# Profitwise

## News and Views

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# Small business access to capital: Alternative resources bridging the gap


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# Profitwise
## News and Views
### May 2012

In this edition of *Profitwise News and Views*, we present a summary of the most recent (2011) Development Banking Conference organized by the National Community Investment Fund (NCIF). The theme for the 2011 conference, which reflects the overall mission of the organization to promote sound banking practices and social impact in disadvantaged communities, was “Mission and Profit: Raising the Bar.” “Small business access to capital: Alternative resources bridging the gap,” by the Fed’s Robin Newberger and Susan Longworth, looks behind the recent sharp decline in bank lending to small businesses to gain an understanding of the sources of financing entrepreneurs are using to meet their credit needs in the current, constrained environment.

# Small business access to capital: Alternative resources bridging the gap

by Susan Longworth and Robin Newberger

## Introduction

Nationwide in the U.S. over the past 15 years, small businesses generated 64 percent of the net new job growth. Small businesses with fewer than 500 employees, a definition used by the Small Business Administration (SBA), represent 99.7 percent of all employer firms, and employ more than half of private sector employees in the United States.[1] Firms with fewer than 50 employees represent 95 percent of all employer firms.[2] Since the recession that began in late 2007, large bank lending to small businesses has fallen by more than 50 percent.[3]

A combination of forces have contributed to this decline: devalued collateral, especially of real estate, damaged credit reports stemming from financial hardship, reduced cash flow due to diminished sales, and general economic uncertainty.[4] Tight standards on home equity loans have precluded a widely used financing method for small companies.[5] Eroded balance sheets and declines in revenue have increased the possibility that bank loan applications will be denied, and some businesses that once qualified for bank loans no longer qualify. Further, banks have been tightening underwriting standards in an effort to manage risk, leading to reduced options for those businesses still seeking credit.[6] Nevertheless, banks remain the largest source of small business credit, including term loans, credit cards, credit lines, commercial mortgages, and capital leases.[7]

Given this environment, it is interesting to take a closer look at some of the entities that are filling the credit gap for small businesses. While many business owners have become more cautious about seeking credit,[8] and may be more concerned about the strength of their sales than access to credit, some business owners have turned to a variety of non-mainstream credit sources.[9] Depository lenders held about 60 percent of the total loans to small business borrowers from traditional sources of credit (excluding owner loans) in 2010. The remaining 40 percent came from finance companies, brokerage firms, family, friends, and other businesses.[10]

In this article, we explore the expanding role that nonbank, often mission-driven, lenders are playing in a period of constrained lending to small businesses by regulated depository institutions. We present key themes from discussions with over a dozen providers of small business credit products and services and other small business experts, and include data from Accion Chicago, a certified Community Development Financial Institution (CDFI)[11] and microlender, that provides evidence of a shift in borrower credit profiles at a nonbank provider. We find that:

- many community development business lenders are "anti-recessionary" as they become a viable alternative when banks tighten lending standards;
- different underwriting metrics used by these nonbank organizations expand the meaning of the term creditworthy borrower;
- while community development lenders always play a key role in redeveloping areas, the shift by borrowers from banks to nonbank entities demonstrates the complementary role of nonbanks when bank credit is very scarce.

The implication of these findings is that investment in the capacity – organizational and financial – of these nonbank providers, and the expansion of a nonbank infrastructure – virtual or physical, can be especially valuable during times of tight credit.

## Findings regarding nonbank small business financing options

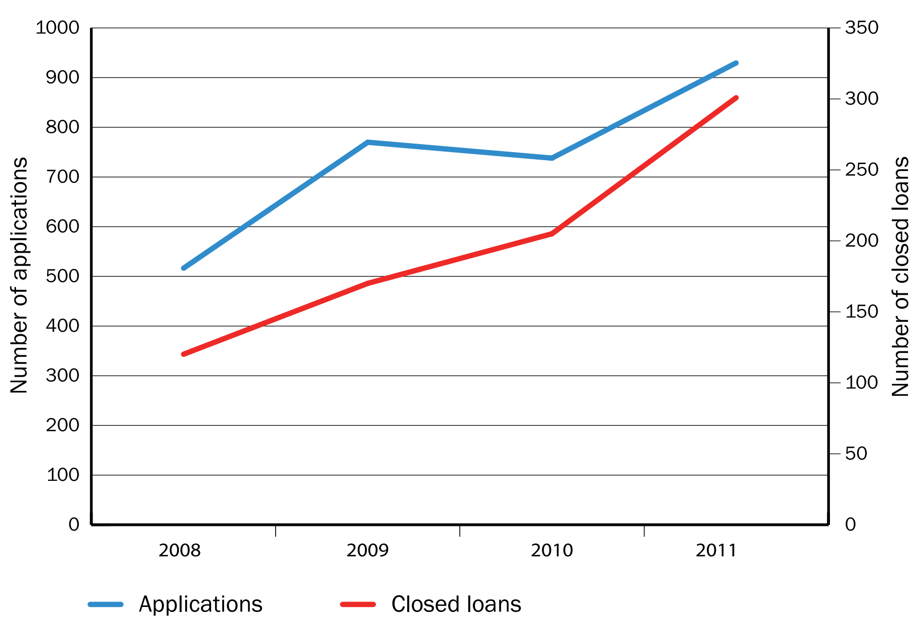
There are several commonly used, formal and informal, options outside of the banking system that small businesses use to finance operations and capital expenditures.[12] Credit cards, friends, family, and personal savings are important sources of financing for small businesses, as is trade credit, merchant cash advance, factoring, microloans, and others. The findings in this article are based on interviews with over a dozen providers of small business credit products and services. We interviewed nonprofit CDFIs, microlenders (some microlenders are CDFIs as well), and a community development corporation that provides SBA 504 loans. We also spoke to entities on the for-profit side, including factoring companies, merchant cash advance providers, and online credit intermediaries. Together this information feeds into our understanding of types of businesses seeking credit and the constraints they may face in obtaining bank financing. Most of these interviewees were local to the Chicago market, although some serve a national market. The three main findings that emerge underscore the role that nonbank providers play during a time of declining credit: nonbank lenders are able to offer financing to small businesses when bank lending is not available; they use alternative underwriting metrics to determine creditworthiness; and they serve as an auxiliary entity for businesses that lose bank credit access due to economic factors, more stringent underwriting standards, or both. We explain the operating methods and profiles of each type of credit provider in this article. The array of nonbank entities discussed represents examples that illustrate the findings, but not the universe of small business credit providers.

**Finding 1:** *Many nonbank financing entities play an "anti-recessionary" role, as small businesses that used to qualify for bank loans before the financial crisis seek financing from nonbank financing entities.*

Interviews with community-based providers and other experts suggest that nonbank small business lending has increased as banks have reduced the availability of products and tightened underwriting standards for small businesses. The increase is difficult to quantify with precision due to the fragmented and nonpublic nature of many of the providers. Community-based business lenders reported that they have been "busier than ever" since the onset of the recession. For example, Accion Chicago, a CDFI microlender that offers loans up to $35,000 (but recently increased its loan limit to $50,000), saw an 80 percent increase in applications between 2008 and 2011[13] (chart 1). A provider of SBA 504 loans ranging from $50,000 to $5.5 million explained that they had a backlog of $90 million in loans that they had approved but had not yet funded, representing a strong appetite for the 504 product. These examples illustrate national trends. Data from the CDFI Market Conditions Report from the Opportunity Finance Network shows that community-based small business lenders saw increases in demand through the recession with almost 80 percent showing an increase in applications, compared to only 4 percent seeing a decrease[14] (chart 2, page 4).

According to interviewees, many banks no longer underwrite loans where the primary collateral is real estate, as dire real estate market conditions undermine banks' confidence in the security value and their ability to appraise value in the first place. Many banks have done away with credit-score-based lines of credit as well. Other products that were targeted to small businesses

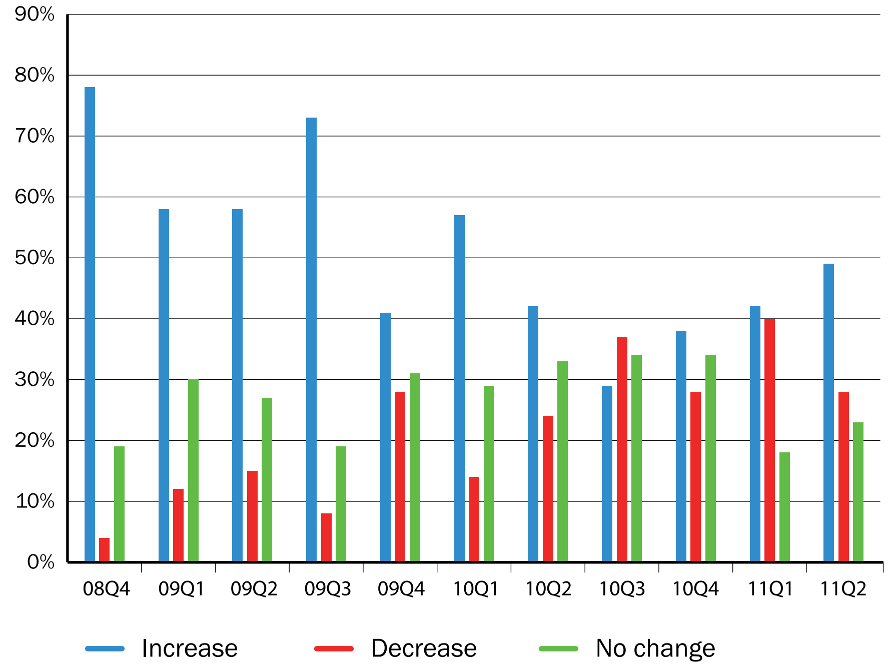
**Chart 1: Accion Chicago – loan demand and production 2008-2011**




**Source:** Accion Chicago.

have also been eliminated, such as the SBA Community Express loan guarantee program, which insured loans up to $35,000.[15] Although the SBA has maintained its 7(a) program and developed two new programs, Small Loan Advantage and Community Advantage[16], the size of the average 7(a) loan has increased by 130 percent, while the number of loans has fallen by 44 percent (chart 3). A similar pattern emerges in 7(a) loans to start-ups: the average loan size has increased by 99 percent and the number of loans fallen by 50 percent between 2007 and 2011. These trends, according to interviewees, reflect banks' reluctance to do small-dollar lending, even with guarantee levels of up 85 percent, further challenging the financing needs of a business needing a relatively small amount of capital. The implication therefore is that demand for small business capital is strong – at least for relatively low loan amounts, which banks (mostly) do not offer.

## Chart 2: Percentage of CDFIs reporting increase/decrease in applications received




**Source:** Opportunity Finance Network: CDFI Market Conditions Report (Second Quarter 2011, Report II – Detailed Tables).

