

Testimony of

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Before the Subcommittee on Consumer Protection and Financial Institutions

U.S. House of Representatives

**“An Examination of the Decline of Minority Depository Institutions and the Impact on Underserved Communities”**

Tuesday, October 22, 2019

**Written Testimony**

Thank you, Chairman Meeks, Ranking Member Luetkemeyer, and Members of the Committee.

It is an honor to be here. My name is Aron Betru, and I am the Managing Director for the Center for Financial Markets at the Milken Institute. The Milken Institute is a nonprofit, nonpartisan think tank that promotes evidence-based research that serves as a platform for policymakers, industry practitioners, and community members to come together in catalyzing practical solutions to challenges we face both here in the U.S. and globally.

For the past century, steady economic growth and ongoing job creation have led to prosperity in the United States. However, not all segments of society have been able to participate fully in this prosperity; inequality does exist. Ensuring all segments of society have an equal opportunity to contribute and benefit when the economy grows is critical to an equitable and just society.

Minority Depository Institutions (MDIs) play a critical role in promoting financial inclusion and economic viability for underserved communities by their presence in and focus on serving these communities. But, for the past decade, their numbers have dwindled, declining by more than 30 percent. A mixture of negative outcomes stemming from the 2008 financial crisis, cost of regulatory compliance, which impacted smaller banks disproportionately, and competition from technology-led nonbanks have resulted in each of the different MDIs, African American, Hispanic American<sup>1</sup>, Asian American, and Native American to experience measurable declines in assets;

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<sup>1</sup> The Milken Institute recognizes the difference between “Hispanic” and “Latino” designations and the ongoing debate regarding which is most appropriate. However, because our research is data-driven and the U.S. Census Bureau uses the “Hispanic” classification, for consistency we have chosen to use “Hispanic” throughout. Likewise, we defer to “Black” versus “African American,” again consistent with the Census Bureau classification, unless the data source denotes “African American.”

46 percent, 34 percent, 26 percent, and 14 percent, respectively. Those that remain today limited in their capacity to serve their communities.

Understanding the forces that led to MDIs' decline can help identify both policy and industry actions required to reverse this, and ultimately, increase access to capital for underserved communities. For these communities, a lack of access to capital for small businesses is a key factor limiting their access to the American Dream.

#### A. Background Context

Historically, small businesses have been the backbone of broad-based economic development, and adequate funding for these enterprises is key to ensuring their ability to create jobs. Unfortunately, over the past decade, the United States has seen a significant (and growing) underrepresentation of minority-owned small businesses.<sup>2</sup> The Milken Institute has been at the forefront of investigating the root causes of this discrepancy and the related negative effects on job creation and wealth generation within minority communities.

Building on initial conversations carried out at the White House in 2016, the Milken Institute and the U.S. Small Business Administration formed an initiative to develop actionable solutions to the challenges limiting minority-owned small businesses' access to capital. The Partnership for Lending in Underserved Markets (PLUM), a two-year pilot program, was launched to this effect in September 2016 and has since completed its research.<sup>3</sup> Building on the initial findings of PLUM, the Milken Institute committed to exploring market-based solutions that specifically address the identified shortcomings in this space.

A key issue identified was that the primary source of startup and acquisition funding for all small businesses is savings and equity investments from personal networks and, secondarily, bank loans. However, for minority-owned businesses, the second most prevalent source of funding is credit cards. While credit card products are effective for short-term liquidity needs, in many cases, they are not designed to catalyze long-term growth, which can place minority-owned businesses at a disadvantage and potentially stymie new business and job creation. Increasing access to traditional bank lending, therefore, is an important component of improving the

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<sup>2</sup> In 2016, 12.7 percent of the U.S. population was Black, 17.8 percent was Hispanic, and 5.4 percent was Asian, compared to 2.2 percent, 6.0 percent, and 5.9 percent, respectively, in terms of % of firms with paid employees, according to U.S. Census data. US Census Bureau, <https://www.census.gov/quickfacts/fact/table/US/PST045217>, accessed May 29, 2018.

<sup>3</sup> In 2017 and 2018, the Milken Institute published summary reports of [phase I](#), [phase II](#), and [phase III](#) of Partnership for Lending in Underserved Markets. The papers provide details of the joint Milken Institute-US Small Business Administration initiative and the operational activities in two target markets. The papers also discuss challenges of minority-owned small businesses in relation to capital access.

potential for both the growth of minority-owned small businesses and associated employment gains in the communities in which they operate.

Unfortunately, there is evidence that minority-owned small businesses have restricted financing choices. According to the findings of a mystery borrower experiment published in the *Journal of Consumer Research*,<sup>4</sup> minority business owners are presented with more loan requirements and offered less help than non-minorities. These challenges limit their ability to secure financing and make them less likely to even continue their financing application due to a negative perception of the process and its likely outcome.

Furthermore, after the 2008 financial crisis, minority and low-income communities disproportionately experienced bank closures. The net effect is that an average of 72 percent of minorities do not have a bank branch in their neighborhood. Simultaneously, regulatory efforts to protect Americans with a more prudent, safe, and sound financial system did increase compliance cost and further fueled the consolidation of financial institutions, resulting in fewer branches in already underserved communities.

