May 2023

Municipal Bank of LA: Financial Justice Portfolio Options

Halah Ahmad,[1] Yakov Feygin,[2] Jack Landry,[1] Alison Lingane,[3] Eric Medrano,[1] Stephen Nuñez[1]

[1] Jain Family Institute, New York, NY
[2] Berggruen Institute, Los Angeles, CA
[3] Project Equity, Oakland, CA

Acknowledgements: The authors would like to thank Parisa Esmaili, Rudoph Espinoza, Lauren Leimbach, Prince Osemwengie, Amelita Pascual, Randi Zeller and members of the Public Bank of LA coalition for helpful input in the development of this report.

Disclaimer — The views expressed here do not represent those of Project Equity or other organizations with which the authors are affiliated.

Jain Family Institute (JFI)
jfiresearch.org
568 Broadway, Suite 601
New York, NY 10012

Berggruen Institute
www.berggruen.org
1114 6th Ave
New York, NY 10036

Contents

Introduction & Relevant Mandates

This memo addresses some of the functions that a public bank in the city of Los Angeles, which we call the Municipal Bank of Los Angeles (MBLA), could perform. We outline how the bank could deploy public investments to respond to its mandates to **build community wealth**, **repair historical harms to Black, immigrant and other working and communities of color, and achieve financial sustainability,** without a highly extractive and myopic focus on profit. While many banks and financial institutions focus on financial inclusion, the public bank would also pursue financial and economic *justice*—that is, make efforts to build financial security and wealth across the city, particularly among historically marginalized groups—something that is urgently needed in Los Angeles. Financial inclusion efforts typically involve providing access to existing banking services, credit, savings accounts, coaching, and other within-system solutions. However, they often lack programs or policies that may address persistent income and wealth inequality, discriminatory lending practices, and other structural factors underlying consistent financial precarity—in other words, financial *justice*. This is the gap a public bank can help to fill, charting new pathways for financial institutions to support economic stability and growth at the individual and household level.

This memo is structured as follows:

- In section one, we summarize current approaches to financial inclusion and wealth-building; and then discuss the limits of those approaches, showing how a public bank can fill these gaps.
- In section two, we discuss ways to operationalize and scale investments in community wealth through small business lending. Specifically, we suggest that MBLA focus on financing employee ownership of small businesses to benefit historically marginalized groups. We also outline potential opportunities for the bank to offer lower-cost student debt and free banking services to Angelenos through partnerships with other institutions.
- In section three, we show how our suggested financial justice lending program could fit into MBLA's balance sheet and discuss the potential impacts of these investments.

- An appendix includes a deeper discussion of current financial inclusion efforts, including initiatives to bank the unbanked, expand small business lending, and make change through legislative reform.

Section 1: Present Financial Inclusion Efforts — Challenges for Financial Justice

We differentiate MBLA's financial justice investments from financial inclusion efforts at other institutions despite overlapping goals. A financial inclusion portfolio typically includes efforts to: bank the unbanked, increase financial literacy, improve access to credit and savings, extend micro-loans and loans to small businesses, and provide other tools for asset building and community wealth creation.

While the objectives of these programs remain important for building community wealth, **many of the challenges that financial inclusion efforts are designed to address are upstream of credit and banking.** Within traditional financial inclusion efforts, a variety of programs have emerged, with mixed success—and sometimes notable failure—in experimental evaluations. For example, financial literacy efforts often fail to meaningfully alter the financial position of beneficiaries, as they do not address the real barrier to financial stability, which is low income. Financial education often does *not* lead to higher wages, or more just credit scoring, or lower student debt burdens (and predatory lending), or address any other first-order issues that hold people back from wealth building and access to financial services.

One of the key mandates of the bank is to invest in communities excluded from the formal for-profit financial system. However, AB 857, the California law authorizing the creation of public banks, substantially limits the consumer banking services that MBLA can offer. Yet financial justice is not restricted to extending access to banking services to individuals. MBLA must also strive to address small business development in ways that grow wealth, wages, and lending.

That said, a public bank is not uniquely well-positioned to solve all issues related to financial justice—whether small business lending, consumer banking, financial literacy efforts, credit offerings, credit rating justice, savings accounts, or easing debt burdens. In our analysis of the bank's potential role, we assess the impacts of existing local, state, and federal institutions. **This brief focuses on a sample of new small business lending products that facilitate employee ownership.** It also discusses the potential for the bank to offer low-cost student loans in the future, as well as longer-term pathways to retail banking that build on existing products offered by local banks, community development financial institutions (CDFIs), and government agencies.

Section 2: The Role of MBLA - Solutions & Recommendations

We have limited the scope of this financial justice portfolio to small business lending focused on employee-ownership transitions explained in this section. As we will discuss further, it is important to note that several CDFIs, banks and government entities are already working to expand lending to small businesses in underserved markets. Much existing small business lending is subsidized: the government or philanthropic organizations pick up the tab for businesses that are unable to meet their obligations (e.g. loan loss funds). This type of small business lending is ill-fitted to the public bank, given its mandate to be profit-generating or revenue-neutral, as per AB 857. Likewise, the wealth of existing options for small business lending, however imperfect, does not leave an obvious point of entry for MBLA. Thus, **we suggest that the municipal bank of LA not focus on traditional small business lending but rather on increasing lending to worker cooperatives and other employee ownership transitions that are not served by traditional banks.** This is a space currently occupied predominantly by nonprofits and CDFIs with limited capitalization and unsustained financing.

We also discuss the possibility of offering low-cost student loans to California residents at competitive interest rates, modeled after the Bank of North Dakota's existing programs. We do not propose the immediate initiation of this lending program. Rather, we sketch out a pilot program that can be implemented at a subsequent stage of MBLA's development.

Finally, **we suggest a combination of ways the bank could support no-cost bank account services through other financial institutions aside from direct retailing banking**, which is explicitly restricted by AB 857, pending the outcome of ongoing legislative debate.

I. Small Business Employee Ownership Lending for the Silver Tsunami

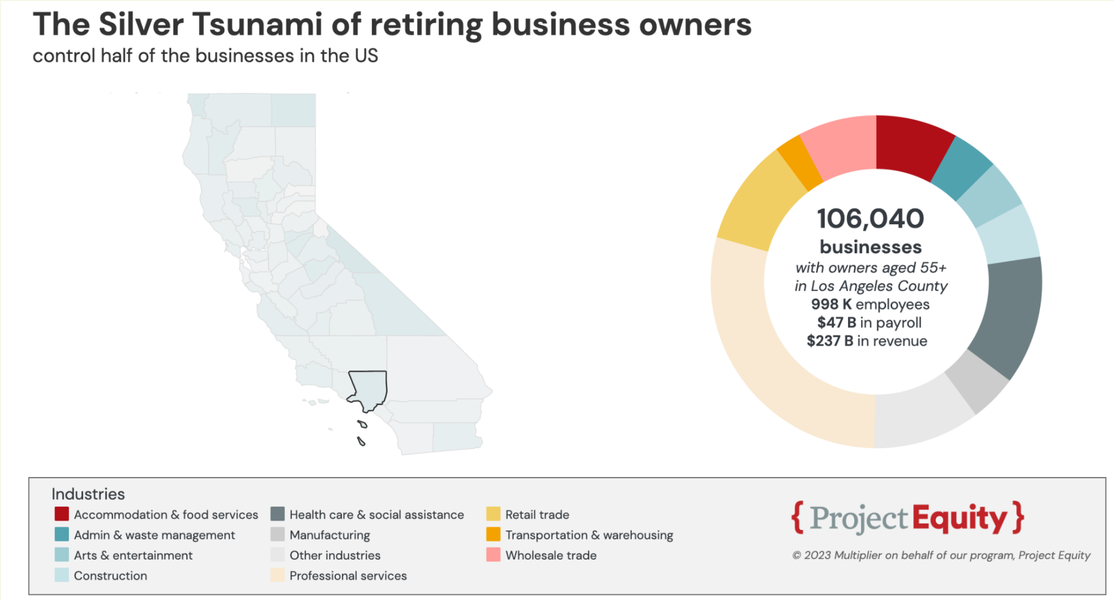
The Silver Tsunami of Business Owner Retirements

