



Microenterprise Programs as Credit Builders

In today's economy, credit is a financial asset. Distinct from debt – which is a liability defined by what we owe – credit is a measure of our financial performance and increasingly defines who will do business with us and under what terms and conditions. Research shows that good credit saves individuals more than \$250,000 over their working lives. Increases in credit scores are directly connected to cost of capital and borrowing power.¹

When entrepreneurs and their businesses are “credit poor” with no credit history or with low credit scores, it costs them. They may pay hundreds of dollars per month in higher interest and fees – money that could be used in more productive ways in their business. Or the costs may result from the inability to access the capital and business relationships required to grow and succeed. Credit scores not only determine access to affordable financing, they increasingly also affect the ability to rent office space, purchase needed insurance, and even turn on the lights and telephone service.

How widespread is this issue? An estimated 40 percent of adults in the U.S. have either no credit score, or a score that falls below the minimum required to access prime credit.² The nation's ever-widening array of financial service providers has become a two-tiered system. Mainstream banks and providers report into the consumer credit system and make decisions based on traditional credit histories. A second tier of financial service providers is using alternative sources of data (or in some cases no data), to extend credit. Often that involves much more expensive credit products and services that can trap the “credit poor” in debt, instead of helping them build equity and wealth. For entrepreneurs, building good credit is synonymous with making the transition from under-banked to banked.

What challenges do microenterprise programs face?

With these changes in our financial system, microenterprise programs are recognizing the importance of helping their clients build strong credit. But the process of sorting out their proper role and developing capacity as “credit builders” has not come easy. The challenges they face flow in part from the way that microenterprise programs have traditionally viewed their mission and identity. External policies, the cost of delivering credit-building services, and the need to develop new partnerships and knowledge also pose barriers.

Microenterprise programs want to distinguish themselves from other creditors. Because programs target individuals who lack access to mainstream sources of credit or business assistance, microenterprise programs historically have not emphasized traditional credit scores as part of their entrepreneurship training or lending activities. Many microlenders do not pull credit reports, instead gathering alternative information from the borrower in the underwriting process. Microlenders also have been concerned about reporting the performance on their loans to credit bureaus, fearing that: they will harm clients who encounter emergencies and are unable to pay their loans on time; reporting will hamper their capacity to

¹ Andrea Coombes, “Improving credit can save,” CBS MarketWatch, 13 January 2004.

² Credit Builders Alliance estimates this figure based on information from three data sources:

Michael A. Turner, Alyssa Stewart Lee, Ann Schnare and others, *Give Credit Where Credit is Due* (Washington, D.C.: Political and Economic Research Council and the Brookings Institution Urban Markets Initiative, 2006); available from <http://infopolicy.org/pdf/alt-data.pdf>; Internet.

MyFICO, “Credit Education Center: About FICO Scores,” available from <http://myfico.com/CreditEducation/CreditScores.aspx>; Internet.

Katy Jacob and Rachel Schneider, *Market Interest in Alternative Data Sources and Credit Scoring* (Chicago: Center for Financial Services Innovation, December 2006); available from http://cfsinnovation.com/research-paper-detail.php?article_id=2817; Internet.

offer flexible, patient capital by making it difficult to restructure loans that encounter difficulties; or reporting will subject their clients to predatory credit offers.

Reporting repayment behavior can be expensive and require building new capacity. For small lenders, building and sustaining the capacity to report credit performance (including the necessary technology, know-how and skills), involves commitment and costs. Credit bureaus found that most small lenders were unable to meet their requirements and set-up minimum portfolio policies that meant few microlenders were able to report data. In response, several leading microlending organizations came together to create the Credit Builders Alliance (CBA), which provides back-end support and data batching to help microlenders and other nonprofits affordably meet the requirements of the credit bureaus.

Microenterprise training organizations have not had permission to pull credit reports and scores for their clients. Most training-led microenterprise programs have not had either permission or the capacity to pull credit reports and scores. Recently, CBA created a partnership with TransUnion that allows nonprofits, including microenterprise programs, to access credit reports for financial counseling and outcomes tracking. Programs are still working to develop the internal capacity and funding required to purchase reports and incorporate the information into their training, assistance and tracking efforts.