The lack of bank coverage in these communities did not dissipate the need for banking services. What resulted was a huge demand met by online platforms and payday lenders. To be clear, there are many types of models and institutions<sup>5</sup>. In fact, there are many reputable institutions leveraging technology to meet the needs of underserved populations in a fair and transparent way. Unfortunately, given the disaggregated regulatory architecture, it's difficult to keep out the bad actors. Indeed, many borrowers have found themselves back under the thumb of unscrupulous lenders.

Given the challenges faced by small businesses,<sup>6</sup> especially minority-owned small businesses, it is imperative to assess which type of lender and products are best placed to provide access to capital for minority communities.

## B. A deeper dive into MDIs

With support from Rockefeller and JP Morgan Foundation, the Milken Institute conducted a series of analyses on MDIs. According to our recently published market overview of minority-

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<sup>4</sup> Bone, S., Christensen, G., and Williams, J., 2014, "Rejected, Shackled, and Alone: The Impact of Systemic Restricted Choice on Minority Consumers' Construction of Self," *Journal of Consumer Research*, 41: 451-474.

<sup>5</sup> Muller, Jackson, 2016, "[The U.S. Online, Non-Bank Finance Landscape](#)," Milken Institute.

<sup>6</sup> Schulman, Carolyn, 2018, "[Partnership for Lending in Underserved Markets: Increasing Minority Entrepreneurs' Access to Capital](#)," Milken Institute.

owned banks,<sup>7</sup> there is evidence to suggest that MDIs (especially Black and Other MDIs), could be meaningful funding sources for minority-owned small businesses, and therefore, important economic development engines due to their relative prioritization of small-business lending. However, these minority-owned banks are small in scale, with median total assets of certain categories of MDIs being less than \$200 million, as shown in Table 1. Many questions remain about what these MDIs would need—equity capital, human capital, technology—to prudently increase their scale, and potentially, their impact. In addition, what community impact would result? Would small business loans be prioritized by these institutions?

**Table 1: Medians for Selected Bank, Demographic, and Income Items by Type of Bank and Census Tract, 2017**

	Total Assets (\$'000)	Number of Small-Business Loans	Small-Business Loans to Total Assets (%)	Tier 1 Capital to Total Assets (%)	Percentage of Total Population (%)				Median Family Income (\$)
					Minority	Hispanic	Black	Asian	
All FDIC-Insured Institutions	212,688	357	17.10	10.39	23.92	6.24	3.33	1.77	69,679
All MDIs	312,360	224	13.24	11.36	85.36	35.37	1.27	3.72	55,790
Black MDIs	173,477	165	19.35	9.09	91.02	4.87	73.15	1.60	46,490
Hispanic MDIs	469,282	285	8.43	10.98	96.22	93.59	0.00	0.00	42,917
Asian MDIs	363,516	194	13.27	11.87	75.46	17.40	2.83	39.18	72,801
Other MDIs	103,493	259	18.76	11.15	36.87	4.99	2.67	0.66	51,413

The FDIC recently completed its analysis of MDIs, and during and after the 2008 crisis, found MDIs were 2.5x more likely to fail than all other banks. Some have suggested the relative inefficiency of MDIs as the cause and/or the lack of market opportunities in underserved areas; let us not conflate the issues.

In a paper to be published by the end of 2019, we engaged in a study to compare the ROAs and small business lending efficiency of MDIs and depositories categorized as “non-MDIs.”<sup>8</sup> The research also examined these institutions for a period that included a recent macroeconomic shock, the 2008 financial crisis. Utilizing data from the FDIC Reports of Condition and Income (Call Reports) for a substantial set of banks, a Data Envelopment Analysis (DEA) was used to determine how a set of MDIs performed relative to comparable institutions. The results indicate that MDIs are not systematically less efficient than comparable non-MDIs. Recognizing that MDIs are not

<sup>7</sup> James R. Barth, Aron Betru, Matthew Brigida, and Christopher Lee, (2019), “[Minority-Owned Depository Institutions: A Market Overview](#),” Milken Institute.

<sup>8</sup> Gregory B. Fairchild, Young Kim, Matt Brigida, Aron Betru, (2019), “Good Money after Bad? The Comparative Efficiency of Minority Depository Institutions (MDIs),” Milken Institute. [NOT YET PUBLISHED]

homogeneous, however, the study also examined relative efficiency across types of MDIs by racial/ethnic grouping, and the findings were that there were differences across MDI types.

The analysis shows that Black MDIs, in particular, are small in the broader commercial banking context, and as a result have greater susceptibility to challenges associated with increased compliance costs, operational complexity, and a fast-paced, technology-enabled competitive market. If enhancing the scale of their impact is the target, the following questions need to be answered about their potential to be greater economic development engines for underserved markets:

- What are potential capacity improvement strategies to better enable an MDI's ability to serve these markets?
- How can these institutions attract resources for their improvement strategies, and what are potential implementation approaches?