Though the small business lending environment is crowded, MBLA can contribute productively in several ways. At present, small business lending to support worker cooperatives and other forms of broad-based employee-ownership transitions is limited due to government regulations and a dearth of available capital. CDFIs and other nonprofits have stepped in to try to fill the space, but they operate on a small scale. ForESOPs (Employee Stock Ownership Plans), another form of broad-based employee ownership, lending is mostly available from big banks; it can be harder to access for smaller transactions (i.e. smaller business transitions). MBLA could supercharge employee ownership (EO) in Los Angeles by making EO lending the core of its financial justice portfolio. In the process, **the bank has the potential to grow wages for thousands of workers across Los Angeles, while also increasing community wealth through shared ownership.**

Employee ownership lending is a particularly promising opportunity for the public bank because small businesses are beginning to see a “silver tsunami” effect: with an unprecedented increase in the aging population, thousands of workers reach retirement age each day, including many small business owners without an exit plan. The baby boomer generation represents 73 million people, with the oldest just turning 75. Since 2001, about 10,000 of them have turned 65 per day. By 2030, all baby boomers will have reached retirement age. Baby boomers exiting the workforce take with them the knowledge, skills, and experience they built over decades. Critically, many have long-standing businesses serving and employing communities.

In fact, based on a study by Project Equity, retiring baby boomers own an estimated half of all small businesses in the US. In California, this translates to nearly 360,000 businesses, employing an estimated 3.9M workers. In Los Angeles County, over 106,000 businesses employing almost a million people have owners that will reach retirement age within the next ten years (see image below). Six out of ten baby boomer business owners will try to sell their businesses in the coming decade. Many will not find buyers. This means that the majority of businesses with retiring owners will either sell their business to private equity or liquidate it, neither of which benefit employees or local communities. In fact, mass buy-outs of small businesses by private equity firms can threaten local ownership and local economies and displace workers or businesses if the business is closed down. These scenarios can lead to unemployment, a loss of economic activity, and a loss of community wealth.

Figure 1: The Scale of the Silver Tsunami in Los Angeles County. Courtesy of Project Equity.



A public bank with a mandate to keep businesses operating and workers employed could make a meaningful impact in turning the tide of the silver tsunami towards positive community benefit in Los Angeles. By significantly increasing employee ownership lending, in partnership with EO experts for pipeline and TA services, MBLA could redirect business turnover and wealth concentration towards community wealth building. EO lending can—and already does—directly build wealth in underprivileged communities. For example, according to the 2019 Worker Cooperative Economic Census, worker co-ops are over 50 percent Black and Latinx owned.

Potential business closures due to the silver tsunami exacerbate job and economic insecurity for working people. Across the US—and especially in large metropolitan areas—working people are not economically secure, with a third of US families unable to manage a $400 emergency expense without turning to credit (if they can manage such an expense at all), and six out of ten of the fastest growing occupations paying less than $27,000 a year. EO lending addresses this problem in two ways. On the one hand, it allows a retiring small business owner to receive fair value for the sale of their business. On the other hand, it enables workers to pay back the bank's loan for that sale using the business' profit. The business owner has the opportunity to preserve their legacy, the workers remain employed, and the community avoids the loss of any economic activity from a permanent closure. The employees, who carry the business forward with a stake in its ownership, can use the profits to create higher quality jobs with higher pay and profit sharing.

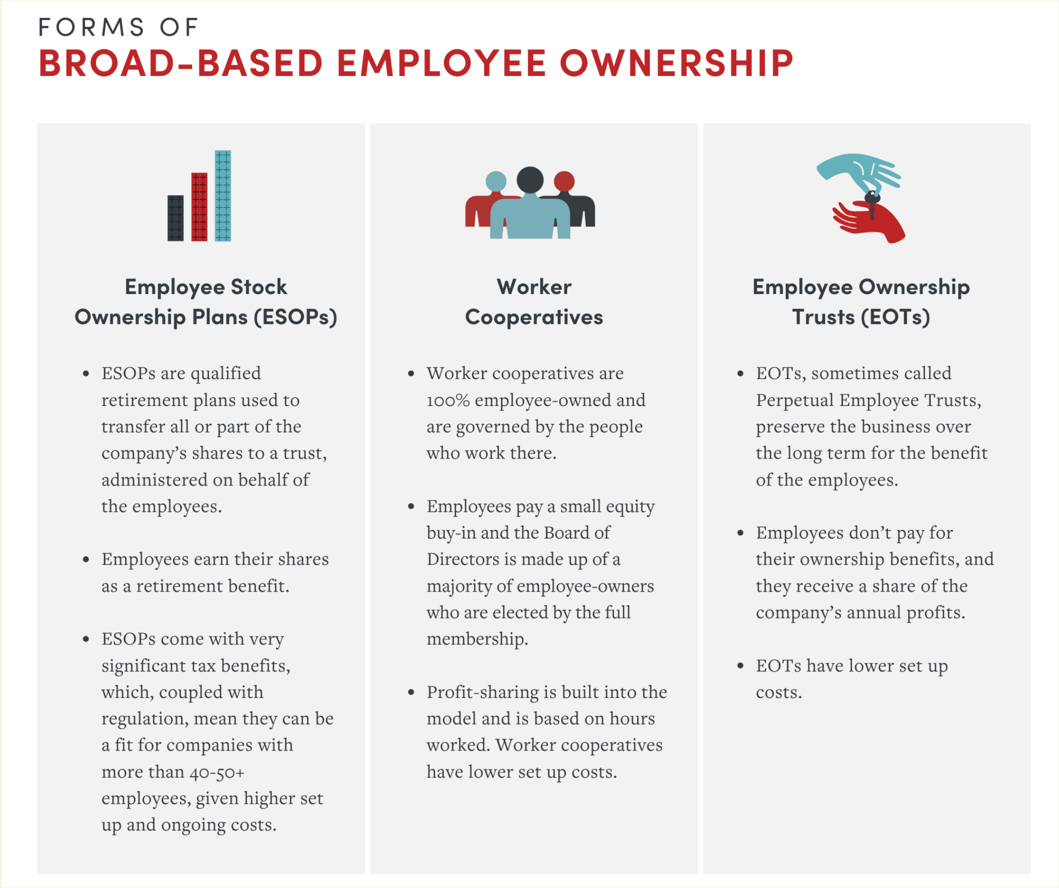
Introduction to Broad-Based Employee Ownership Transitions

An employee ownership (EO) transition is a sale of a business from a single owner (or sometimes a handful of owners) to a broad-based employee ownership structure, in which the full base[1] of employees has access to becoming an employee-owner. Typically, these transactions are financed by a loan that the business takes out. If the employees bring any financing to the closing table, it is usually a very small percentage of the transaction (zero to five percent) and only in one form of broad-based EO, a worker cooperative. The financing is typically based on a dependable historical positive cash flow (what banks refer to as "cash flow lending"). It is usually unsecured, given that few small businesses have enough assets to meaningfully collateralize the loans. Usually the seller retains a note of 30-40 percent of the transaction value. One or sometimes two lenders provide the remainder of the financing.