Microenterprise organizations are not trained in how to build credit. While credit-counseling training and certifications have been available to housing and credit-counseling organizations to help families get out of debt, microenterprise organizations have had little access to credit-building training relevant to their mission and clients.

Facilitating the Process of Credit Reporting: Credit Builders Alliance

In 2005, leading microlenders came together over concern that credit bureau policies blocked them from reporting information on their borrowers' repayment records. Together they launched Credit Builders Alliance, which in 2006 created a successful partnership and pilot with Experian, one of the three major credit bureaus. Today CBA supports more than 75 microlenders – approximately 25 percent of the nonprofit U.S. microlending industry – and collectively reports more than 7,000 loans each month to two major bureaus, Experian and TransUnion.

Since 2007, CBA has begun sharing best practices and training strategies around credit building with all microenterprise development organizations. CBA has seen an enormous increase in the number of microenterprise programs that now recognize the direct link between credit-building services and their mission to help entrepreneurs access mainstream capital. To support their efforts to add new credit-building services, CBA is now offering credit education workshops for staff of microenterprise organizations.

CBA also created a unique partnership with TransUnion that makes credit reports accessible to all microenterprise programs for financial education and outcome tracking purposes. CBA already has helped 25 microenterprise programs access credit reports and is working to expand the number of microenterprise programs that use its tools and services to improve and expand their delivery of services to entrepreneurs.

How microenterprise programs are helping

Most programs believe that “graduating” their business clients to mainstream capital – through the process of building credit – is part of their core mission. In the current credit crunch, this focus has taken on increasing relevance, as even business clients with strong credit histories are struggling to access the affordable capital they need to maintain and grow their businesses. Specifically, microenterprise organizations are taking on a variety of new strategies in credit building:

Enhancing access to credit by reporting payment histories. The best way to help entrepreneurs build credit is to report on-time monthly loan payments to the credit bureaus. Although a handful of the largest microlenders have forged direct

reporting relationships with the credit bureaus, an increasing number of smaller-scale microlenders are reporting through CBA. Organizations that are reporting their clients' loan payments to the credit bureaus can harness the process as a just-in-time educational vehicle to help microentrepreneurs understand the nature of credit and the importance of making timely payments.

Enhancing delivery of financial education with credit reports. Growing numbers of microenterprise organizations recognize the need for financial education, services and tools to help underserved microentrepreneurs. Integrating credit reports into this delivery allows microenterprise programs to go beyond increasing knowledge and help clients make long-term changes in their financial behavior (e.g., creating relationships with creditors that report on-time monthly payments) that are necessary to successful business owners.

Enhancing access to credit through “credit builder” loan products. Many programs are adding small loans that seek to help entrepreneurs build credit, consolidate debt, decrease interest and fee payments, and qualify for small business loans. For example, Business Center for New Americans (formerly NYANA) offers loans up to \$500 to help emerging entrepreneurs establish a credit history with them and the major credit bureaus. Citizen Potawatomi Community Development Corporation offers affordable salary-advance loans so tribal employees avoid the payday loan debt trap. And Four Bands Community Fund, highlighted below, created a \$2,500 loan product to help clients build credit while eliminating more costly payday loan debt. Both training-led microenterprise programs and microlenders seeking to grow their portfolios are interested in adding small loan products now that they are able to report their data.

What can funders do?

Funders can support microenterprise programs in a variety of ways as they move into this emerging area of practice.

Invest in building microenterprise programs' knowledge about credit. The credit reporting industry has changed dramatically over the past 10 years, with more changes likely in the next decade. Programs need to understand not only today's credit reports and scores, but also what they and their clients might expect in the future as alternative credit models mature. Investments in research, training and other knowledge-building resources will be important in helping microenterprise programs become strong partners in the credit-building process.

Support microenterprise programs to pull credit reports at client intake. Programs need staff training as well as financial support to integrate the pulling and analyzing of credit reports into the intake process and ongoing assistance with clients.