## Community development financial institutions (CDFIs)

**CDFIs promote access to capital and local economic growth in urban and rural low-income communities across the nation.[17] CDFIs are mission focused and generally target their services to disadvantaged populations and communities, and therefore often serve a local market. These institutions can be banks, credit unions, loan funds, venture capital funds, or other financial service providers with community development as their primary objective.[18] They are certified by the U.S. Department of the Treasury and have access to resources available through the CDFI Fund. Through monetary awards and the allocation of tax credits, CDFIs provide access to capital to spur local economic growth in urban and rural low-income communities across the nation.[19] While CDFIs include banks and credit unions, this article focuses on the nonprofit CDFI small business lenders and microlenders – an unregulated segment of the small business market – covering a spectrum of small business lending from under $1,000 to $250,000 or more. About 22 percent of the dollar amount of outstanding CDFI financing went to small enterprises in 2009 (most went to financing housing and real estate), and another 3 percent went to microenterprises, for a total of $5.2 billion in financing outstanding to small businesses.[20]**

**Finding 2:** *The rise in business at nonbank lenders adds nuance to the definition of a creditworthy borrower.*

Nonbank providers underwrite businesses that banks are not willing or able to serve, often by applying different measures of risk. Nonbank financial intermediaries evaluate risk, and therefore small business creditworthiness, through a different lens than banks. According to interviewees, changes in credit scores and credit score standards have had perhaps the biggest impact on whether someone gets financing at a mainstream banking institution. Anecdotal accounts indicate that the credit score requirement used to be 600-650 at mainstream banks; it is now above 700.

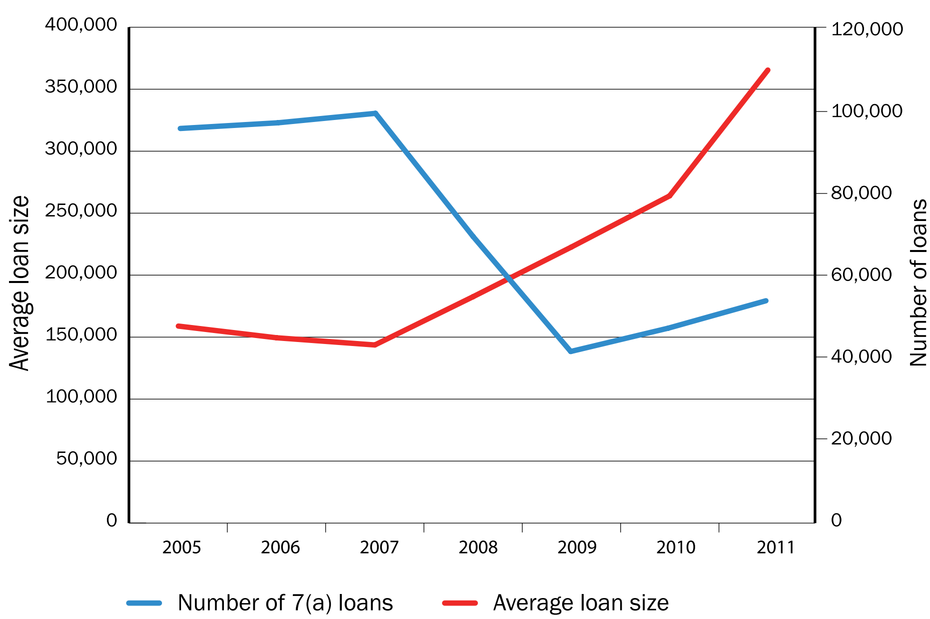
## Microenterprise development organizations

**Microenterprise development organizations help small business owners most at risk – namely low- and moderate-income and other disadvantaged individuals who do not typically have access to the full range of mainstream financial services – to create or expand their small business.[21] Microenterprise is commonly defined as a business with five or fewer employees that requires no more than $35,000 in start-up capital. Microenterprise development involves providing these business owners with loans, capital, deposit accounts, budgeting services, tax preparation services, business-specific technical assistance, and other support. Not all microenterprise development organizations provide financing. Because of the local nature of their product offerings, most microlenders serve a localized market. Perhaps most well-known in the U.S. is the Accion "network" of microlenders.[22]**

In contrast, alternative lenders base their decisions on other variables besides (or in addition to) balance sheets or the credit score of the owner. They often consider borrowers with good credit but no collateral, or with collateral but no business history. Nonbank entities also evaluate small business customers by weighing time in business as an indicator of sustainability, and considering "global cash flow" – the financial capacity of a family – when considering a credit decision. Other providers ensure that a business is current on rent payments as a determinant of business health. The factoring industry (see profile) removes the burden from the small business entirely, extending credit based not on their clients' financial condition, but on the financial condition of their clients' customers. As a result, a company with creditworthy customers may be able to factor even if it can't qualify for a loan. Merchant cash advance (see profile) underwriters typically evaluate the past four months of cash flow, rather than the three years usually required by a bank, enabling a small business that is turning a corner after a rough period to qualify for some capital. Others, such as online provider On Deck (see profile), alter payment structures – offering daily payments tied to cash flow, as opposed to one monthly payment – enabling a business to better manage debt and other expenses. Mission-driven organizations – CDFIs (see profile) and other nonprofit lenders – generally consider the social impact of a business, such as its ability to create jobs in a distressed community, as well as its solvency in the lending decision.

To be sure, the work of nonprofit providers is often subsidized by public (e.g., the CDFI Fund and SBA) and private (e.g., foundations and corporations) sources, which enables these providers to absorb higher loss rates than banks, ranging between 5 percent to 10 percent, whereas 1 percent to 2 percent is a general rule of thumb for banks. The subsidy also covers the costs of technical assistance (TA) to unseasoned borrowers, or those who need advice as they work through challenging times. As one microlender reflected, "For us to do 300 loans, we need to raise $1.6 million in operating grants" – a subsidy of almost $5,000 per loan, covering the costs of administration as well. For 504 Certified Development Companies, the financing comes from SBA-backed bond sales. The 504 lenders are able to offer lower interest

### Chart 3: SBA 7(a) loans 2005-2011 – number of loans/average loan size




**Source:** NAGGL.

## Factors

Factoring, one of the oldest forms of business financing, is very common in certain industries, such as the textile industry, where long-term (i.e., longer than the 30-day cycle common to most businesses) receivables are part of the business cycle. When using factoring, a business owner will sell accounts receivable at a discount to a third-party funding source to raise capital.[23] In a typical factoring arrangement, the client (the small business) makes a sale, delivers the product or service, and generates an invoice. The factor (funding source) buys the right to collect on that invoice by agreeing to pay the client the invoice's face value less a discount – typically 2 percent to 6 percent of the invoiced amount (potentially leading to 24 percent to 30 percent APRs). The factor pays 75 percent to 80 percent of the face value immediately to the business and forwards the remainder (less the discount) when the customer pays the invoice. According to one factor, the works better for businesses with revenues under $500,000[24] because a smaller company has a harder time financing growth internally (due to a lack of available cash) and externally, since their small size and fast growth increases their risk profile in the eyes of a bank. A factor can finance this growth because the credit burden is on the business that is buying the product, not on the (small) business that is providing the product. Factoring is unsecured, and "nonrecourse." If the business doesn't pay the invoice, then the factor has no recourse against the supplying business.

## Merchant cash advance provider

Merchant cash advances (MCA) provide capital in exchange for a share of future credit card sales. MCA is most typically used by retailers, restaurants, and other small businesses where a large number of customers pay with credit cards, and may serve to replace a working line of credit. Advance providers offer small business owners up-front, unsecured capital in exchange for the right to collect a portion of their future credit card sales as those sales are made. Most MCA providers are national in scope and many offer the products online. Sixty percent of customers served by the MCA industry are restaurants – a sector that the banking industry has struggled to serve due to its perceived riskiness. MCA clients have an average credit score of 650 – below what many banks are reportedly comfortable with today.[25] Average advances are small, approximately $20,000, and carry a discount rate of approximately 30 percent over a six to 12 month term, reflecting that these providers supply an amount of capital that is needed by businesses, but not cost effective for banks to provide. Cash advances are not covered by lending laws because they are structured as sales of future income.[26]

rates because investors accept a lower rate of return – the February 2012 504 20-year debenture rate was 2.63 percent.[27] For-profit providers, such as factors and merchant cash advance lenders who do not benefit from or have access to subsidy, often charge high rates for their unsecured capital – approximately 30 percent for MCAs and 2 percent to 6 percent of the invoice amount for factors.[28] The nonbank, nonregulated entities profiled in this article "price" the increased risk and higher loss rates into their business models by charging higher interest or fees, or by raising subsidy.

As much as alternative providers use metrics that expand the definition of "creditworthy," they do not finance everything that is within their capacity to finance, and some have altered their own tolerances for risk. Some have turned down borrowers that might have been approved prior to the recession. For example, some nonprofit providers speak of looking more carefully at businesses that are reliant on disposable income (e.g., restaurants, beauty salons, or car washes) whose cash flow may be impacted during a recession. Even some of the most aggressive providers of capital, such as merchant cash advance providers, have become more conservative in their underwriting, given that advances are based on future credit card sales, and in a recession there is increased risk that those sales may not materialize. And, nonbank providers are quick to point out that they do not lend to businesses in distress. Although a business – even in distress – may qualify for financing, providers recognize that putting such a business owner into further debt or tying them into commitments that may extend beyond the life of their business is not in anyone's interests.

**Finding 3:** *The shift of borrowers from bank to nonbank institutions suggests that nonbank entities play an auxiliary role to banks when bank credit is less available.*

Most alternative providers are accustomed to absorbing clients that banks would see as high risk, based on credit score, collateral levels, cash flow, time-in-business, and other factors considered during a bank underwriting process. These include businesses in particular industries, like restaurants, that make up 60 percent of the businesses using merchant cash advances.[29] Or they include businesses with irregular payment cycles, such as those that experience quick or seasonal growth, or have long payment cycles, such as textiles businesses, which comprise many factoring company customers.[30] In addition, many nonbank lenders lend amounts much lower than banks can profitably lend. The nonprofit lenders interviewed provide loans ranging from as little as $500 to $100,000. While SBA will insure 504 loans as high as $5.5 million, they will also go as low as $50,000 for commercial real estate – a level that is under the lower limit of most banks. The average merchant cash advance is $20,000.[31] Banks are an important source of referrals for nonbank providers who work with customers that do not qualify for bank underwriting. This symbiotic relationship is especially important during credit contractions when banks wish to retain a depository relationship, but are unable to provide financing, and the alternative providers do not have the capacity to individually source deals.

## Online resources

Online resources have emerged as a new piece of "infrastructure" that exists outside of the banking system. For example, On Deck has an underwriting model that works to match the payment capacity to the cash flow patterns of the small business borrower. On Deck started in 2006 as a financial technology lending platform with the potential to aggregate data to provide a more accurate cash flow assessment, resulting in a daily loan payment servicing system. A typical On Deck borrower is a community-based business – a florist, restaurant, car repair shop, gas station, or doctor's office, for example – with strong cash flow but little collateral. Most of On Deck's borrowers have been in business more than nine years, have around $1 million in revenue, and have credit scores above 600. When using its own capital, On Deck offers unsecured loans in amounts ranging from $35,000 to $150,000, terms ranging from three to 18 months, a turnaround time of about a week, and rates similar to a credit card.[32] On Deck increasingly works as an intermediary leveraging their proprietary underwriting platform to help banks and other providers, including CDFIs, underwrite difficult deals.