The three main types of broad-based employee ownership all provide important benefits to business owners and employees: (i) Employee Stock Ownership Plans (ESOPs); (ii) worker cooperatives; (ii) and Employee Ownership Trusts (EOTs). Each is slightly different. While it is outside the scope of this brief to go into much detail, a summary of each form is explained in Figure 2.

[1] Note that in some cases there may be a waiting period, a vesting period, or a minimum work schedule for eligibility.

Figure 2: Forms of Broad-Based Employee Ownership. Courtesy of Project Equity.



Existing EO lending in the US is most established for the ESOP form of employee ownership. Most major banks have an ESOP lending arm, and it is easiest to get ESOP financing for companies over $20M in transaction value. ESOPs come with many tax benefits, which in turn entails a lot of regulation, introducing additional costs—both for the transition and ongoing operations. As a result, ESOPs are not a financial fit for companies with fewer than about 40 employees, or about $1M in EBITDA (EBITDA is essentially an accounting measure of gross annual profit).

The mainstream banking system does not currently lend to worker cooperatives and EOTs. Nonprofit institutions and CDFIs, have stepped in to fill the gaps. Unfortunately, the federal government programs that exist to open up bank lending to small businesses have overlooked this form of small business. For example, the SBA loan guarantees (e.g. the 7a product) are not a fit for employee ownership, given the personal guarantee requirement. In an EO transition, which of the ten or 50 or 500 employee-owners should personally guarantee the loan for the business? In 2018, Congress passed the Main Street Employee

Ownership Act, which directed the SBA to implement practical alternatives to the personal guarantee requirement. Employee ownership advocates offered a range of practical suggestions for how to address their concerns. Yet the SBA made no changes to its policies.

Over the years, as a growing number of nonprofit and CDFI loan funds have formed, the available capital to finance independent transitions to these forms of broad-based employee ownership—Employee Stock Ownership Plans (ESOPs), worker cooperatives and Employee Ownership Trusts (EOTs)—has grown. The municipal bank of LA can learn from these methods. In particular, **MBLA can significantly increase investment in EO lending. This will simultaneously build a test case for other regulated financial institutions to similarly invest in broad-based employee ownership.** While not detailed in this brief, the bank or its intermediaries may also participate in a secondary market for EO loans to buy seasoned loans, enabling the existing lenders to recycle their capital faster and likely giving greater confidence to help them attract more traditional investors, who often exhibit an aversion to non-traditional lending. This potential is made more likely if the EO lending is standardized to have a loan guarantee from California IBank. The loan guarantee program, unlike the federal SBA7(a) loans, has extended to EO transition lending (to ESOPs and worker cooperatives loans) in the past year through Project Equity's Employee Ownership Catalyst Fund. MBLA could preference lending partners that utilize the IBank guarantee for their lending. This would be valuable for many reasons. First, it reduces the risk of repayment by the intermediaries to the MBLA. Second, having a reasonable sample size of employee ownership loans that have utilized the IBank loan guarantee could help demonstrate to the SBA that their loan guarantee programs should be modified to make it feasible for EO transitions.

Debt-Capacity Analysis

Part of the proven model for EO transition lending involves a debt capacity analysis, which assesses the business's ability to repay the loan it takes out to buy out the seller.

A debt capacity analysis reviews the last three to five years of financial statements to project the amount of debt that the business could handle over a period of five-to-seven-years. Given how financing is structured for these transactions, this analysis provides a ceiling for the sale price. A debt capacity analysis is not a business valuation (though it is one of several approaches taken by valuation firms to triangulate an estimated business value). Rather, it takes the value of the future profits generated by a business, using which it generates a range of potential sale prices. This offers a starting point for negotiation. The process can be combined with a formal business valuation (which is required in some forms of EO transition).

To make these transactions possible, the business takes out the loan to finance the buyout. The average frontline worker lacks access to a HELOC, a home equity line of credit, or the ability to take out a personal loan to come up with the financing. However, the work of the employees creates profit, which is used to pay down the loan used to purchase the business.

To illustrate this with a simple example, let's take a business of 20 employees, which generates $200,000 in profits in a single fiscal year. Over the course of the previous five years, the business has generated $1,000,000 in profits. Assuming the business environment and operations haven't changed significantly, the business can project similar positive free cash flow over the next five years. Based on this historical performance, the business is able to take on about $800,000 in debt (not the full $1M, since that would overburden it, and to allow some cushion for forward investing or for an economic downturn). The $800,000, which represents the debt capacity of the business, helps determine the sale price and lays the foundation for the loan "deal structure" created for the outgoing small business owner. Equity or revenue- or profit-based financing and more complex financial instruments can be utilized as well, including earn outs and warrants. A discussion of these is beyond the scope of this paper.

Frontline, low-wage, and immigrant workers at small businesses typically do not have access to credit, capital, connections, or resources needed to purchase a business, let alone their current place of employment. The debt capacity analysis—with the business (not the individual employees) taking out the loan—bridges this gap by providing an alternative lending criterion based on the real performance of the business, regardless of how individual workers look on paper from a fiscal standpoint (or a typical "KYC," know-your-customer, or credit evaluations).

Two Main Roles for Capital in EO Transitions

In this section, we will discuss two approaches by which companies can transition to broad-based employee ownership: 1) **independent transitions** and 2) **a "capital forward" approach**. In either approach, the MBLA would, given the public bank's legal restriction to wholesale lending (and not retail lending, lend to regulated lending institutions or loan funds, which will in turn lend the capital toward the creation of more broad-based employee ownership. In other words, MBLA would not lend directly to the businesses that are transitioning to EO. It would instead form relationships with banks, CDFIs, and loan funds that can lend or invest in businesses to support their EO transitions. We use the term "intermediaries" to describe these institutions.

I. Independent Transitions

Most employee ownership transitions in the United States are independent transitions. These are transitions in which the company starts as independent and private and remains so after the ownership transition. These businesses are not being acquired by private equity or a related fund structure. Nor are they going public as a part of the transition. Staying rooted in their communities, they have chosen an ownership structure with deep employee engagement, which will help them be more competitive.

Business owners are targeted through standard marketing strategies. Pipeline efforts will be made to capture the attention of owners, who are invited to learn more about employee ownership and have a feasibility analysis done to assess whether their business is a good fit and ready for transition. From there, the owner (and typically a small team of employees) works closely with the service providers for six to twelve months, to complete the transaction, educate the different parties, and set the business up for success in its new ownership structure. Ideally, the service provider will support the business post-transaction, for a meaningful period of time (one to two years), to help it cultivate employee engagement and develop employee ownership practices. This approach will likely attract business owners who value employee ownership for legacy or other reasons.