Support microlenders' capacity to report credit histories to the major credit bureaus. Reporting to the bureaus involves direct costs and staff time to acquire the necessary credentials, knowledge, technology and ongoing capacity to manage reporting requirements. CBA's back-end support helps small programs in a cost-effective and manageable manner; however, reporting still involves annual costs of about \$600 per year through CBA. In addition, set-up costs range from \$300 to \$1,000, depending on the organization's loan accounting infrastructure.

Invest in linking credit report information to outcome tracking. The microenterprise field has struggled to develop objective, reliable measures and data on the outcomes associated with financial education and microlending. Credit reports are a widely recognized source of financial behavior data and offer an untapped opportunity to measure the mid- and long-term changes in participant financial management and behavior. In addition, the reports provide insight into the key variables that mainstream financial institutions use to make credit decisions, giving practitioners the opportunity to shape programming that fosters graduation into mainstream credit. At a few dollars per report, credit reports can provide microenterprise programs with a cost-effective tool to measure the results of their efforts and their persistence over time. However, the field needs to invest in access to reports and the further development of the processes and methodologies required to collect and analyze this data.

Support sharing of best practices. The field's work and experience in credit building is still relatively new. As it continues to grow, funders can play an important role in supporting the identification and dissemination of best practices in credit building.

Support policy that expands, protects and enhances credit records for disadvantaged entrepreneurs and their businesses. Funders, especially those connected with large mainstream financial institutions, can support policies and leverage their relationships to ensure that both traditional and emerging alternative data repositories and scoring systems are aware of and responsive to the need for microenterprise organizations to create histories both for entrepreneurs and their businesses through consumer and small business reporting.

A Native Entrepreneurship Program Offers the Only Credit Reporting Mechanism on the Reservation

Four Bands Community Fund of Eagle Butte, South Dakota, is a certified Community Development Financial Institution (CDFI) serving the Cheyenne River Indian Reservation. Four Bands assists entrepreneurs with training, business incubation, and access to capital in pursuit of its mission to encourage economic development for low-income residents of the reservation.

Four Bands staff found that credit worthiness often emerged as a barrier to entrepreneurs seeking to access its micro and small business loans. To better understand the issue, the Fund's staff reviewed the credit profiles of more than 500 loan applicants in 2006. They found that more than 50 percent of clients lacked a traditional credit profile, and that among those with credit scores the average score was 600. Four Bands also noted that most clients lacked any positive histories and also had significant collections and payday debt.

In response, Four Bands joined Credit Builders Alliance to report monthly repayment data to the major credit bureaus and introduced a credit-builder loan product with credit education. The Credit Builder Loan offers entrepreneurs a 24-month installment loan of up to \$2,500 to pay off expensive and/or derogatory debts and create a single, affordable, positive credit line. Clients create and implement a Credit Action Plan to obtain the loan. The action plan includes: reviewing their credit report; contacting creditors to confirm amounts owed; and completing Four Bands' financial education training, "Credit When Credit is Due," which focuses on the importance of on-time monthly payments in order to build a strong credit history and score. To date, Four Bands has provided training to more than 50 people and made 35 Credit Builder loans. Ten clients who started with no credit score have created a positive credit file. Other clients have seen credit scores improve by up to 100 points. Nearly ten clients have been able to purchase major assets such as homes and vehicles with their improved score.

The credit builder and small business loan products give borrowers the opportunity each month to build an active positive credit history while paying back their business loan.

For more information

Additional resources on this topic are available from:

- Credit Builders Alliance, www.creditbuildersalliance.org;
- Center for Financial Services Innovation, www.cfsinnovation.com;
- Political and Economic Research Council, publisher of *New to Credit from Alternative Data*, which can be accessed at: http://perc.net/files/New_to_Credit_from_Alternative_Data_0.pdf

FIELD Funder Guides are produced by the Aspen Institute's FIELD program, dedicated to promoting best practice and policy for microenterprise development in the United States. This guide was written collaboratively by FIELD and Credit Builders Alliance. Series funding is provided by the Charles Stewart Mott Foundation.

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