Biz2Credit (B2C) is an online financial intermediary, established in 2007 to match prospective borrowers with an appropriate form of credit, including alternative providers. The business originally targeted minority and immigrant business owners. With the onset of the recession, B2C's market expanded dramatically, and they currently process between 8,000 and 9,000 funding requests a month ranging from $25,000 to $3 million.[33] Functioning similarly to a broker, B2C serves exclusively small businesses, linking them to traditional sources of credit – both large and small banks – as well as alternative providers, including CDFIs, credit unions, factors, merchant cash advance providers, and others.

In some cases, businesses fall outside of banks' lending guidelines because of a lack of business training or experience on the part of the loan applicant, in addition to subpar credit scores and collateral. Bankers recognize that many small businesses benefit from TA in addition to financing. Alternative lenders often provide TA beyond what banks can offer. Many banks do not have the expertise or cannot bear the development and other costs of special small business finance programs, especially those focusing on reinvestment areas. Going a step further, some banks assist neighborhood nonprofit organizations and community-based development corporations by funding operating costs for TA to small businesses in their communities. The motivation is both the Community Reinvestment Act (CRA) and the efficiency gained by offloading counseling to an entity that can access subsidy and has local market familiarity. According to the 2008 CDFI Data Project, 65 percent of capital raised by nonprofit loan funds is borrowed; the vast majority of that capital derives from banks that ostensibly receive CRA credit for the investment.[34]

Since the financial crisis, the characteristics of small businesses financed through the banking system, versus those that are

### The Chicago Microlending Institute

In an effort to increase access to business credit, a group of institutions recently came together to create a citywide network of community-based, nonprofit, small business lenders. Accion Chicago joined the City of Chicago, Citibank, and the Searle Funds at The Chicago Community Trust to create the Chicago Microlending Institute (CMI). CMI – the first entity of its kind – is a partnership of public, private, and nonprofit organizations that leverages Accion's microlending expertise to provide technical assistance and start-up capital to build a small business lending infrastructure in Chicago. CMI will provide training and start-up capital to two nonprofit organizations to begin microlending in the first year of this initiative. CMI will also provide best practice consulting to other nonprofit organizations interested in microlending and/or improving their existing lending operations.

Small businesses with five employees or less employ over 20 percent of Chicago residents. These businesses have the potential to create jobs in the neighborhoods they serve, but often lack the financial resources needed for growth. Without a capital infusion, many of these small businesses will fail to reach their full potential. However, Accion estimates that it currently reaches only 5 percent of the demand for small business microloans in the Chicago market. Thus, the training and capital provided by CMI will be instrumental in expanding the capacity of organizations that work with small businesses which are creating jobs throughout the city's communities.

The $1 million investment from the city of Chicago, along with funding from Citibank and the Searle Funds at the Chicago Community Trust, is projected to result in a combined 280 business loans totaling $2.8 million over the next four years, creating or maintaining an estimated 850 jobs and providing more than $14 million in payroll to employees.

financed by nonbank entities, have become less distinct. Businesses that used to seek credit at mainstream banks are working with nonbank providers. Microlending portfolios used to comprise almost entirely "mom-and-pop," home-based, and start-up businesses have expanded their lending to business owners with higher credit scores and more experience in business. These are business owners who formerly qualified for bank financing. The evidence comes from both anecdotal accounts, as well as from data collected by alternative lenders. For example, the online intermediary Biz2Credit (B2C) (see profile) reports that, "Initially we were getting people who couldn't get financing anywhere, now we are getting people who would normally get financing from banks," and that most borrowers were rejected by the primary bank before they came to B2C.[35] In addition, the percentage of approved borrowers at Accion Chicago with credit scores over 700 increased from 2 percent to 20 percent between 2006 and 2010 (before falling to 16 percent in 2011). Data provided by Accion shows the percentage of borrowers with credit scores under 600 fell from 49 percent to 27 percent (chart 4).

Accion Chicago is also serving an increasing number of existing businesses. The median time in business of a borrower has increased from 1.5 years in 2008 to 2.4 years in 2010, an increase of 56 percent, indicating that even businesses that might be able to provide the financial history required by banks have migrated to other sources. Average time in business of online intermediary B2C applicants is slightly more than two years with an average credit score of just above 680.[36]

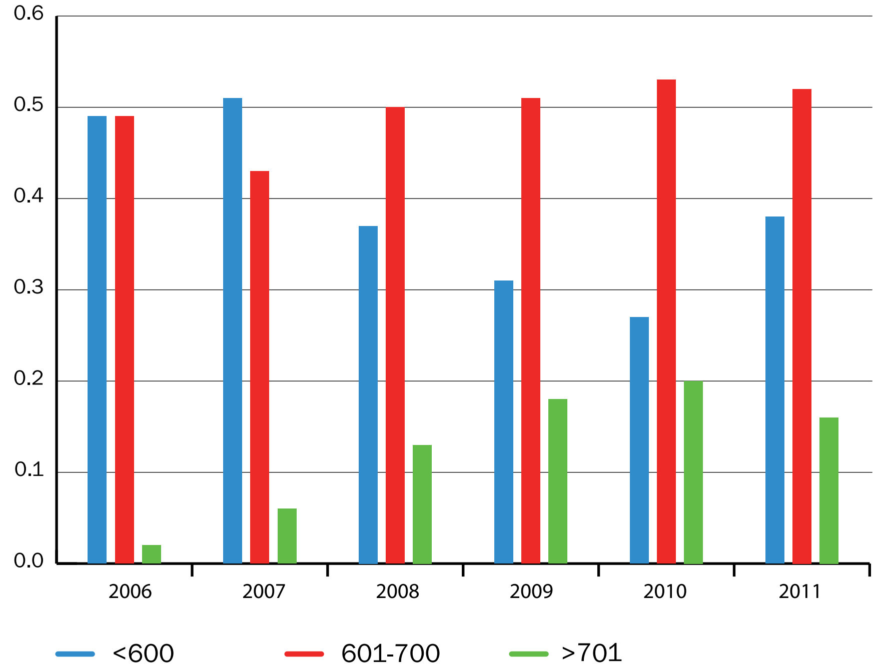
This casts nonbanks in a complementary role in terms of their interaction with traditional banks. To the extent that resources allow, they pick up small business customers when bank underwriting tightens and credit is in shorter supply through traditional institutions. To be sure, the aggregate lending from nonbanks is much less than that from the banking system: the largest microenterprise lender in Chicago closed 301 loans in 2011, totaling just over $2 million. The merchant cash advance industry amounts to $750 million a year in purchased receivables (over 60 percent of which would never have been funded by banks due to low credit scores or industry risk, according to industry leaders). They help fill the gap between $25,000 and $125,000. Some nonbank entities also report to the credit bureaus to build the credit scores and "bankability" of their customers, supporting the longstanding premise that part of the mission of CDFIs is to move their clients toward access to mainstream financial services. Finally, none of the providers interviewed for this article seek to supplant the depository relationship between a bank and a small business owner, reinforcing the complementary relationship that exists between nonbank providers and mainstream financial institutions.

## Implications

A key implication of our findings is that more support could flow to small businesses if more nonbank small business intermediaries had more resources. The largest microenterprise organization in Chicago estimates that it reaches just 5 percent of the market for microloans. The number of deals it can process is based entirely on how many loan officers it has, and its ability to either hire or develop skilled staff depends on securing sufficient operating subsidy.

Policymakers involved in the wave of new small business initiatives understand that nonbanks are important sources of credit for small businesses. Much of the recent federal support for small business lending is aimed at nonbank entities. The U.S. Department of the Treasury's Small Business Lending Fund made loan capital available to both nonprofit community development organizations and community banks.[37] The Treasury's CDFI Fund has remained a constant provider of both capital and TA support for (nonbank) CDFIs, including those that serve small businesses, and received unprecedented additional support through the American Recovery and Reinvestment Act.[38] In addition, the SBA, through its microloan, community advantage and 504 programs, has successfully channeled additional funds and guarantees to nonprofit community lenders.[39]

### Chart 4: Accion Chicago percentage breakdown in borrower credit scores – 2006-2011




**Source:** Accion Chicago.

Private initiatives, such as the Goldman Sachs 10,000 Small Businesses program, provide both training and capital to small, existing businesses through CDFIs and local community colleges.[40]

But additional resources are not the only thing alternative providers need to enhance the amount of credit they can offer to small businesses. An overarching challenge to helping small businesses is the condition of the greater social and environmental context for small business development and growth. In order for small, community-based businesses to thrive, they must be part of a viable local market, with busy commercial corridors, stable home prices, and quality employment for residents. A significant impact can be made in weak economic times by investing in community infrastructure, as well as people and technology, but in the current economic climate, resources remain scarce.

Importantly, technology and the Internet have allowed alternative lenders and TA providers to leverage significantly their ability to deliver credit and services. Online credit intermediaries catering to small businesses gained visibility through the recession with their ability to use technology to link small businesses with sources of capital. With excess capacity, these resources, available only through the Internet, may serve as models to expand small business credit (and TA) delivery, especially in rural or other underserved markets. In the future, capacity building may become less of an issue at community-based entities if the field moves in the direction of online providers, although national providers do not share the local knowledge of community-based entities, and do not offer the TA component that community-based lenders provide to small businesses.

## SBA 504 Loan Program

The SBA CDC/504 loan program is a long-term financing tool, designed to encourage economic development within a community. The 504 program accomplishes this by providing small businesses with long-term, fixed-rate financing to acquire major fixed assets for expansion or modernization. The 504 program serves small businesses requiring "brick and mortar" financing. Access to the SBA 504 program is provided through a Certified Development Company (CDC), a private, nonprofit corporation set up to contribute to economic development within its community. The typical structure of a 504 loan is 50/40/10: the bank provides 50 percent of the capital, the CDC 504 is in second position providing 40 percent of the capital, and the business owner must contribute 10 percent equity. As a result, the bank's exposure is reduced and the business owner is only required to contribute 10 percent, as opposed to the 20 percent or more in a standard structure[41] (chart 5). In addition, the interest rate on the 40 percent second lien provided through the 504 program is well below market (2.63 percent in January 2012), further improving the cash flow position of the borrower. The 504 program also contains a statutorily-mandated job creation component, a community development goal, or a public policy goal achievement component, to help facilitate job creation.[42] SBA 504 loans range between $50,000 and $5.5 million to finance projects usually between $250,000 and $15 million.[43]

**Chart 5: Structure of a 504 loan – typical example ($1 million project)**

| Conventional Financing | | | Financing with 504 Program | | |
|---|---|---|---|---|---|
| Conventional Lender | $750,000 | 75% | Conventional Lender | $500,000 | 50% |
| Borrower Contribution | $250,000 | 25% | SBA 504 Loan | $400,000 | 40% |
| **Total** | $1,000,000 | 100% | Borrower Contribution | $100,000 | 10% |
| | | | **Total** | $1,000,000 | 1% |

**Source:** SomerCor 504 Inc.

## Conclusion

This article presents some of the key themes from discussions with over a dozen providers of small business credit and services, and other small business experts, and considers the roles of these nonbank financial entities in the current credit contraction. When mainstream institutions tighten credit qualifications for small businesses and lending volume falls, a variety of alternative financial service providers fill credit gaps, either directly or through participations and guarantees with bank lenders. Drawing from the data and interviews, it is clear that nonbank, alternative providers of capital are seeing an increase in formerly bankable clients. These providers employ various alternate methods to determine creditworthiness, and apply different underwriting metrics, pricing the risk into their credit products or raising subsidy to offset it. Nonbanks offer a back-up option for at least a segment of the market, enabling small businesses to potentially transition to mainstream institutions in the future. Ultimately, the extent to which small business credit and TA intermediaries can grow their human and financial capital (and thereby capacity) to help small businesses get financing – in both good and bad economic times – depends on how public, private, and philanthropic resources can be directed to craft meaningful interventions.