Where a Public Bank Would Focus

If MBLA's mission is to use public funds for the benefit of the community, it is valuable to formulate criteria by which to gauge the relative impact of its investments in various forms of employee ownership. This involves both assessing where increased capital can most accelerate EO growth (for example, ESOPs vs. EOTs vs. cooperatives and the transition of larger versus smaller businesses), and where capital would be additive rather than simply replacing existing capital sources for EO transitions.

Given that larger ESOP transactions can typically access financing through mainstream banks, MBLA would not focus here. Instead, **MBLA would focus on both smaller ESOP transactions and on the other two forms of broad-based employee ownership: worker cooperatives and Employee Ownership Trusts (EOTS).**

For these types of transactions, MBLA would—all else being equal—aim to foster employee ownership among companies with frontline workers, low- and moderate-income workers, and workers of color. This can be accomplished by collaborating with intermediaries (banks, CDFIs, and loan funds) that share this priority, and by requiring these intermediaries to capture data to show where the dollars are going. Intermediaries that focus on particular industry sectors and/or locations can help hone in on businesses MBLA would hope to target (i.e. in low-income areas, including low-wage workers, etc.).

Finally, the MBLA would also prioritize forms of employee ownership that incorporate significant worker decision making power into their structure. This can be accomplished in any of the three main forms of EO, but varies significantly across employee-owned businesses. It can go as far as having employee-owners make up a majority of the board of directors, as is a requirement for worker cooperatives. Many other EO transitions do not incorporate worker voice directly into the structure; this is the case in most Employee Stock Ownership Plans (ESOPs). However, ESOPs and EOTs can incorporate worker representation on their boards or other oversight structures. The EO service provider or intermediary can advise businesses to ensure such decision-making power for workers is incorporated. MBLA would seek to give preference for such structures that thereby prioritize worker voice.

Independent Transition Intermediaries

Outside of the major banks that lend to large ESOP transactions, the direct financing for EO transitions mostly comes from national or regional CDFIs and funds that specialize in either employee ownership or worker cooperatives. Relevant CDFIs, Community Banks and funds that either have a national footprint or a regional footprint that incorporates Los Angeles include Project Equity's Employee Ownership Catalyst Fund, Shared Capital Cooperative, SEED Commons, and Beneficial State Bank, among several others. Only a subset of these potential intermediaries also have robust local pipelines to create deal flow in Los Angeles. The deal flow will be absolutely critical to the success of MBLA investing in intermediaries of this type. We anticipate that reduced cost of capital is likely to attract additional intermediaries to this space, helping to incentive more deal flow activity, and further amplifying MBLA's impact.

II. "Capital Forward" Approach to Transitions

As contrasted with independent transitions, a "capital forward" approach enables an EO fund to approach a business owner much in the way an acquirer would, and in a similar fashion to a private equity firm. A number of funds take this approach. Some are already active, while others are in formation. Interest in this area is growing. Funds will bring anywhere from 30-80 percent of the transaction value to the table (most are on the higher end). They typically have a shorter transaction timeline that requires significantly less involvement from the seller. Most of these funds do not actually acquire the business but rather go directly to employee ownership. Some bring the newly minted EO business into a holding company structure; others keep it as a standalone company. A minority of existing funds acquire the company first and then exit the investment through employee ownership.

This approach has broader appeal among business owners because it is similar to how other business acquisition / M&A transactions are approached, and because it saves them from getting involved in designing the next chapter of their business' ownership and governance.

By targeting a more mainstream business owner, the potential for pipeline volume is higher. Additionally, the capital required per transaction is typically higher in this approach, for two reasons: 1) the business size is larger; 2) and the seller note is smaller. As a result, with the right partners, investing in these types of intermediaries (funds that operate similar to private equity acquirers) has the potential to put more MBLA capital to work to foster employee ownership than through independent transition intermediaries.

Where a Public Bank Would Focus

MBLA would focus on three types of intermediaries. First, "impact" intermediaries that prioritize companies with frontline workers, low- and moderate-income workers, and workers of color. Second, those that prioritize meaningful employee-owner decision making power and/or majority governance by the employee-owners. Third, those that take the companies directly to employee ownership, whether through a holding company or maintaining it as a standalone business.

Some potential intermediaries for MBLA that follow the "capital forward" approach, and are national in scope, or include Los Angeles in their regional footprint, are Apis & Heritage, Mosaic Capital Partners, and Project Equity. As with independent transitions, we believe that lowering cost of capital for such "capital forward" transitions could attract further intermediaries to this space, further amplifying MBLA's impact.

Scale of Investment

- With an initial capital allocation of $4 million, this loan product can fund almost $40 million worth of employee ownership transitions.
- An annual interest rate of 3 - 4.5% will be attractive for a variety of intermediary lenders that finance employee ownership transitions, while creating incentives for lenders (and philanthropy) to invest in pipeline efforts within the Los Angeles market.
- In the first ten years, we anticipate this level of funding from MBLA can support nearly 1,500 Angelinos to be on a path to becoming business owners through

employee ownership, assuming a mix of over 30 small and mid-sized businesses making an EO transition.
- If MBLA included investment across Los Angeles County, this would provide additional incentive for EO efforts to target this region. Presently, over 990,000 workers across Los Angeles County are employed at small businesses with owners reaching retirement age as part of the silver tsunami (see Figure 2).

Note that these estimates are on the high end of what could be feasible given the environment of capable intermediaries. Still, this investment would require a concerted effort to engage with intermediaries—both those that are already active and those that aren't yet active in EO transition pipeline development in the LA region, to engage them and utilize the attractive low interest rate as an incentive for them to increase and focus their work in Los Angeles Additionally, the authors recognize that if the public bank were expanded to include Los Angeles County, the footprint of potential pipeline would be significantly expanded, making an investment at this level more likely to be able to attract pipeline partners and dedicated EO lenders and intermediaries.

The economic impacts for Los Angeles communities are likely to be manifold. Employee-owners have been shown to earn 33 percent more than their counterparts in non-employee-owned firms, according to a 2017 study published by the National Center for Employee Ownership.

Collaboration with CDFIs and Existing Nonprofit EO Practitioners

Some CDFIs are increasing their participation in the EO lending space. However, to expand the intermediary lenders available to receive PBLA capital, it will be crucial to grow the pipeline of intermediaries and educate lenders about how to structure loans to make these transactions effective.

Existing nonprofits in the EO space are critical partners for the technical assistance, EO training, and operational consulting needed for the long term success of the newly-minted employee-owned businesses. Employees will need training to shift to thinking (and acting) like an owner, to learn how to read and interpret financial statements, and understand the key levers of profitability within their companies. In some cases, employees will need support to take on leadership roles—which will require resources. A financial institution like a public bank is not well-suited for such a role. Existing nonprofit and employee ownership practitioners have built the capacity and expertise to support the training and support necessary for long term success.

The EO field needs more scalable capital sources (especially for non-ESOPs or ESOPs on the smaller size spectrum) to be able to grow employee ownership at a desirable rate. One element of the mission of a public bank is to offer alternatives to the lending available from large commercial banks.

