philadelphia/news/2016/11/21/small-business-growth-philly-lancaster-allentown.html

development, create jobs, generate income and wealth, and help chip away at the city's persistently high poverty rate.

Role of CDFIs in Small Business Lending

CDFIs are an important part of the small business lending ecosystem, providing capital to businesses that cannot access traditional financing. As mission-driven lenders, increasing access to affordable, responsible capital for business owners with limited options: women, people of color, startup firms with limited revenue and less than perfect credit, is a key component of their strategy. CDFIs lend successfully in distressed markets and communities of persistent poverty by taking a localized approach to lending, adjusting their strategies and products to meet the needs of their communities, and by being accountable to the communities they serve.

For small businesses owners with financial impediments to securing financing like lack of collateral, cash flow challenges, modest business revenues, or imperfect credit, CDFIs address these issues by providing a variety of financial products, including working capital, equity investments, bridge loans, senior and subordinated debt, sometimes at below market rates with lower and fewer fees, with more flexible underwriting criteria, credit standards, collateralization and debt service requirements than what is otherwise available in the marketplace.

As mentioned previously, some of the challenges facing small businesses served by CDFIs are financial, while others are related to the business management practices. However, the experience of CDFIs has shown that both issues must be addressed for the business to be successful and grow. To that end, CDFIs address this issue by providing financial education, technical assistance, and capacity-building development services to their borrowers, including business training and access to social and professional networks.

Beyond providing capital and technical assistance, CDFIs often have relationships with community stakeholders including nonprofits, foundations, chambers of commerce, government agencies, and financial institutions, allowing them to connect entrepreneurs to a rich network of resources and opportunities. Many CDFIs also have referral relationships with local financial institutions, whereby a bank may refer a potential borrower who is not quite ready for conventional financing to a CDFI, where the business owner can receive any needed training or technical assistance as well as financing. For many CDFIs, the goal is to help the borrower strengthen and grow their business, improve their financial position, and eventually be able to "graduate" to traditional financing from a mainstream institution.

There are currently 17 certified CDFIs located in southeastern Pennsylvania, with more than half providing small business loans. CDFIs lending to small businesses in the Philadelphia region are able to address a spectrum of capital needs: from

EntrepreneurWorks and the Economic Opportunities Fund providing the smallest of microloans, sometimes as little as $500 in initial seed capital to turn an idea into a business, to The Enterprise Center and FINANTA who provide critical growth capital in the range of $50,000 to $250,000, to the Philadelphia Industrial Development Corporation that provides multimillion dollar financing for larger businesses poised for growth. But often, CDFIs themselves face access to capital challenges and require support from the federal government to provide the flexible, patient capital or credit enhancement programs needed to reach underserved businesses and communities.

Federal Support of Small Business Lenders

The federal government already has several tools at its disposal that can increase the supply of capital to mission driven lenders like CDFIs, who are adept at channeling those resources into distressed communities. The following are recommendations that will preserve and expand key federal programs that help increase the availability of capital for small businesses:

- **Full funding for the Department of Treasury's CDFI Fund's Financial Assistance and Technical Assistance program** to allow certified CDFIs access to the flexible, patient capital needed to provide financing to underserved businesses, and to provide critical technical assistance and development services to help small businesses grow and thrive. The equity capital provided through the CDFI Fund's programs is crucial to attracting private sector capital, allowing CDFIs to leverage public sector dollars for greater impact. For every $1 in CDFI Fund awards, CDFIs generate $12 in financing to bring economic opportunity, growth, and prosperity to rural, urban, and Native communities where mainstream capital is scarce.
- **Permanent reauthorization of the New Markets Tax Credit (NMTC) Program –** The NMTC program increases the flow of capital to businesses and low-income communities by providing a modest tax incentive to private investors. Over the last ten years, the NMTC has proven to be an effective, targeted and cost-efficient financing tool valued by businesses, communities and investors across the country. The NMTC expires on December 31, 2019.
- **Make permanent the Small Business Administration's Community Advantage Pilot Program** – The Community Advantage program provides a credit enhancement for small business loans made by mission-driven lenders. The program, set to sunset December 31, 2020, should be made permanent and the maximum loan amount increased to $500,000. The SBA's Microloan program should also be expanded and should provide additional technical assistance funds.

- **Reauthorization of the recently expired State Small Business Credit Initiative (SSBCI),** a $1.5 billion program created through the Small Business Jobs Act of 2010 to increase access to capital for small businesses, with a focus on reaching underserved communities. CDFIs made nearly 11,000 loans or investments supported by SSBCI funds, totaling $835 million in new financing through 2016. In fact, CDFIs accounted for 60 percent of the total number of SSBCI-supported loans and investments in Pennsylvania. A new round of funding for the program could further increase the supply of credit for underserved businesses.
- **Strong small business borrower protections** that ensure business owners have access to better information, clear disclosure, and understanding of the loan terms and agreements so they can make informed financial decisions. There are substantial disclosure requirements in the mortgage lending and now, the consumer lending markets but no such protections or requirements currently exist for small business borrowers.

Thank you for the opportunity to testify at today’s hearing. I would be happy to answer any questions.