## Notes

1 Small Business Administration: http://www.sba.gov/content/what-sbas-definition-small-business-concern. SBA defines a small business concern as one that is independently owned and operated, is organized for profit, and is not dominant in its field. Depending on the industry, size standard eligibility is based on the average number of employees for the preceding 12 months or on sales volume averaged over a three-year period.

2 Bureau of Labor Statistics. See http://www.BLS.gov.

3 The National Bureau of Economic Research defines the most recent recession as lasting from December 2007 through June 2009. According to CRA data, loans to businesses with less than $1 million in revenue fell by 53 percent in dollar amounts and 71 percent in total number of loans originated between 2007 and 2010.

4 "Addressing the Financing Needs of Small Businesses: Summary of Key Themes from the Federal Reserve System's Small Business Meeting Series," July 21, 2010.

5 Lenney, William, "The Business of America Is Small Businesses," available at http://www.fedpartnership.gov/federal-reserve-resources/business-of-america-is-small-businesses.pdf.

6 "Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices," available at http://www.federalreserve.gov/boarddocs/SnloanSurvey.

7 Congressional Oversight Panel, 2010, "The Small Business Credit Crunch and the Impact of the TARP," May 13.

8 National Federation of Independent Business, "Small Business Economic Trends Survey," available at http://www.nfib.com/research-foundation/surveys/small-business-economic-trends.

9 "Addressing the Financing Needs of Small Businesses: Summary of Key Themes from the Federal Reserve System's Small Business Meeting Series," July 21, 2010, available at http://www.federalreserve.gov/newsevents/conferences/sbc_small_business_summary.pdf.

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13 Data provided by Accion Chicago.

14 CDFI Market Conditions Report, Second Quarter 2011, available at www.opportunityfinance.net. (Data not collected prior to Q4 2008.)

15 With the implementation of two new loan initiatives – Small Loan Advantage and Community Advantage – the Community Express Program ended on April 30, 2011. See SBA's December 15, 2010, press release for more information.

16 Small Business Administration, "Advantage Loan Initiatives," available at http://www.sba.gov/advantage. "SBA and U.S. Department of Commerce studies have shown the importance of low-dollar loans to small business formation and growth in underserved communities.... In line with that, SBA is rolling out two new initiatives on February 15, 2011, aimed at increasing the number of loans in these communities." Because these two loan products were launched in 2011, data is not yet available. Both loan types offer loans up to $250,000.

17 The CDFI Fund enables locally based organizations to further goals, such as economic development (job creation, business development, and commercial real estate development); affordable housing (housing development and home ownership); and community development financial services (provision of basic banking services to underserved communities and financial literacy training). To learn more about CDFIs, visit www.CDFIFund.gov.

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30 Udell, Gregory, 2004, Asset Based Finance: Proven Disciplines for Prudent Lending, Commercial Finance Association, p. 83.

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33 2011, interview with Biz2Credit, December 1. See http://www.biz2credit.com.

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37 U.S. Department of the Treasury, "Small Business Lending Fund" (enacted as part of the 2010 American Jobs Act), available at http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx.

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41 SBA, "CDC/504 Loan Program," available at http://www.sba.gov/content/cdc504-loan-program.

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43 SomerCor 504 Inc. See http://www.somercor.com.

## Biographies

**Susan Longworth** is a business economist in the Community Development and Policy Studies Division at the Federal Reserve Bank of Chicago.

**Robin Newberger** is a senior business economist in the Community Development and Policy Studies Division at the Federal Reserve Bank of Chicago.

# NCIF Annual Development Banking Conference:

## The CDFI banking industry – raising the bar for mission and profit

**By Saurabh Narain and Joe Ferrari**

### Introduction

The National Community Investment Fund (NCIF) held its Annual Development Banking Conference on November 2 and 3, 2011, at the Federal Reserve Bank of Chicago. The conference brought together 160 CEOs, investors, regulators, and other stakeholders from the Community Development Financial Institution (CDFI) banking industry to share knowledge and discuss issues around the theme of "Mission and Profit: Raising the Bar." There were seven panels over two days that centered on topics addressing how these institutions can continue to serve their community development mission while operating in an increasingly challenging economic climate and under heightened, post-crisis regulatory scrutiny.

NCIF convenes the Annual Development Banking Conference in order to share information on new ideas, opportunities, and challenges within the CDFI banking industry to its key stakeholders. This effort is intended to help shape a path forward for an industry that has significant and measurable impact in many of the nation's poorest communities. These effects are not broadly understood by those outside of the communities in which CDFI banks serve, so the conference in part offers the opportunity to "tell the story." As this message becomes more focused and targeted, it increases the potential to grow the development banking industry and by extension the capacity of CDFI banks' to serve low- and moderate-income communities.

> **"I believe that at times like these—especially at times like these—when we are filled with doubt and hesitation, and can hardly make out the road before us, we cannot just stop and wait for the way to become clear. We will never move forward if we simply stand still."**
>
> **- Director, Donna Gambrell, CDFI Fund**

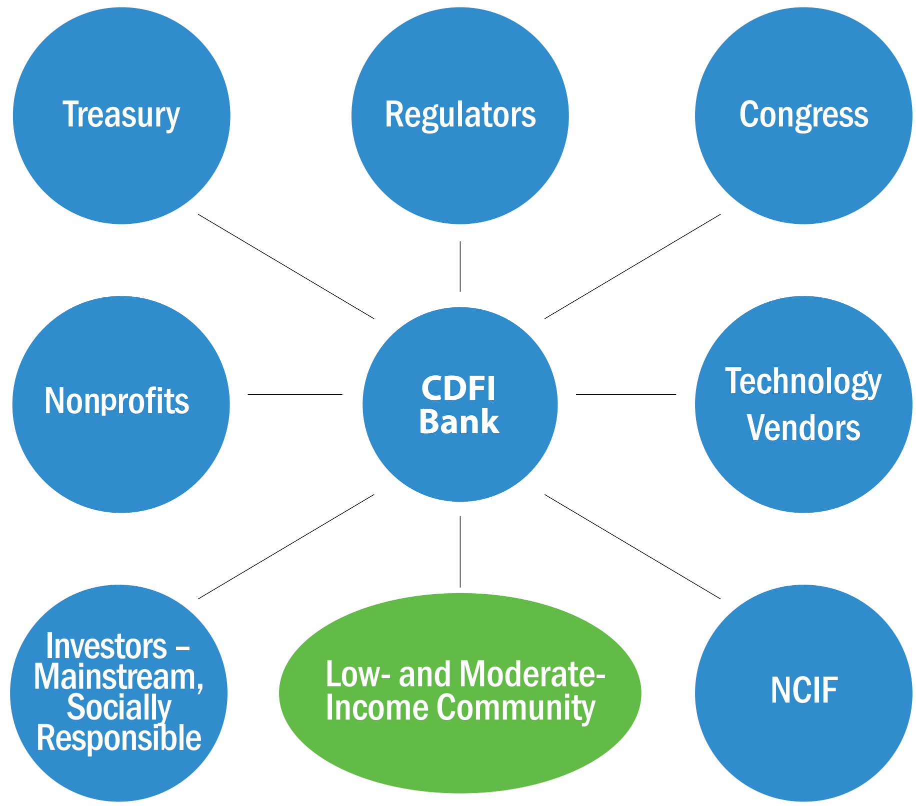
NCIF's conference is also designed to stress the need for collaboration within the areas critical to the CDFI banking industry, specifically capital raising, governance, best practices, technology, and sharing information about successful ideas, products, and practices.

This article highlights themes from the panels, as well as the major takeaways from the conference for stakeholders in the CDFI banking industry. There is also a section discussing the major ideas from keynote speeches provided by: Sandra Thompson, director, Division of Risk Management Supervision at the FDIC; John Hale III, deputy associate administrator, Office of Capital Access, Small Business Administration; and Donna Gambrell, director of the CDFI Fund.

### Conference opening and themes

Michael Berry, director of policy studies at the Federal Reserve Bank of Chicago, opened the conference by stressing that as the lead sponsor of the NCIF conference for six straight years, the Chicago Fed is committed to assisting NCIF in its mission to help grow and strengthen the CDFI bank sector. He highlighted the community development activities of the Chicago Fed, such as providing technical assistance on the Community Reinvestment Act (CRA) and other regulations, research on government policy and trends impacting disadvantaged populations, and assistance in creating products and services for low- and moderate-income communities. The Community Development and Policy Studies department has focused a good deal of research on policy and economic conditions related to CDFI banks, and they have recognized the significant, positive impact these institutions have in their communities. Mr. Berry emphasized the commitment of the Chicago Fed to help grow the number of CDFI banks in the coming years.

**Figure 1: The CDFI bank ecosystem**




Saurabh Narain, chief executive of NCIF, gave a presentation on the current state and probable future of the CDFI banking sector that focused on six strategic goals and one aspiration. These goals were determined based on industry engagement of 46 participants via interviews, surveys, and a day-long strategic planning workshop.

Taking the CDFI banking industry to substantial scale is a key aspiration for the sector. The six strategic goals that were cited are:

- Elevate recognition across stakeholder groups – investors, regulators, public and private partners – that CDFI banks are double bottom line (i.e., having both mission and profit goals) financial services leaders;
- Build a CDFI banking industry advisory/transactional service provider or investment banks to support the sector;
- Promote social performance impact measurement standards and CDFI certification;
- Create high performance collaborations to address various key, distinct issues;
- Enhance the CDFI brand; and
- Implement leading-edge technology, both customer facing and back office.

Continuing, Mr. Narain presented a vision of the probable future of the CDFI banking sector that arose from the strategic planning process. This "probable future" includes a highly networked industry, working together to form collaborative business models for capital raising, operations, impact measurement, and communications. An initial step towards this future will involve the upcoming CDFI Bond Guarantee Program. This program has the potential to inject enormous liquidity into the sector. Mr. Narain emphasized NCIF's desire to facilitate collaboration between CDFI banks to leverage the program, which was explored in more detail during a later panel. Mr. Narain provided some background on the current CDFI bank ecosystem, which is an intricate web of relationships between the bank, regulators, nonprofits, and others.

## The CDFI bank ecosystem

In the current environment, CDFI banks are working in silos, diligently focused on their own communities, their own mission, and operating profitably. Mr. Narain stressed that through collaboration and effective networking, CDFI banks can help develop economies of scale and foster innovation, build shared knowledge and effective best practices, while covering areas of common concern, including capital raising, risk management, finding liquidity for investors, government funding, impact measurement and brand building, technology, shared services, and research.