The municipal bank of Los Angeles sets itself apart from any other institution in that it can—and is expressly mandated to—prioritize the financial wellbeing of local communities, small businesses, and employees. EO lending sits squarely within these priorities.

II. Low-Interest Student Debt for Angelenos

Another community wealth-building opportunity—and reparative economic investment—is in higher education. The Bank of North Dakota, which is conceived of as a partner-bank model for most lending (as stipulated by AB 857 for California public banks) provides loans directly to North Dakotans and students in nearby Midwestern states. The interest rates and loan origination fees are both lower than Federal student loans. They have flexible repayment plans for up to 25 years. Notably, some of the loan options allow students to spend on any expenses, not just tuition or room and board. In a potential future expansion, the municipal bank of Los Angeles could offer student loans along similar lines.

Lower-cost debt for students will not solve all issues relating to rising tuition and unaffordability that are plaguing students nationwide. However, it can help to reduce the student debt burden in Los Angeles and California more broadly. California has one of the highest average student debt burdens in the country, with an average of $33,521 in student loans in 2021 (average debt across 18-35 year-olds in 2021). Data also suggests that student debt is exacerbating wealth inequality and the racial wealth gap—rather than helping to close wealth gaps by providing a pathway to higher incomes and wealth-building.

In Los Angeles County, average student debt burdens are higher than the state overall, at $35,500 (Median $16,100). This trend continues across race and ethnicity:

Student Debt Burdens in LA and California by Race and Ethnicity (2021)[2]		
	California	Los Angeles County
Plurality-Asian Census Tract	Median: $16,990 // Mean: $37,501	Median: $18,154 // Mean: $43,141
Plurality-Black Census Tract	Median: $18,553 // Mean: $34,988	Median: $18,759 // Mean: $35,249
Plurality-Latino Census Tract	Median: $13,122 // Mean: $26,003	Median: $13,619 // Mean: $27,253
Plurality-white Census Tract	Median: $17,757 // Mean: $38,718	Median: $20,530 // Mean: $46,752

Similarly, as indicated in the table below, Los Angeles residents are more dependent on federal student loans and grants than California writ-large. This demonstrates especially high demand for lower-cost debt in Los Angeles.

	Federal Loans		**Pell Grants**	
Institution Type	California	Los Angeles	California	Los Angeles
Public	11.5%	10.5%	32.4%	37.5%
Private Nonprofit	44.1%	41.5%	29%	26.7%
Private Forprofit	58.3%	61.4%	52.4%	55.1%

The proposed future lending program would include both private student loans and student loan refinancing in the long term. As with federal student loan applications, prospective borrowers would fill out the FAFSA and undergo a hard credit check for refinancing applications. The loan offerings listed below are modeled after those of the BND.

[2] All stats in this section draw from JFI's analysis of Experian credit bureau data, sampling over 1 million borrowers each year.

Scope of Potential Future Investment

- Student loans will range from $500 - $50,000 loans to Los Angeles residents
- Option of either a 6.29 percent fixed interest rate or a 6.44 percent variable interest rate with no loan fee. The variable interest rate is capped at 10 percent, and repayment plans are flexible for up to 25 years.
- The loans may be spent on most expenses and are not limited to tuition, room, and board.
- Applicants who are US citizens may apply using the FAFSA. Undocumented applicants will be required to fill out the California Dream Act Application (CADAA), in keeping with the process used across the state.
- Non-residents may apply for a similar loan, but with the added charge of a loan fee of 3.75 percent, and a higher fixed interest rate (6.29 percent) or variable interest rate (7.44 percent).
- Refinancing of student loans will be available only to Los Angeles residents who have attended a California-based institution.

As the program scales and complements non-bank solutions to the student debt and higher education affordability crisis, the bank could contribute to generational wealth building by enabling higher education wage premiums for Angelenos unhampered by extortionary debt burdens. During the pandemic, the BND was able to lower interest rates and pause repayment on their loans, in a manner similar to the federal government's repayment pause, showing how a public-serving institution could respond to public need during periods of downturn, instead of protecting profit alone. Other features of the BND student loan program, which offers both private loans and loan refinancing, include flexible repayment of up to 25 years, cutting monthly costs to borrowers, and a six month grace period. Likewise, the debt refinancing program has no maximum and is available regardless of program completion or graduation, although only North Dakota residents can refinance both private and public loans (only private loans for non-North Dakota residents).

While we do not anticipate a student loan program to feature in the initial investments of MBLA, it could serve an important role in the bank's community wealth building and financial justice mandates in the long term.

III. No-Cost Bank Accounts Through Bank-to-Bank and Fintech Partnerships

Often the core focus of financial inclusion efforts by community and private banks or credit unions, no or low-cost bank accounts are also among the common goals of public bank advocates nationwide. However, similar to the restrictions on the Public Bank of North Dakota, AB 857 does not enable chartered public banks to serve directly as retail banks for consumers. Two possibilities could allow the bank to serve a role in banking the unbanked: future legislation could enable the bank to take consumer deposits or manage state or federal accounts, should legislation for "CalAccounts" or "FedAccounts" be passed. This would provide a crucial service to unbanked Angelos, and would also increase the total amount of loanable funds MBLA would have at its disposal via leveraging consumer deposits. On the other hand, the legislation as it currently stands could allow for accounts to be offered through the municipal bank, which is owned and operated by partner financial institutions. The general goals of advocates for this form of financial inclusion are to establish widely-available bank account services, with many or all of the following features:

- That are no cost to the consumer
- That provide debit cards and digital transfer services
- That allow for more straightforward appropriation or remittance of public cash assistance directly to consumers
- That do not require individuals to have permanent housing
- That create mechanisms for personal identification without requiring federal or state government-issued photo IDs
- That maintain the confidentiality of consumers (as consistent with applicable law), including from law enforcement or border patrol agencies
- That provide web-based portals for accessing banking information and enrollment
- That provide direct deposit services for receipt of payment
- That allow bank-to-bank transfer services similar to other commercial banking accounts

Now we turn to legislation that may enable bank accounts at MBLA. The proposed CalAccounts envisioned in AB 1177 encompass virtually all of these features. AB 1177 establishes a committee to investigate the feasibility of such accounts.Similar parameters are described in Representatives Rashida Tlaib and Alexandria Ocasio-Cortez's Public Bank Act of 2020 , as well as other versions of public or postal banking proposals raised (but not yet passed) at the federal level. Several proposals suggest intermediate measures to enact the legislation, such as “sidecar accounts” at existing banking institutions, which would either be authorized to receive government deposits or constituted as depository accounts, temporarily held by those existing institutions. If a secondary bill were passed that implements the recommendations of the feasibility study conducted via AB 1177, the most basic incorporation of the CalAccounts proposal (or FedAccounts for that matter) would be to host CalAccounts services at MBLA, while a state entity serves as the legal depository institution holding the accounts. All technical functions, online banking, and app-based services would be accounted for by the establishing legislation (of CalAccounts), likely through partnership models. Similar to federal proposals, CalAccounts could also work through sidecar accounts to private bank accounts, with services offered via state institutions and public financial institutions like the municipal bank of L.A.