### C. Strategies to increase the credit capacity of MDIs

With greater credit capacity, MDIs could be an even more effective resource for underserved communities. To enhance their capacity, a series of strategies are available.

- Promote MDI's increased access to Federal deposits. To increase output and revenue, MDIs must compete for market share in terms of securing more deposits and borrowers alike. With regards to deposit growth, larger banks have experienced considerable deposit growth, typically at the expense of smaller institutions, according to the FDIC. A key driver of this is the introduction of easier multi-point customer engagement leveraging technology and remote banking capabilities. Simultaneously, MDI's minority communities themselves are still recuperating from the reduction in assets that resulted from the 2008 crisis. MDIs need deposits to grow. Increasing the U.S. Treasury's Minority Bank Deposit Program may be a path forward.
- Explore potential MDI-FinTech collaborations to improve lending. A new report from FinRegLab details how new FinTech entrants built online platforms for delivering various credit products to small businesses. The report provides a broad picture of the use of cash-flow data in the small business lending market and finds that the data is useful because it provides a more detailed, timely picture of small businesses' income flows and cash reserves than traditional credit history information. Potential bank-nonbank collaborations should be explored, including implication on consumer protection, which

may be particularly important in determining the pace of adoption going forward. More importantly, these partnerships can also assuage regulatory concerns about a non-bank platform given the role a partner bank plays in conducting oversight and compliance in its partnerships with third-party providers. As a regulated entity, a depository institution must adhere to FDIC and OCC third-party vendor management guidelines, which essentially place the FDIC and OCC, and potentially their Offices of Innovation, as de-facto regulators of bank-partnered FinTech firms that provide another layer of protection. Through a partnership approach, both FinTechs and incumbent banks can utilize each other's strengths to address several weaknesses. For MDIs, partnerships with third-party FinTech firms offer the opportunity to lead in the future of banking without spending considerable resources on building the future.

- *Leverage Opportunity Zone investments to increase the equity capital of MDIs and CDFIs.* Opportunity Zones were established by Congress in the Tax Cuts and Jobs Act of 2017 to encourage long-term investments in low-income urban and rural communities nationwide. As the Opportunity Zones initiative is currently structured, MDIs can participate by creating and operating Qualified Opportunity Funds. Low-income communities, however, would greatly benefit if MDIs serving Opportunity Zones could themselves be eligible for investments from Opportunity Funds. But, because Qualified Opportunity Zone Businesses cannot have more than 5 percent of their assets in “nonqualified financial property” (as defined in paragraph (8) of 26 USC section 1397C(b)), MDIs are excluded from eligibility for Opportunity Fund investments. Even Community Development Financial Institutions (CDFIs), which can be either MDIs or non-MDIs and must demonstrate that at least 60 percent of their total lending or investing activities benefit qualified target markets (e.g., low income or underserved people and places) are excluded. Legislative action would be required to address the exclusion of these institutions. All financial institutions, including CDFIs and MDIs, have more than 5 percent of their assets in the form of nonqualified financial property. The original purpose of this exclusion in the Federal Enterprise Zone statute was to exclude conventional financial institutions or market-rate investment vehicles that are viable without subsidy from benefiting from federal tax incentives. CDFIs (especially MDIs that are also CDFIs) are different, and their creation as a class of financial institutions occurred after the formation of the Federal Enterprise Zone statute. CDFIs, including MDIs that are also CDFIs, are required to submit annual reports on their aggregate activities to the U.S. Treasury Department to maintain their certification status. Many businesses and projects located in designated Opportunity Zones are smaller in scale, and thus may not be able to directly utilize the type of investment incentive offered by Opportunity Funds due to capital structure, size or inability to pay sufficient returns to meet Opportunity Fund

expectations. These businesses, however, are important to the economic vitality of Opportunity Zones. With increased capital to fuel their capacity, CDFIs, and in particular MDIs, could be more effective in serving their communities and further the original intent of the Opportunity Zone initiative.

In conclusion, we are now more than 150 years after the creation of MDIs, as well as the 50<sup>th</sup> anniversary of the establishment of the Minority Business Development Agency. We are sitting in the tail end of one of the longest periods of economic expansion for this country. Yet, for the past 30 years, median household wealth for African Americans and Hispanics has declined by 75 percent and 50 percent, respectively<sup>9</sup>. A recent study by McKinsey & Company<sup>10</sup> detailed that closing the racial wealth gap (just looking at black and white Americans) could mean improving the U.S. GDP by as much as 7 percent. As demographics shift, and minority groups become a majority of the United States population, it is no longer just a nice to have, it is an economic imperative for the growth of the U.S. economy and our global competitive advantage that we meet this challenge with the full weight on U.S. public policy, and I believe MDIs can play a critical role here.

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<sup>9</sup> CFED, Racial Wealth Divide Initiative, Institute for Policy Studies, 2016

<sup>10</sup> <https://www.mckinsey.com/industries/public-sector/our-insights/the-economic-impact-of-closing-the-racial-wealth-gap>