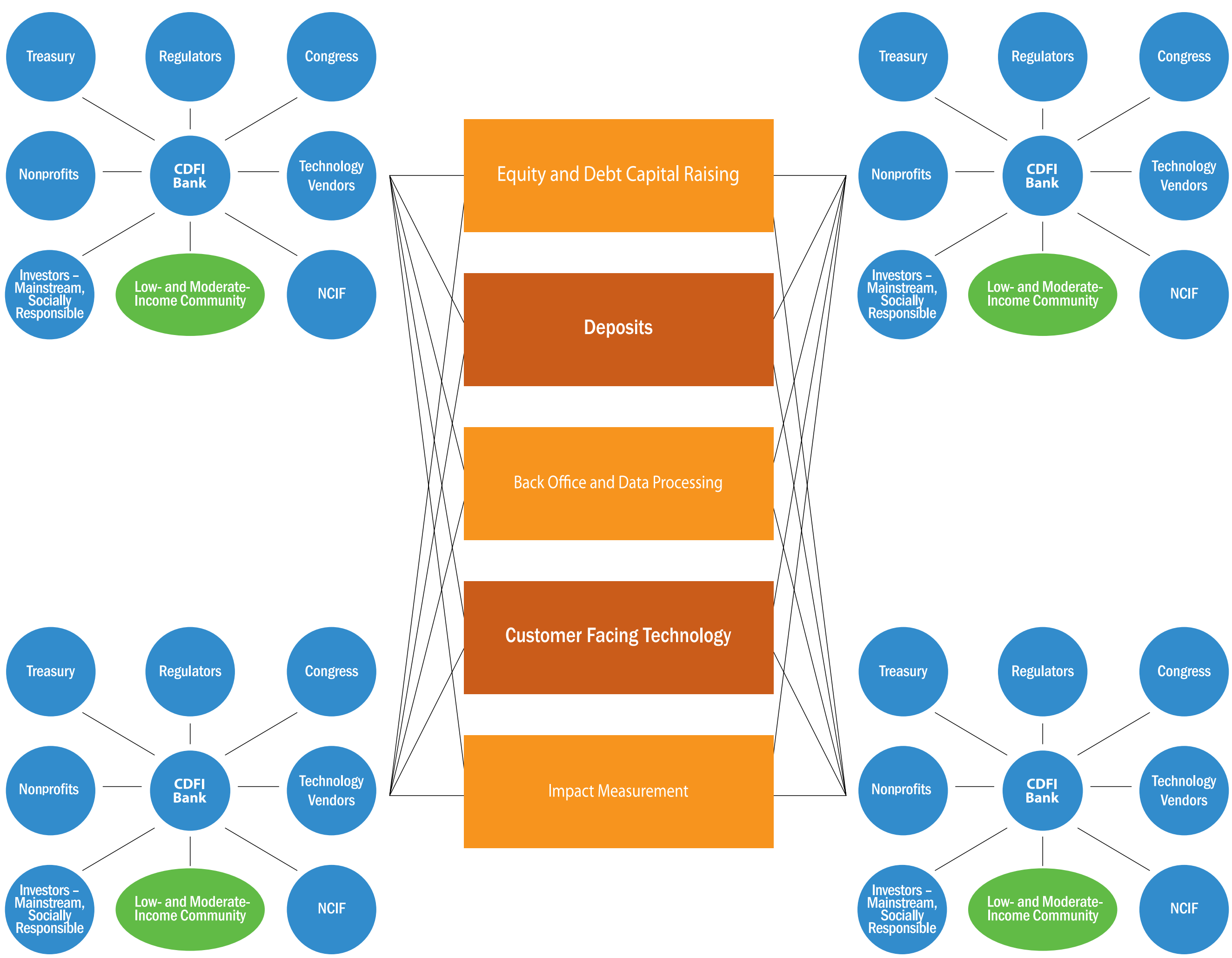
## Collaborative business models in action

Due to the geographical distribution of CDFI banks, and their relatively small service areas, they rarely compete directly with one another. Collaboration offers geographically diffuse but like-minded institutions the opportunity for higher visibility, greater financial strength, and more social impact. Mr. Narain stressed that NCIF welcomes the chance to work with CDFI banks (and aspiring CDFI banks) for the betterment of the industry.

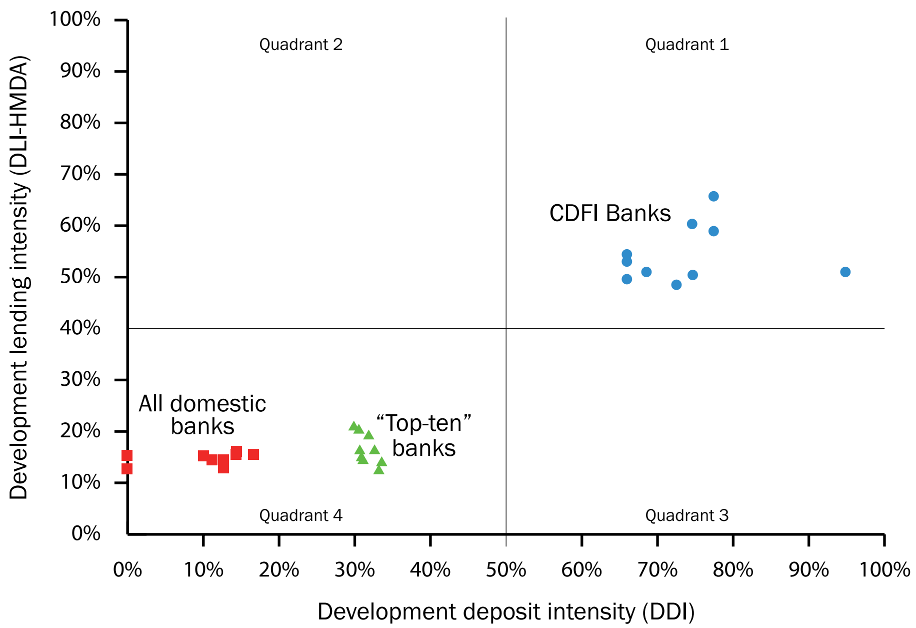
Finally, he focused on the idea of "telling the story" of CDFI banking, which is that the industry needs to work cooperatively to achieve the strategic and aspirational goals he set forth. Mr. Narain discussed the need for CDFI banks to work together to measure and communicate the impact they have in their communities in a clear, transparent, and efficient manner to investors, regulators, and other stakeholders. At the median, CDFI banks rate three times higher on NCIF's DLI-HMDA[1] (Development Lending Intensity – HMDA) metric compared to banks generally (denoted as "all domestic banks"), and four times for DDI[2] (Development Deposit Intensity) when compared to banks generally. This implies that, at the median, the CDFI banks have three times more housing lending originated in low- and moderate-income areas, and have many more branch locations providing very scarce savings and lending related services in these same areas.

He stated that the CDFI banking sector should commit to collecting data for these and other metrics that illustrate their significant, positive

### The CDFI bank collaborative business model



## Chart 1: Ten-year quadrant chart CDFI banks and peer groups




**Source:** DDI based on 2010 Summary of Deposits and Census data, available from www.fdic.gov and www.ffiec.gov. DLI-HMDA based on 2010 Home Mortgage Disclosure Act data, available from www.ffiec.gov.

impact in low-income communities. For example, chart 1 details how for the past 10 years, when plotting the Social Performance Metrics of CDFI banks compared to all banks and the top 10 ("Top-Ten") banks by assets, CDFI banks have routinely maintained a significantly higher level of social impact performance.

## The story and the plan for CDFI banks

The first panel focused on the idea of "telling the story" of CDFI banking, featuring Raj Gupta, professor at the Kellogg School of Management, as moderator, and panelists: William Farrow, president and CEO of Urban Partnership Bank, IL; Deborah C. Wright, chairman and CEO of Carver Federal Savings Bank, NY; Preston D. Pinkett III, CEO of City National Bank of New Jersey, NJ; and Leigh Anne Russell-Jones, treasurer of United Bank, AL. The panelists discussed their experiences as CDFI banks in the current economic climate, what challenges they face as the sector grows, and how they are taking advantage of new opportunities and organizing behind shared goals and strengths. Some themes that came out of that discussion were that investors and regulators do not recognize the double bottom line of CDFI banks and often do not fully understand the business model. There is a lack of knowledge about the work that CDFI banks are doing, and how the regulators view them versus traditional banks, and what types of financial – versus social – return investors can expect from these institutions. All of the institutions that were represented on the panel operate in economically distressed communities, serving those often most affected by the current economic climate in a responsible manner, and doing so under the same regulatory restrictions as traditional banks. These institutions generate reasonable financial returns in normal times, and the panel stressed that creating a compelling story that captures both social and financial outcomes will help attract investment to fuel the growth and impact of the CDFI banking industry.

## Equity and deposits: Capital raising

The second panel consisted of investors, and focused on capital raising and the investor perspective. Laura Sparks, director of Development Finance Initiatives at Citi Community Development, moderated the panel. She framed the session by picking up on issues raised in the previous panel, specifically focusing on unique business models, and distinguishing the industry from the wider banking and investment community with regard to raising capital. Scott J. Budde, managing director of Global Social and Community Investing at TIAA-CREF, Ommeed Sathe, director of Social Investments at Prudential Financial, Inc., Dan Letendre, managing director of Global Social and Community Investing at Bank of America, and Frank Blanco of Keefe, Bruyette & Woods were the panelists. A key theme from this panel was that despite foundational interest in the sector due to its impact, there is a lack of private sector investment into CDFI banks due to liquidity and return issues. It was also clear that the compelling story of CDFI banking is still not widely known among potential investors, and that this is a major hurdle in trying to gain the attention of institutions seeking double bottom line returns. However, there was considerable discussion on services and products that mainstream institutions provide in

(continued on page 18)

## Keynote speeches

NCIF was also very thankful to have three esteemed keynote speakers, including Sandra Thompson of the FDIC, John Hale III of the Small Business Administration, and Donna Gambrell, director of the CDFI Fund, who all reiterated their organizations' support for the CDFI banking industry.

### Sandra Thompson, director, Division of Risk Management Supervision, Federal Deposit Insurance Corporation

Ms. Thompson opened the conference and focused on how the FDIC takes particular interest in issues impacting the CDFI banking industry. She talked about goals, and how she wants to see the status of the community banking sector as key to providing financial services in low- and moderate-income communities. As she put it: "CDFIs are catalysts for community development, and this economic climate is an opportunity to expand impact. New products and services represent an opportunity to recapture the business of unhappy customers. No one understands communities better than local banks."

### John Hale III, deputy associate administrator, Office of Capital Access, U.S. Small Business Administration

Mr. Hale gave a keynote address stressing that the central theme of the SBA is job creation and the ARRA, SBA, and the American Jobs Act have all focused on and are determined to press the economy forward. He highlighted that 200 lenders have returned to the SBA program and they have exhausted their $17 billion authority for the first time in history. The SBA relies on community banks to reach this goal, and he reported that of the 86 CDFIs that are SBA microlenders, 75 are CDFI banks. Both of those numbers are too low, and he believes there is tremendous opportunity for collaboration.

He discussed several SBA programs that CDFI banks might be able to leverage, including the microloan program, which has a maximum loan limit of $50,000, and the Community Advantage Program (CAP), which allows CDFIs to access 7(a) loan funds.