These are useful models for the municipal bank of Los Angeles to support banking services via existing bank institutions, rather than establishing retail services itself, in keeping with the bank partnership model of AB 857.

In practice, the City of Los Angeles has recently begun to offer such account services in partnerships with private banks, through the Angeleno Connect program. Functionally, that program could work more naturally through the municipal bank in a similar way, while being implemented through an entity that would be more widely known—and accountable—to the public, as the city’s dedicated public bank. The Angeleno Connect program began as a means to implement and distribute emergency cash, particularly during the COVID-19 pandemic. The Angeleno Connect Immediate Response Cards (IRC) provided one-time payments of up to $1500 to low-income households, distributing over 37,000 prepaid cards through Mastercard. Later, in September 2021, Mayor Garcetti expanded the program to allow Angenelo Connect debit card users to access a free bank account. The platform for enrollment and app-based services related to these cards are run by the fintech company MoCaFi (Mobility Capital Finance, Inc.), with deposits held by Sunrise Banks. The card also connects users to other city services, part of a longstanding effort toward unified access, login, and credentialing across the city’s social services (an idea originally championed through Mastercard City Key and the Angeleno Campaign of Accelerator for America). The permanent bank account aspect of this program is still in its early phases. At present, MoCaFi serves as the administrative partner, able to host the bank accounts through its platform. It is able to define unique account terms for deposits held at Sunrise Banks, a medium-size bank headquartered in Minnesota. As impactful as the Angeleno Connect IRC program may have been for its recipients, scaling the program to full service bank accounts across the city would more naturally be a project of a dedicated municipal bank. Our proposal is to leverage a partnership like this one, with MoCaFi or another fintech institution, alongside another bank partner as the depository institution (such as Sunrise Banks), to offer free accounts defined by terms set by MBLA.

Such partnership programs could bolster the city's ongoing efforts to bank the unbanked and make retail banking more widely available. As of 2021, over 20 percent of residents of the Los Angeles- Long Beach Metropolitan Statistical Area are unbanked or underbanked. In Los Angeles County, one in five neighborhoods do not have a bank or a credit union. In California, one in four people do not have full access to the financial system and spend about $3.3 billion annually in accessing informal financial services. Furthermore, in California, Black and Latinx households are most likely to be unbanked or underbanked, with Black households being six times more likely to be unbanked relative to white households.

Being unbanked often entails facing greater difficulty accessing city, state, and federal benefits and the loss of such benefits to fees or intermediaries. The impacts of a public banking institution in extending the reach of the best no-cost services could be dramatic. Notably, the cost of working through existing institutions would likely be much lower than building bank expertise and infrastructure up from scratch to manage such retail payment systems and products. For example, the San Francisco Municipal Feasibility Task Force estimated that a new public bank, which would take over day-to-day banking services and payroll, would require over $100 million in subsidies, two years before operation. While some members of that committee found such estimates to be overstated, the cost of building new capacities with the necessary staff and tech infrastructure is significant. Later legislation and funding may make such services more feasible.

Section 3: Sample Portfolio Impacts & Balance Sheet

We model that at MBLA's inception, $4.2M of the bank's startup capital be dedicated to financial justice mandates, via financing employee ownership transitions. In later years, management may gauge the feasibility of offering the suggested partnership-based bank account services and the student loan pilot program. With a 10.5 percent capital ratio for the initial $100 million bank capitalization fund, this would result in $40M in loanable funds. The example balance sheet below details how we suggest funds be allocated to different business sizes through intermediaries, with projected numbers of employee-workers transitioned within the first ten years.

Example Balance Sheet

We estimate that $40M in loanable funds to intermediaries serving employee-ownership transitions could lead to nearly 1500 employees transitioning to worker owners. As previously mentioned, these worker owners are likely to see ten percent or more increases in wages and consequent gains in wealth as shared small business owners. Across Los Angeles County, the silver tsunami effect is expected to see over 106,000 business owners reaching retirement age, employing over 990,000 people. As EO intermediaries and lenders grow in number and capacity, more of this market could be captured over time. While we do not estimate a precise number of businesses transitioned in the balance sheet below, we expect approximately 30 businesses (depending on size) would make up the worker-owner outputs described below.

Product	Loaned Amount	Loan Loss Rate	Loan Loss Adjusted Amount	Interest Rate	Net Margin (Yearly)	Net Profit (Yearly)	Avg Capital Placed Per Intermediary	Loan Term (Years)	New Worker Owners
Small Employee Ownership Fund Investment (“Independent Transition” Funds - $250k - $1M)	$2.5M	2%	$2.45M	4.5%	0.75%	0.75%	$500K	8-10	250
Large Employee Ownership Fund Investment (“Capital Forward” Funds - $2M - $10M)	$30M	2%	$29.4M	4.5%	0.75%	0.75%	$7.5M	8-10	750
CDFI or Community Bank Investment ($2M - $5M)	$7.5M	2%	$7.35M	4.5%	0.75%	0.75%	$2.5M	7-8	438

Timelines and Relevant Costs for EO Lending

Employee ownership transitions, depending on the size, the approach (independent versus capital forward), and business preparedness, can take between six and 18 months to close.

In that time, the business is assessed from a fiscal and managerial standpoint; the existing employee base is educated on their responsibilities and rights as post-transition employee-owners; and they are trained on how to read and make decisions based on financial statements. The initial technical assistance and training efforts to prepare a business and its workers for broad-based employee ownership can come from partnered nonprofit EO developers and CDFIs (e.g. Project Equity). In-house evaluation and underwriting capacities will require an initial subsidy to operationalize.

A debt capacity analysis produces the range of potential sale prices for a business, based on the projected revenues it will generate over the course of the next five to seven years. The larger the profit, the more debt available, and therefore the higher the sale price for a business deal. Once the loan to sell the business is paid off, these excess profits are distributed among employee-owners and/or reinvested in the business. The larger the business, the more likely it will be to take on more debt and generate higher revenue. Employee ownership transitions can be a fit for companies of any size above a ten employee threshold (with no upper size threshold) and in almost any sector. Loan amounts to complete the transition vary widely based on this range.

Impacts on Community Wealth

In keeping with the community wealth-building mandate, this lending program would go beyond financial literacy, by improving the financial position of workers throughout Los Angeles. Employee-owners typically have higher quality jobs with higher wages, earn profit sharing (each form of broad-based EO is a little different), and also share in wealth generation. **In one study by the National Center for Employee Ownership, employee-owners had 33 percent higher wages, 53 percent of them had longer job tenure, and 92 percent had a higher household net worth than their counterparts.** This represents a dramatic increase in both income and wealth across the employee base, as excess revenue and profits are distributed across the a) cost of the original loan, and b) the employees. The expectation is always that the profit-sharing capacity will be lower until the original loan is paid back. But even in this initial time period of five to seven years, the employees are often able to increase the profit of the business, enabling meaningful increases in pay, benefits, and/or profit sharing.