Mr. Hale said there was a high cost to becoming involved in SBA lending, so an economy of scale and utilizing shared resources would be helpful for the industry. CDFI banks who have successfully leveraged the program would be good leaders within the CDFI banking industry in collaborative efforts for more banks to become involved. He said that in the future there would be increased SBA lending and support for the CAP program, which will grow resources for mission based CDFI banks.

### Donna Gambrell, director of the Community Development Financial Institutions Fund at the U.S. Department of the Treasury

Ms. Gambrell opened the second day of the conference by offering guidance and support for the CDFI banking industry that is weathering one of its most difficult years and witnessed the failure of several CDFIs. She focused on the resiliency of the industry by encouraging institutions to embrace their unique position to continue to create considerable impact in the communities that have been most affected by the crisis, and to take advantage of new opportunities for growth that the economic landscape offers.

She suggested that the worst of the crisis was over, but the impact on LMI communities, such as rapid deterioration as a result of widespread foreclosures, remain considerable challenges that the CDFI banking industry is positioned to address. She accepted that there are fundamental questions around the balance of mission and profit, to looking ahead or to simply hold on, to survival or raising the bar. She said that there must be transformation from something that is merely possible into something that is real, enduring, and sustainable. She recognized that NCIF provides a forum for discussing practical steps to achieve that transformation.

Despite the difficulties facing the CDFI banking industry, she provided three reasons to be optimistic:

- **Power of innovation.** The industry is creating a new road map by developing a capacity for innovation to face new challenges. CDFI banks are improving capital raising, recruiting, and developing management. Ideas from last year's NCIF conference, like shared services and backroom offices are an example. At Urban Partnership Bank, the ShoreBank legacy is being carried on, while developing a new business network, microbranches, and a financial service center for nonprofit customers only one year after the acquisition.

- **Power of collaboration.** The difficult work that NCIF is doing via the Social Performance Metrics focuses the strengths, financial position, and trajectory of the CDFI banking industry message. When expertise and resources are combined, reach is extended, and impact is multiplied. NCIF has been a leader in facilitating this collaboration.
- **Power of vision.** Capital can be an instrument of compassion. It can be an uplifting way for communities to achieve self-sufficiency. People bring this idea into their communities and that vision has spread.

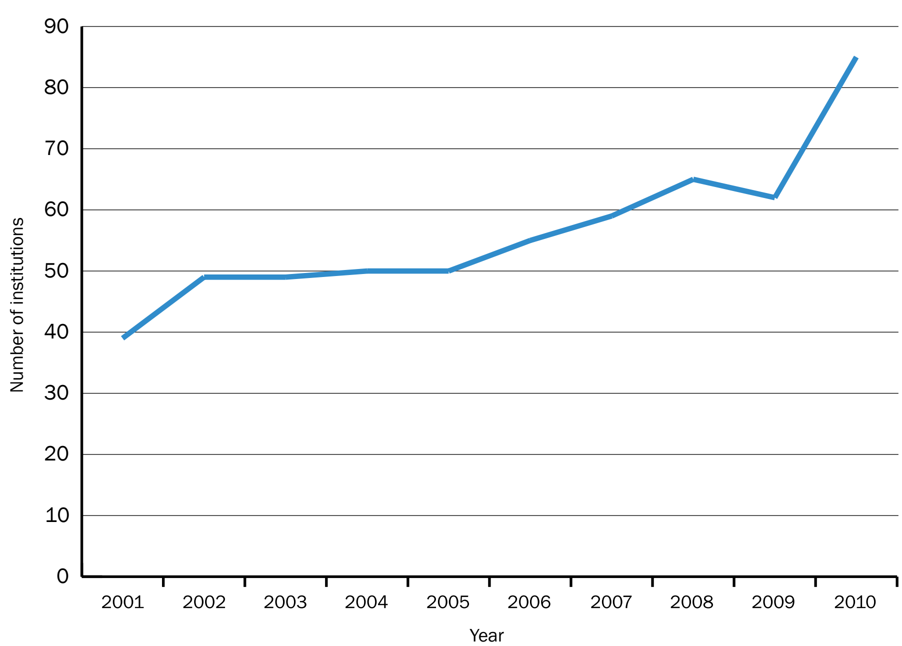
Ms. Gambrell said that the CDFI Fund will support organizations that represent those three powers. They will continue to advocate for increased funds for the critical role CDFI banks play. Their Capacity Building Initiative provides training and assistance to CDFIs. The BEA, FA, and NMTC programs are essential for CDFI banks, and the new CDFI Bond Guarantee program will be a game changer.

She recognized that issues affect CDFI banks differently than other organizations for financial assistance grants. Only two were awarded last year, but they want to make sure there is geographic and institutional diversity. Each year they are dealing with different dynamics, but she urged the industry to continue to apply for these programs.

She concluded by saying that the vision of the industry is its life blood, its strength, and what communities and their own employees embrace. She said that even in difficult times there is a way out and way up. Ms. Gambrell is proud of the work being done and emphasized that it was a key time for collaboration.

low- and moderate-income (LMI) communities versus what CDFI banks provide. The speakers suggested that CDFI banks could experiment with models of collaboration and strategic partnerships with the larger institutions to address this gap. A synergistic model will help the banks grow, and as a more cohesive story develops surrounding the impact CDFI banks are having in these communities, there is potential to increase investments from stakeholders in these communities.

## Chart 2: Number of CDFI banks




**Source:** NCIF, CDFI Fund.

## NCIF Social Performance Metrics and impact of CDFI banks

The next panel focused on the impact CDFI banks are having, and what metrics can be used to articulate this message to a broader audience. Joe Schmidt, vice president of NCIF, moderated the panel, which consisted of James Greer, senior research analyst at the CDFI Fund, and Robin Newberger, senior business economist at the Federal Reserve Bank of Chicago. They each discussed their research on CDFI bank impact, and highlighted the need for more

NCIF NATIONAL COMMUNITY INVESTMENT FUND

# Development Impact Dashboard

COMMUNITY DEVELOPMENT CDBI BANKING INSTITUTION

CARVER FEDERAL SAVINGS BANK

75 West 125th Street
New York, NY 10027

Established 01/01/1948
www.carverbank.com

Exchange/Ticker: NADAQ: CARV
Branches: 9

## Impact Indicators:

| | |
|---|---|
| Quadrant: | 1 |
| Certified CDFI: | Yes |
| Certified MDI: | Yes |
| Explicit CD Mission Statement: | Yes |
| CRA Rating (2009): | Outstanding |

## 2010 Social Performance Metrics - Peer Comparison

*Based On Publicly Reported Data*


| | Carver Federal Savings Bank | CDFI Bank Median | All Bank Median | Top 10 Bank Median |
|---|---|---|---|---|
| DLI-HMDA | 76.50% | 54.22% | 15.94% | 14.97% |
| DDI | 66.67% | 66.67% | 16.67% | 31.20% |

**DLI-HMDA score was 76.50%:**

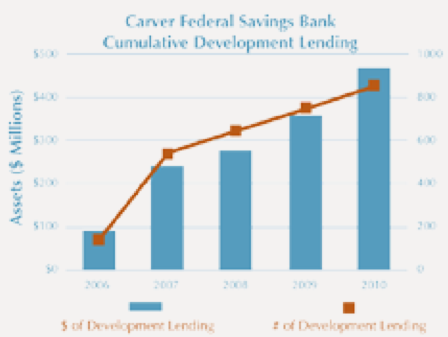
Ranks in the 96th percentile within the "All Banks" peer.

**DDI score was 66.67%:**

Ranks in the 87th percentile within the "All Banks" peer.

## 2010 Development Loan Reporting

*Based on Self Reporting*




| Carver Federal Savings Bank | DLI |
|---|---|
| DLI-All Loans | 72.06% |
| DLI-CRE | 69.88% |
| DLI-Housing | 81.57% |
| DLI-Small Business | 69.35% |
| DLI-Consumer | 100.00% |
| DLI-Agricultural | NA |

- For every $100 of total lending, $72.06 was lent to borrowers in low- and moderate- income communities.
- Since 2006, Carver originated **$364.4 million** in **823 loans** to low- and moderate- income communities.

**Definitions**

**DLI-HMDA:** Development Lending Intensity – HMDA is the % of HMDA reported loans located in CDFI Investment Areas. *Source: FFIEC. As of 2010.*

**DDI:** Development Deposit Intensity is the % of branches located in CDFI Investment Areas. *Source: FDIC. As of June 30, 2010*

**DLI-All Loans:** Development Lending Intensity – All Loans is the % of total annual lending located in CDFI Investment Areas. *Source: Self Reported by Banks. As of 2010.*

**DLI – Loan Category:** Development Lending Intensity – Loan Category is the % of lending in each loan category (CRE, Housing, Small Business, Consumer) located in CDFI Investment Areas. *Source: Self Reported by Banks. As of 2010.*

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collaboration within the CDFI banking industry to collect and disseminate data that shows how impactful the banks are. Mr. Greer's research showed the CDFI programs that CDFI banks leverage, including New Markets Tax Credits, Bank Enterprise Awards, and Financial Assistance, are concentrated in the most highly distressed communities. This indicates that CDFI banks are an effective conduit for these programs to reach financially underserved populations. Ms. Newberger focused on how the CDFI banking sector changed with the addition of the newly certified banks following the introduction of the Community Development Capital Initiative (CDCI), and the impact of, by definition strong – given screens to qualify for CDCI – institutions on the industry overall. Ms. Newberger's analysis (see chart 2) showed that the sector is stronger with the addition of the recently certified banks, but that many of the new banks are still struggling to reconcile the new mission focus with their traditional business models. However, Ms. Newberger found that there is a lot of overlap with the traditional products and services many of the new institutions offer with the types of services other CDFI banks provide to low- and moderate-income communities, so this could indicate that many of these institutions are already meeting double bottom line goals.

Mr. Schmidt drew attention to the Development Impact Dashboard that NCIF has created with the input of many CDFI banks (see page 24 for details on metrics). NCIF created a publication containing Dashboards for 16 institutions that was provided to all attendees. The Dashboard is a profile of a participating institution that provides a uniform report of data most important for presenting return and impact to investors. NCIF hopes to expand this work to many other institutions, and hopes that

NCIF National Community Investment Fund

CARVER FEDERAL SAVINGS BANK

Carver Federal Savings Bank, a certified CDFI was originally founded in 1948 as a minority thrift to address the financial credit needs of an underserved African American and Caribbean American community particularly in low and moderate income areas. It is currently the largest African American and Caribbean American managed bank in the United States.