Two case studies on the following page demonstrate the powerful wealth-building impact of such transitions:

Case Study 1: Proof Bakery

Proof Bakery, an LA-based bakery, recently transitioned to a worker-cooperative. Proof Bakery first opened in 2010 by chef/owner Na Young Ma in Los Angeles. After ten years of successfully running the business, building strong loyalty from its customer base, and receiving accolades from the James Beard Foundation, *The New York Times*, and other noteworthy institutions, Na Young decided to turn the business into a worker-cooperative. Part of why Proof Bakery's transition to employee ownership was successful is the founding owner's heavy buy-in to the approach, from the beginning. In its first ten years, Na Young took care to build a collaborative and lateral culture in the business, with teamwork and group decision-making being a central part of its culture. The financial success of the bakery enabled the founder to be paid for her deep investment in starting and growing the company, while also enabling the employee-owners to pay down the debt from their acquisition of the business. As with any employee ownership transition, additional financial success now goes directly to the new owners. They decide how much to invest in the business and how much to pay to themselves.

Case Study 2: Delta Pipeline

Craig Danely and his business partner Richard Vance II opened Delta Pipeline in Long Beach in 1991. Delta Pipeline is a well-respected utility business employing nearly 70 people. Working in both the public and private sectors, their projects include construction and redevelopment of schools, medical buildings, retail, office and industrial space.

In 2017, Delta Pipeline became 100 percent employee-owned, through an ESOP. When a worker joins Delta Pipeline, they become an employee-owner, with a personal stake and shared responsibility in the company.

Danely found that a major benefit of employee ownership was changing the organizational hierarchy. The 68 present employees have the opportunity to be an owner and to add value to the company—not just the CEO. When a team member joins, they go through orientation, and after a year of employment, they become eligible to start their ESOP vesting period. Employees become 100 percent vested after six years. The company shares 10 percent of their gross margins with its employee-owners.

Conclusion

Our proposed financial justice lending program will dramatically increase employee ownership in Los Angeles. Without intervention, demographic trends in Los Angeles point to a large wave of retiring small business owners. Many of them have no exit plan. Without intervention, their businesses will likely cease operating or be bought out by an out-of-area buyer or private equity. MBLA will allow these owners to transition to an employee ownership model by providing much-needed financing for these transactions. We project that, if $40M of MBLA's portfolio was dedicated to financing employee-owner transitions, it could provide pathways to business ownership for nearly 1,500 Angelinos. This is a powerful strategy that augments the region's investments in entrepreneurship as a pathway to business ownership, given that the worker-owners created are owners of established, profit-generating businesses from their first day of business owners.. Facilitating the creation of employee-owned firms serves the core of the bank's mandate to build community wealth. Employee-owned firms have higher wages and give employee-owners an equity stake in the business. Crucially, they also give employees a stake and voice in the firm's direction, which can make them more productive and profitable.

Outside of financing employee ownership transitions, we also suggest potential future MBLA programs focus on student loans and no-cost bank accounts. There is a great need for less exploitative and more public-spirited lending for higher education. A precedent for such a program is set by the public Bank of North Dakota. Similarly, a large fraction of Angelenos have a tenuous relationship to the existing consumer banking market and lose money to fringe banking alternatives. While MBLA is legally prohibited from setting up its own retail banking services, there may be potential to partner with existing banking institutions to offer no-cost bank accounts for underbanked and unbanked Angelenos.

Appendix: Financial Inclusion Landscape

As alluded to in previous sections, our aim in this brief was to assess what the public bank could *add* to the landscape of financial institutions that are already serving similar aims. With regard to efforts for financial inclusion and small business lending, we sought to review the current landscape of bank or CDFI solutions within which the municipal bank of LA would operate. In doing so, we hope the proposed lending programs above extend beyond these efforts to support greater financial justice and wealth building. Below, we discuss these traditional financial inclusion efforts in further detail. Advocates and consultants to the public bank effort may benefit from asking what MBLA's comparative value would be in this context.

Banking the Unbanked

In general, an "unbanked" household is defined as one that does not have a bank account at an FDIC-insured banking institution, and an "underbanked" household is one that does have a bank account, but still needs to rely on informal banking services outside the formal regulated financial system. Financial inclusion typically refers to efforts to help the unbanked and underbanked access mainstream financial and banking services and products like checking accounts, credit cards, small business loans, retirement savings vehicles (IRAs, 401k, etc.) and reduce use of the subprime or "fringe" banking alternatives. These are important efforts, as it is often very expensive for working class households to do simple things like cash checks, receive their wages, and secure loans from exploitative sources, such as payday lenders. For example, the Consumer Financial Protection Bureau found that a typical payday loan takes the form of $500 being borrowed for two weeks at an annualized percentage rate of almost 400 percent. Those excluded from the banking system may fall into a kind of a poverty trap: low-income households spend a large portion of their wages on accessing basic banking services, which exacerbates poverty, or at the very least, hinders upward mobility and wealth building.

A public bank governed by a democratic process and mandate to serve people over profits may well fulfill several goals of the traditional "financial inclusion" flag bearers. A few key initiatives generally make up the financial inclusion playbook: bank accounts, short-term credit, and long-term savings.

A focus on low or no-cost bank accounts with convenient access points and schedules that work for working class folks is supported by many major financial institutions, including through the BankOn Coalition. The alternative to such bank accounts is often the use of check cashers, in which a middle man eats a chunk of an individual's income and thereby leaves less financial buffers to handle basic needs and cost fluctuations or to build savings in case of emergencies.

Another focus of financial inclusion efforts is a lack of access to short-term credit due to a bad credit score, absence of credit history, or a "thin file." This means that when dealing with an emergency or an income shortfall, households either have to do without, borrow from family/friends (not always an option and never socially costless), or rely on very high-interest loans from pawnshops, payday lenders, car title lenders, among others. This creates an additional debt service burden that can leave households chronically underwater.

Still another focus is on long-term savings for education, retirement, car/home down payments, etc. With little knowledge of or access to 529 accounts, IRAs, 401ks, or other savings options, the working class—and particularly communities of color—have difficulty building wealth. A patchwork safety net system for working class families makes building wealth difficult.

While these programs remain important tools in building community wealth, many of the problems they designed to address are upstream of credit and banking. Likewise, there is little government involvement in this space. For example, with a proper safety net, including robust social insurance (UI, health insurance, retirement benefits) and income support (child allowance, GI, etc.) there would not be much of a high-interest, short-term credit market to speak of. On the other hand, unbanked or underbanked (and off-the-grid households in rural, resource-poor areas) would still face problems even if there was an adequate safety net, because of a lack of complete pipelines for distributing government benefits, allowing for-profit companies to eat into that benefit delivery gap.

According to an FDIC Survey, the most common reasons why people are unbanked or underbanked include not having enough money to satisfy minimum balance requirements, the lack of trust in formal banking institutions, a lack of privacy, the high and unpredictable fees of bank accounts, and problems with personal identification, credit, or former bank accounts. At the heart of the matter is the goal of profit-maximization that drives private banking institutions.It is simply not profitable for them to extend banking services to low-income customers and communities of color. While opening accounts is not very expensive for banks, they are unwilling to do so without charging fees, which in turn prohibitively expensive for many. Similarly, banks impose minimum balance requirements not out of any innate need but rather out of a desire for profit. It is for this reason that FedAccounts and Postal Banking are often seen as improvements over the status quo. Since the government can serve goals other than profit-maximization, a municipal bank of LA can play an important role in fostering financial justice.