## FINANCIAL HIGHLIGHTS ($000/%)

| End of Period | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | CDFI Median |
|---|---|---|---|---|---|---|
| Assets ($000) | $765,672 | $803,387 | $790,750 | $811,369 | $743,604 | $180,329 |
| Equity ($000) | $61,771 | $67,744 | $61,749 | $78,027 | $42,122 | $16,298 |
| Total Loans & Leases ($000) | $613,484 | $661,334 | $658,208 | $688,203 | $599,296 | $114,770 |
| Deposits ($000) | $634,391 | $648,314 | $622,566 | $589,112 | $592,207 | $155,104 |
| Net Income ($000) | $4,106 | $6,606 | $(2,785) | $3,002 | $(12,287) | $113 |
| Leverage Ratio (%) | 7.63 | 7.60 | 7.71 | 8.47 | 6.36 | 8.34 |
| NIM (%) | 3.43 | 3.69 | 3.37 | 3.68 | 3.58 | 3.72 |
| Efficiency Ratio (%) | 81.40 | 82.14 | 94.94 | 85.69 | 84.80 | 78.81 |
| ROAA (%) | 0.59 | 0.87 | -0.35 | 0.37 | -4.11 | 0.31 |
| ROAE (%) | 6.60 | 10.03 | -4.06 | 3.98 | -50.52 | 2.51 |
| NCLs/Total Loans (%) | 0.61 | 0.64 | 2.08 | 4.82 | 15.04 | 4.42 |
| NCOs/Total Loans (%) | 0.01 | 0.02 | 0.13 | 0.26 | 1.95 | 0.82 |
| Reserves/Loans (%) | 0.86 | 0.84 | 0.84 | 1.30 | 2.77 | 1.98 |

Source: SNL.com. Financial Data as of 12/31/2010 unless stated otherwise.

## NCIF MODEL CDBI FRAMEWORK: DEVELOPMENT ORIENTATION *Based on Self Reporting*

**MARKET NEED**

Carver operates nine full-service branches and nineteen 24-hour ATM centers located throughout New York City's underserved neighborhoods. Bank branches are located in Harlem, Brooklyn and Queens. Carver's target market is a mix of multi-cultural low-to moderate income communities comprised of African American, Caribbean and Hispanic segments. Based on recent quantitative research conducted specifically in Carver markets: 71% of the population in the target market areas are foreign born (highest in Queens and Brooklyn) and 33% are undocumented immigrants (no SSN) with a high portion of renters at 87%. Employment is dominated by service, construction and retail, consistent with the low to moderate income profile of Carver's catchment areas.

**CREDIT PRODUCTS & SERVICES**

Carver offers a variety of home loan products, including products with special features such as flexible underwriting criteria to accommodate the needs of low and moderate income customers. Carver also offers the use of non traditional credit lines such current rent payments, utilities, etc. as alternative credit to evaluate credit worthiness. The use of alternative credit allows these individuals to apply for residential mortgages regardless of lack of a traditional credit score.

**NON-CREDIT FINANCIAL PRODUCTS**

Carver currently serves over 40,000 depository account holders in its target market. The base consists of primarily low to moderate income individuals, small businesses, and not for profit organizations. As a full service community bank, Carver offers an array of financial products and services that accommodate the needs of low and moderate income customers. Carver recently expanded its offerings to include a suite of new products and services that fulfills the needs of its community, whether a customer possess a bank account or not. Via Carver Community Cash, a customer can cash checks, pay bills and send or receive Western Union money transfers, purchase discounted money orders and prepaid VISA debit cards. To utilize these services, no bank account or credit check is required; and funds are available immediately.

**NON-FINANCIAL PRODUCTS**

Carver established a formal Financial Empowerment Workshop Series and since 2006, over 10,000 attendees have benefited from over 450 Carver-sponsored seminars and events. Additionally, over 4,200 individuals have completed Carver supported one-on-one counseling services. Attendees were comprised of Carver customers and non-customers who increasingly demonstrated need for greater access to more affordable financial products and services.

**PARTNERSHIPS**

Carver has recently partnered with the Food Bank of Greater New York and the City of New York Office of Financial Empowerment (NYC-OFE) to provide both free tax preparation services and match-funded savings accounts to qualified low income filers. In addition to receiving free tax preparation from trained professionals, participants will be eligible to receive up to $500 in matching funds from NYC-OFE when they commit to save a portion of their tax refund in a new Carver Bank savings account.



other CDFI banks would look to partner with NCIF to further increase the visibility of the impact CDFI banks have in their communities. Above, and on the previous page, a sample dashboard is provided for Carver Federal Savings Bank.

## Governance, board composition, and human capital for CDFI banks

Charles Van Loan, director of Independent Bancorporation and a trustee of NCIF, moderated the fourth panel on governance, board composition, and human capital. Panelists, M. Anthony Lowe, regional director of the FDIC, and W. Ronald Dietz, director and chairman of the Audit and Risk Committee for the Capital One Financial Corporation, discussed the importance of management and board composition, especially during bad economic times. Mr. Van Loan discussed the need for board members to have familiarity with banking and financial markets, even if they are brought on as a specialist in an area such as information technology. He suggested those types of roles might be better filled by consultants. He supported stringent criteria for board membership and strict codes of conduct for members, especially important in the event a board member needs to be removed. Mr. Van Loan also suggested that board members are good sources for business referrals for banks, but that they should avoid directly sourcing loans.

Mr. Lowe focused on the skills that the FDIC looks for when evaluating a bank's board, such as integrity, relevant skills, experience, time and focus devoted to the board, personal financial stability, and the willingness to dissent when necessary. Mr. Dietz discussed the need for risk management procedures and policies, especially at several levels within the organization. This has become increasingly important at small banks given the current economic climate. He suggested that organizations with more formal and effective risk management systems will demonstrate better financial performance in the future and gain support from regulators as they expand.

## Opportunities, new issues, and challenges for CDFI banking

The final panel on day one focused on opportunities, new issues, and challenges for CDFI banking. Joe Ferrari, senior analyst at NCIF, moderated this panel with John Moon, assistant director of Capital Formation at Living Cities, and Jodie Harris, policy specialist at the CDFI Fund as panelist. Mr. Moon presented findings on the Integration Initiative, a part of Living Cities launched in 2010 to build an ongoing cross-sector program that tackles problems to improve the lives of low-income people in their cities through grants and below-market-rate loans and commercial debt. Living Cities is looking for more partners to be involved at the project level, and emphasized that CDFI banks could take advantage of this opportunity.

Ms. Harris discussed the upcoming CDFI Bond Guarantee Program, which is a part of the Small Business Jobs Act in 2010. Under the program, the U.S. Treasury provides a 100 percent guarantee of bonds issued by CDFIs, and will guarantee up to 10 issues a year for a maximum of $1 billion (minimal bond issuance is $100 million). The Federal Financing Bank will purchase the guaranteed bonds, and they will not be sold in the open market. Ms. Harris compared the program to the Historically Black Colleges and Universities (HBCU) Bond Guarantee program. While there has been some delay, Ms. Harris stressed that the final regulations should be announced very soon.[3]

Regarding the issue of allowing flexibility when institutions are facing capital issues and want to partake in the program, Ms. Harris noted that the program will have that flexibility. It will be sensitive to reduce the level of work that goes into administering the issuance of bonds so that the cost of issuance remains minimal. The focus is on making this work for CDFIs and determining the best structure for CDFIs. Currently they are looking into recommendations on structuring, and she mentioned that NCIF is actively working with CDFI banks to develop and implement workable structures.

Mr. Narain concluded by pointing out that this will be the single biggest source of liquidity for the CDFI sector. The CDFI Bond Issuance Working Group that NCIF is forming will constitute an important voice in the development of this program. He encouraged CDFI banks and other stakeholders to contact NCIF to get involved in this initiative.

## Intersection of financial technology and community development

Mr. Narain opened the first panel of day two by stressing the need to implement state of the art technology into CDFI banks as a way to achieve cost reduction, better product delivery, and attract investors as technologies increase profitability. He introduced David Reiling, CEO of Sunrise Banks, to lead the session. Mr. Reiling began by demonstrating the intersection of community development and financial technology with Sunrise Bank's program, the Underbanked Empowerment Journey. The program was considering both technology and mission with a central purpose to bank one million un- or under-banked people. It involves technologies and services such as prepaid cards, and has been a resounding success. Other panelists included: John Davis, senior vice president of FiServ; Steven Doctor, COO of Chexar; Sarah Livnat, senior director at Progreso Financiero; and Steven Reider, founder and CEO of Bancography. Each demonstrated a piece of their technology offerings that could be useful to CDFI banks.

Mr. Davis started by discussing how the unbanked are working primarily in cash because of the need for liquidity. He suggested that using prepaid technology could leverage that relationship into other programs, products, and services that would transfer the customer from transactions to financial planning activities. This technology can also extend functionality beyond bricks and mortar. He then introduced his colleague, John Lovelet, who demonstrated Popserv, a technology that allows electronic client database construction, which reduces transaction time (from 45 days to three to five days in some cases), and can reduce back office costs for CDFI banks.

Mr. Doctor discussed Chexar's check cashing services and the success that Carver Bank – a CDFI bank – has had with their product. He led a demonstration of this technology, and emphasized that CDFI banks have an advantage over check cashers because of their location and their connection to the communities they serve.

Ms. Livnat demonstrated the interface for Progreso Financiero's Small Installment Loan program that allows loan officers to quickly assess and provide small credit loans to underserved populations, and is available to other financial institutions such as CDFI banks. This offers a clear example of utilizing technology to improve the customer experience, a lesson that can be learned by CDFI banks.

Mr. Reider concluded with a presentation on a design-centered solution to operating branches with lower costs. The Bancography concept stresses that bank branches are an essential part of the urban context, and discussed how Urban Partnership Bank has a microbranch that they just opened in Chicago using many of these small-branch concepts. His conclusion was that through smaller formats, instead of in-store branches, more sites become viable for banks like CDFI banks that operate in low-balance markets.

## New Markets Tax Credits and NCIF's three-way partnership program

The conference concluded with a panel on the New Market Tax Credits and NCIF's three-way partnership program. Joe Schmidt, vice president of NCIF, moderated and gave a short presentation on the NMTC program and the three-way partnership developed by NCIF that is structured so that it directly benefits CDFI Banks and allows them to gain experience in the program and develop internal NMTC programs. Blondel A. Pinnock, president of Carver Community Development Corporation, Alden J. McDonald, president and CEO of Liberty Bank and Trust, Steven Kramer, senior vice president of NMTC & HTC Investments U.S. Bancorp, and Aaron Seybert, of Chase Community Equity, served as panelists. They discussed several projects that their institutions had undertaken as part of NCIF's three-way partnership to great success, both financially and in terms of social impact in low- and moderate-income communities. Two examples of note were the 4469 Broadway project in New York between NCIF and Carver, and the Pikeville College School of Osteopathic Medicine project in Kentucky between U.S. Bancorp and NCIF.

The 4469 Broadway development is located in Washington Heights/Inwood and is a mixed-use, mixed-income project, with 17 of the 85 apartments reserved for low-income families. The project has the additional impact of helping to establish a commercial corridor and childcare service center for the community. This project financing closed in January 2012.

The medical school project was built in a distressed, rural area near Pikeville, Kentucky. The medical school offers a free clinic to increase capacity to 4,000 annual patient visits in an area where there is a shortage of medical services. It also will help expand the current medical school to provide training for new doctors that can serve in the area. The project financing closed in 2011, and construction has begun.

The session concluded by putting an emphasis on partnerships for high-impact projects. CDFI banks are the eyes and ears on the ground in many of these projects. Mr. Narain reminded participants that the program is up for reallocation and stressed that communities should tell their congressional representatives of the benefits of the program and seek support for it.