A variety of other programs and financial products have emerged out of traditional “financial inclusion” efforts, with mixed success. The “financial education” movement, for example, has failed spectacularly in experimental evaluations: working people are not held back by their lack of understanding of how to budget or inability to understand what a loan is. Likewise, **greater financial education does not lead to higher wages, or more just credit scoring, or lower student debt burdens (and predatory lending), among other primary issues with wealth-building.** On the issue of credit, there are credit building programs that help individuals fix mistakes in their credit documentation and provide them secured loans or secured credit cards to begin building credit with the end goal of having participants graduate into using mainstream credit instruments. These programs are sometimes funded or supported by major corporations in this space (e.g. MetLife through the MetLife foundation). These efforts have produced success stories, but they have not structural forces that lead to disparity in access to credit and lending.

Other programs seek to provide lower cost alternatives to the services working class households typically rely on. For example, there are efforts to support and expand the reach of credit unions. Public-private partnerships like BankOn see big banks (e.g. Wells Fargo) offering special low-cost accounts for the poor. Organizations like The Financial Health Network (formerly known as The Center for Financial Services Innovation) develop or evaluate products meant to be non-exploitative alternatives to payday and pawn loans. These have found limited success since loans, regardless of size, have a high fixed cost in paperwork/underwriting and the industry has little information on credit worthiness, leading to high default rates.

Finally, financial inclusion advocates have promoted long term savings products like IDAs (individual development accounts—savings accounts with matched funds from state TANF or other benefit funds) or side-car accounts for 529 programs that have been developed to encourage illiquid savings among the working class, particularly for children. They may include matched funds and other incentives to induce saving. These have shown some success but can run up against a lack of financial slack on the part of the targeted households. In other words, while these efforts can be good vehicles for savings, the targeted household does not necessarily have sufficient income to save to begin with

One of the key mandates, therefore, needs to be to promote financial justice for communities excluded from the formal financial system. This is not limited to extending retail banking services to these communities. It requires that MBLA strive to rectify historical underinvestment of public dollars and discrimination in wealth-building opportunities such as home ownership, small business development (growing wealth and wages), and student loan programs, among others. Ideally, MBLA authorities would work closely with historically excluded communities to build trust and assess and address their needs.

Current Small Business Lending & Limitations

There are several government programs at the federal, state, and local levels that provide small business lending. At the federal level, the Small Business Administration provides loans to small businesses primarily through its 7(a) and 504 loan programs. Rather than directly applying for loans via the government, the Small Business Administration works with lending partners (banks or other financial institutions) that process the loan and share the risk of the loan with the SBA. In the event of default, the SBA typically takes 75-85 percent of the loss, with the partner institution taking the remainder. This arrangement encourages banks to extend loans to businesses with more credit risk than if a bank had to shoulder 100 percent of any losses.

Importantly, many current lending options for small businesses are subsidized, meaning either the government or philanthropists pick up the tab for businesses that are unable to meet their loan obligations. Given MBLA's mandate to be profit generating or at least revenue neutral, this is difficult to compete against. The San Francisco Municipal Task Force report assumed that direct small business lending would have a loss rate between 15 and 30 percent, and recommended allocating only 2.5 percent of the bank's portfolio to that purpose.

Between 2010 and 2021, in Los Angeles, the SBA provided guarantees for an average of 548 loans per year through its 7(a) program and 89 through its 504 program. The median loan size in the 7(a) program was $250,000, of which the SBA provided a guarantee for 75 percent. Loan sizes range from anywhere between five thousand dollars and five million dollars, and term lengths can be shorter than one year or as long as 25 years (the median length is ten years). On average, the SBA program supports almost $300 million dollars of Small Business Lending in LA every year.

As mentioned earlier in this report, at the state level, the California IBank provides a loan guarantee program to small businesses, defined as firms with less than 750 employees. Similar to the SBA, loans are administered by seven financial development corporation partners. Their loan portfolio is relatively modest. In fiscal year 2020-2021, the bank approved 363 loans worth $163 million. If MBLA prioritizes lending partners that utilize the IBank guarantee for their lending, the risk of repayment by intermediaries to MBLA is reduced. The model could be used to demonstrate ways SBA loan guarantee programs can be adapted to include EO transition lending. In the context of employee ownership, there are examples of the IBank guarantee being utilized for both ESOP and worker cooperative loans (the latter having been done through Project Equity's Employee Ownership Catalyst Fund). These loan guarantees could make it possible for MBLA to create a secondary market for seasoned EO transition loans, if they are standardized to have IBank loan guarantees.

At the city level, the Los Angeles Economic and Workforce Development Department issues Small Business Loans using Community Development Block Grant Funds. Unlike other programs, they directly lend the money to small businesses. They are specifically directed at businesses that do not qualify for bank financing,which are required to create one permanent full-time equivalent job for every $35,000 in financial assistance received. Out of the total jobs created, a majority must be fulfilled or made available to low and moderate-income persons.

CDFIs also provide credit for small businesses. Some use a philanthropic model to backfill any losses from their loan portfolio. This is particularly attractive for philanthropists, who benefit from their donation's "multiplier effect." By covering a small amount of loan losses, a CDFI can fill a whole portfolio of slightly more risky loans that they would not be able to offer if required to stay revenue neutral without philanthropic support. However, CDFIs generally operate at a small scale with small caps on loans. Most businesses do not apply to CDFIs for credit. While there are a variety of institutions that extend credit to small businesses (including CDFIs, fintech firms, and credit unions), large banks are still dominant.

The current small business lending system does not adequately serve minority-owned businesses or those in the informal economy. According to the latest data from the Federal Reserve's Small Business Credit Survey, almost one in three firms owned by people of color reported a financing shortfall, compared to just one in five white-owned firms. Overall, white-owned firms were twice as likely as Asian- and Hispanic-owned firms and three times as likely as black-owned firms to have their financing needs met.

Some of these patterns arise due to underlying societal inequalities. For instance, minority-owned businesses might be less likely to have extensive personal wealth available for use as collateral. However, discrimination in the banking sector also plays a role. Recent research found that black business owners in Florida were far more likely to be denied PPP loans than their white counterparts. Some of the discrepancies could be explained by factors like differing rates of preexisting banking relationships. But even after controlling these factors, a significant discrepancy remained. There are two other sources of evidence of racial discrimination. First, in counties where racial discrimination was higher, the black-white loan approval discrepancy was also higher. Second, after banks automated their lending practices (rather than relying on individual bankers' discretion), lending to black-owned businesses increased.

Supporting CDFI Small Business Lending Through Public Dollars

Some business lending requires intensive technical assistance and inclusive underwriting practices for relatively small loan amounts. Small loans with reasonable interest rates to businesses with limited technical capacities or traditional financial structures will never be profitable. Even with high repayment rates, profit from interest cannot compensate for the hours of labor supporting each loan. For instance, the CDFI Inclusive Action reports that it spends an average of 10-15 hours of pre-loan technical assistance for every loan applicant, to support an average loan size of $11,000. While unprofitable, these kinds of loans support businesses that are underserved by the mainstream financial system.

Currently, this kind of lending activity is supported by CDFIs like Inclusive Action for the City, which rely on philanthropy to sustain operations. While a public bank with a revenue-neutral mandate cannot directly support these initiatives, future local or state revenues could be directed toward those that have a track record of non-predatory lending to local businesses but require outside revenue to operate successfully.