## Conclusion

The 2011 Annual Development Banking Conference was designed to discuss topical issues among the broader CDFI banking industry and its key stakeholders. It is focused on helping the industry define a path forward. To increase the visibility and understanding of the sector, the conference helps stakeholders recognize the need to communicate the impact these banks have – to "tell the story." As this message becomes clear and spreads, it will help strengthen the industry and increase the ability of CDFI banks to continue their work in low- and moderate-income communities.

NCIF's second objective is to stress the need for collaboration within the CDFI banking industry, not only around impact and documenting successes, but around issues stressed in all the panels, such as capital raising, governance, best practices, and technology. The CDFI banks have shown how they can individually have significant impacts in their local communities, but to achieve scale and further increase the visibility and impact of the sector in a meaningful way, they will need to work together to make that future a reality.

NCIF would like to thank the Federal Reserve Bank of Chicago for its leadership in helping convene the conference. Also, we would like to thank our other sponsors whose support made this conference possible and affordable – Bancography, Bank of America, JPMorgan Chase, Keefe, Bruyette & Woods, Urban Partnership Bank, U.S. Bancorp, and Wells Fargo.

## CDFI Bond Guarantee Program

The CDFI Bond Guarantee Program is a part of the Small Business Jobs Act in 2010. This program will provide much needed capital for CDFI banks. Some highlights include:

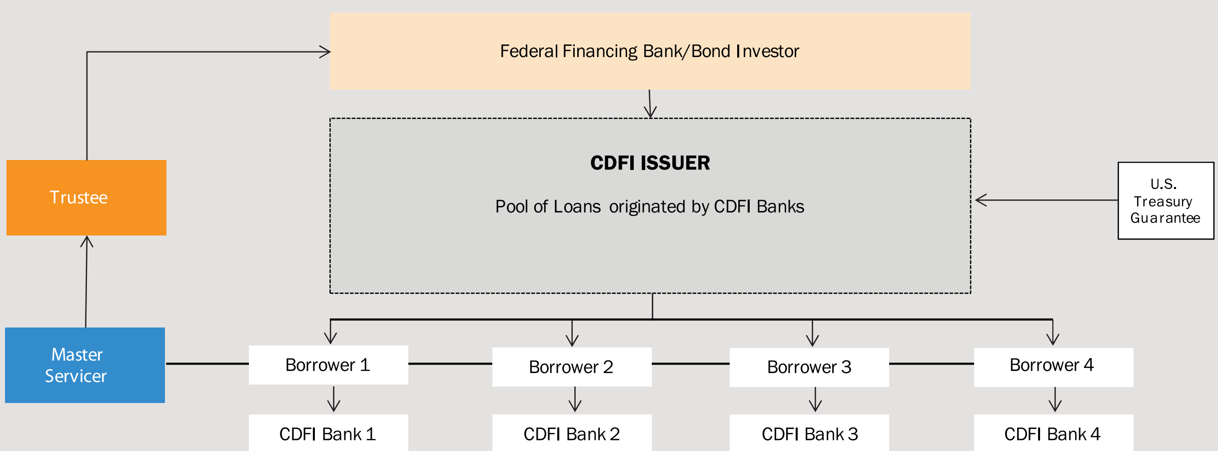
- The U.S. Treasury will guarantee bonds issued in support of CDFIs.
- Up to 10 issuances per year will be allowed, each at a minimum of $100 million with a maximum $1 billion per year.
- There is a 3 percent maximum loss rate allowed.
- The Federal Financing Bank (FFB) will purchase the bonds.
- Bond issuer must be a certified CDFI or designated by a CDFI to serve as issuer.

Proceeds from the bonds can be used to originate or refinance loans to CDFIs for eligible community development purposes. These include, but are not limited to, loans used for job creation, provision of financial services, community stability, commercial facilities, and development in low-income or underserved areas. At a minimum, 90 percent of the proceeds must be invested as loans to CDFIs.

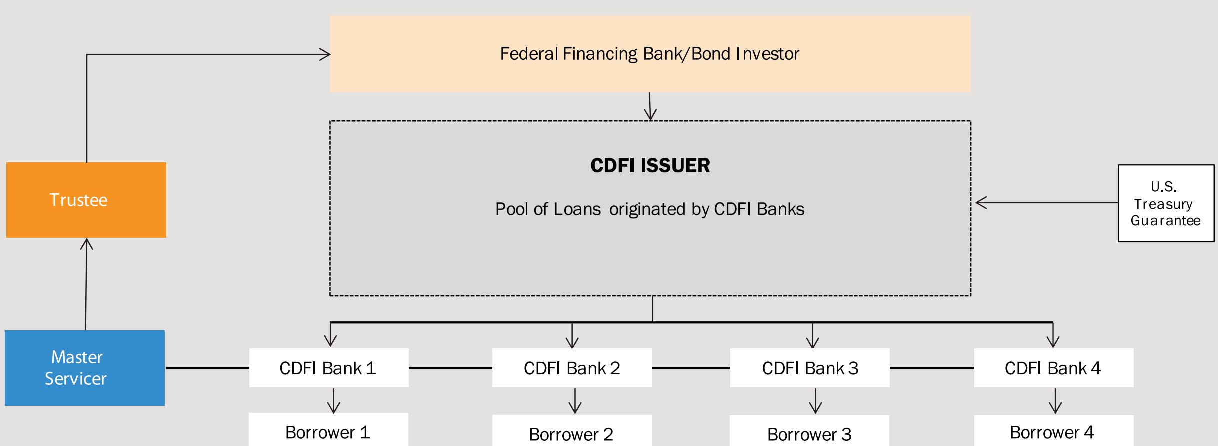
The CDFI Fund announced that they expect the draft regulations to come out soon – in the spring – and soon thereafter the application materials will be made available. However, due to the short time frame, the first set of guarantees is unlikely to be issued until fiscal year 2013.

The following graphics illustrate two possible alternatives for how the pool might be structured to work for CDFI banks. Alternative 1 is a liquidity vehicle, whereby CDFI banks originate loans to the pool, while alternative 2 is a capitalization vehicle, whereby CDFI banks directly borrow from the pool. As the regulations are yet to be announced, it is not clear exactly what structure will be allowed, but in either case, the program promises to provide critical support for the vital CDFI banking industry.

**Alternative 1: CDFI Banks originate loans to the pool**




**Alternative 2: CDFI Banks as direct borrowers from the pool**



## NCIF Social Performance Metrics – at a glance

In 2007, NCIF developed a methodology for identifying depository institutions with a community development mission. The resulting NCIF Social Performance Metrics initially utilized publicly available census data, branch location data, and Home Mortgage Disclosure Act (HMDA) lending data to measure the social output and performance of banks and thrifts. Institutions that score highly on the metrics are those banks that are focusing on serving the needs of low- and moderate-income communities. NCIF has mined the data on all 7,300+ banks in the country since 1996, and is able to analyze institution level performance as of a certain year, over a period of time in the past and against customized peer groups.

### Core metrics

- **Development Lending Intensity – Home Mortgage Disclosure Act (DLI-HMDA)**
  The percentage of an institution's HMDA reported loan originations and purchases, in dollars, that are located in low- and moderate-income census tracts.

- **Development Deposit Intensity (DDI)**
  The percentage of an institution's physical branch locations that are located in low- and moderate-income census tracts.

### Additional metrics

- **Adjusted DLI-HMDA**
  The percentage of an institution's HMDA reported loan originations and purchases, in dollars, that are located in LMI census tracts, not including loans classified by HMDA as high-rate loans.

- **DLI-HMDA highly distressed**
  The percentage of an institution's HMDA reported loan originations and purchases, in dollars, that are located in census tracts that exhibit a median family income that is 70 percent, 60 percent, 50 percent or 40 percent of the relevant geographic area.

- **DLI-HMDA low income**
  The percentage of an institution's HMDA reported loan originations and purchases, in dollars, that are provided to borrowers that have a household income that is below 80 percent of the relevant geographic area.

- **DLI-HMDA equity**
  The ratio of an institution's HMDA reported loan originations and purchases to the institution's total equity.

In addition to the housing focused DLI-HMDA, NCIF creates DLI – CRE, DLI – Agribusiness, DLI- Small Business, etc., based on reporting on all loan origination and purchase activity that is provided by CDFI banks. The addition of these DLI metrics allows stakeholders to comprehensively measure and communicate the impact of the banks. NCIF investee banks provide this information, and many non-investees are also reporting to distinguish themselves from the rest.

NCIF's full suites of Social Performance Metrics have already proven highly valuable to investors. For more information on the NCIF Social Performance Metrics, please visit the NCIF Web site at www.ncif.org.

## Notes

1 DLI-HMDA: The percentage of an institution's HMDA reported loan originations and purchases, in dollars, that are located in low- and moderate-income census tracts.

2 DDI: The percentage of an institution's physical branch locations that are located in low- and moderate- income census tracts.

3 At the CDFI Institute (CDFI Coalition Policy Conference) held in March 2012, the CDFI Fund announced that the regulations will likely be announced soon but that the first issuance will not occur until FY 2013.

## Biographies

**Saurabh Narain** is chief executive of National Community Investment Fund. He is involved in policy and advocacy for the industry through his board positions in the CDFI Coalition, and memberships of the Federal Reserve Board's Consumer Advisory Council (2008-10) and the Minority Depository Institutions Advisory Council of the Officer of Thrift Supervision (2009-11). Narain is a graduate of the BA Graduate Stonier School of Banking, holds an MBA from the Indian Institute of Management in Ahmedabad, and a bachelors of arts in economics from St. Stephens College, University of Delhi, India.

**Joe Ferrari** is a senior analyst at National Community Investment Fund (NCIF). Before joining NCIF, he attended the University of Illinois at Chicago's (UIC) graduate program in urban planning and policy and focused on economic development and development finance. He received both bachelor of science and master of science degrees in general engineering from the University of Illinois at Urbana-Champaign.

CONNECTING TO MARKETS SERIES

# Exploring Low-Income Neighborhoods in the Regional Context


Neighborhoods throughout metropolitan areas function very differently from one another: some are primarily residential neighborhoods that, in effect, export labor; others contain industrial, commercial and retail districts where goods and services are produced and consumed. Lower-income neighborhoods often fail on both counts, neither exporting labor nor acting as production centers that draw employees and consumers from other parts of the metropolitan area.

Over the past decade, researchers have called attention to a variety of ways in which lower-income neighborhoods participate in the regional economy, including discovery by retailers of the untapped market potential of lower-income neighborhoods, emergence of clusters of arts and cultural activity, and the role of anchor institutions as employers and service providers.

Please join our national and regional panelists as they take on some of the hard questions around low-income neighborhood connections to the regional economy. How effective are these strategies on the ground? Taken together, can they produce a meaningful increase to the contribution of urban core neighborhoods to regional economic activity? How have community developers taken advantage of neighborhood assets to advance their economic presence?

## JUNE 20, 2012
## 10:00 a.m. to 2:30 p.m. (Central Time)

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For updates on this event, please visit: http://www.instituteccd.org/calendar/4212

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The CDPS division would appreciate your feedback on these blogs. To provide feedback, click on "leave a comment" at the bottom of each blog entry. You may also subscribe to the blog by entering your e-mail address and clicking the "subscribe" button on the right hand side of the Web page. You will then receive an e-mail alert every time we post a new blog entry.


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