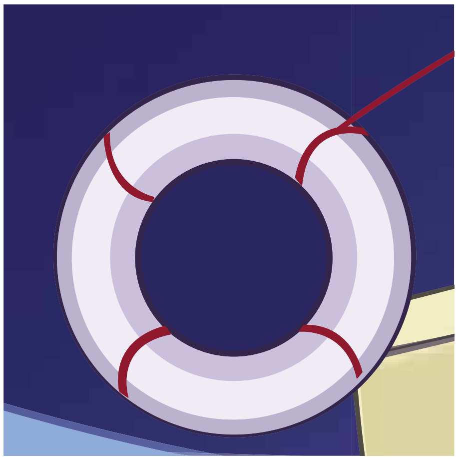
Lending to Small Business

The Evolving Bank-Nonprofit Lender Relationship

Illustration: David DeSouza

by Geoff Smith and Sean Zielenbach
Woodstock Institute

Understanding the collaborative and competitive relationships between nonprofit community development financial institutions (CDFIs) and mainstream banks in small business lending has always been critical when examining how entrepreneurs in underserved markets access business financing. Today, given the fallout from troubles in the financial services industry and the more restrictive lending policies employed by many mainstream banks, CDFIs can play an important role in lending to business owners beyond the markets they have traditionally served.[1] Understanding the interactions between these types of financial services providers can help policymakers find ways to ensure access to small business capital.



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Community Development Financial Institutions

CDFIs, particularly nonprofit loan funds, are a primary provider of credit for a subset of small business owners in underserved markets who lack the experience, collateral, or credit history to obtain financing from conventional banks. With their explicit focus on community economic development and lending to underserved populations, CDFIs are able to attract funding from a range of public and philanthropic sources.

Although mainstream banks traditionally have had less interest in working with small business owners in underserved markets, that attitude has changed as competition has increased for the potentially large market of unbanked but bankable borrowers and depositors, both individuals and businesses.[2] But because small businesses in low-wealth communities frequently require much more intensive, relationship-based underwriting and technical assistance than conventional lenders are willing to provide, banks are learning to work with CDFI small business loan funds to build and sustain a base of new customers.

Here's how it works. To address the business's financing needs but retain the customer, a bank will refer depositors who cannot qualify for bank financing to CDFIs that specialize in less sophisticated small businesses. Similarly, CDFIs will send bankable CDFI "graduates" to mainstream banks for small business lending services. Additionally, mainstream banks provide CDFIs with low-interest loan and investment capital, operating grants, and technical assistance in the form of board and loan committee members as well as training in lending and underwriting. The banks receive Community Reinvestment Act (CRA) credit for their CDFI-related work and also may partner with the CDFIs in making direct loans to more-stable small businesses needing larger amounts.

Such collaborative relationships do not come without costs to the CDFIs, however. Many have noted the bank partners' growing emphasis on ensuring that their grants and investments in CDFIs ultimately improve the banks' bottom line. For example, banks increasingly require financial returns on their capital investments in, and formal referral agreements from, CDFI partners. In some cases, the banks' capital comes with a requirement that a bank member be seated on the CDFI's board of directors. These conditions could limit the CDFI's ability to work with a variety of financial institutions and to maximize funding opportunities. Yet, thus far, the benefits of working with banks appear to outweigh the costs.

Loan Funds vs. Depositories

There are notable differences in the relationship between banks and CDFI loan funds—such as Cooperative Business Assistance Corporation in Camden, New Jersey, and the Colorado Enterprise Fund—and the relationship between banks and CDFI-insured depositories—such as Chicago's Shorebank or Santa Cruz Community Credit Union. The former tend to be more collaborative, the latter more competitive. As regulated institutions, community development banks and credit unions have less flexibility in their lending because of regulator concerns about financial soundness and safety. Thus, although they may do some lending to small businesses deemed too costly or risky by mainstream institutions, they must supplement those transactions with loans to more-stable companies, many needing larger loans. That often places CDFI depositories in competition with more conventional lenders trying to carve out a niche in the local market, expand their activities, or satisfy both CRA and internal lending benchmarks.[3]

The competition affects both lending and deposits. To attract borrowers and depositors, many CDFI depositories seek to exploit their emphasis on relationship-based lending and financial services, their flexibility in addressing customer needs, their in-depth knowledge of the local market, their community development mission, and the technical assistance they are willing to provide. Their relatively small size, however, often limits their competitiveness in attracting capital. Larger banks frequently invest more in internal technology, which lets them offer sophisticated cash-management services and automated consumer loans in addition to basic checking and savings accounts. They also tend to have broader branch networks and thus a greater range of potential depositors.

Looking Forward

How the weak economy will affect the CDFI-bank relationships remains to be seen. On one hand, stricter bank underwriting standards may well drive formerly bankable borrowers toward CDFIs as declining real estate values undermine the worth of collateral. On the other hand, CDFIs may have to tighten their own underwriting standards in response to the economy and, for depositories, changes in regulatory accounting standards. That could limit their lending to previous small business markets.

A potentially greater problem for CDFIs is acquisition of loan capital. To meet the potential increase in demand for financing, and to expand the borrower base, CDFIs must be able to build their loan pools. To continue offering affordable pricing and technical assistance to higher-risk borrowers, they need a fair amount of low-cost capital. Yet the sources of such capital are nowhere near as plentiful as they were in the late 1990s and early 2000s. Until recently (until the American Recovery and Reinvestment Act), the federal CDFI Fund's budget was less than half of its 2000 budget. Some foundations that had been supportive of CDFIs have cut back their grants to CDFIs and program-related investments. Similarly, banks have sharply curtailed the amount of equity-like investments they make in CDFIs, opting for term loans with rates closer to what the market bears. For depository CDFIs, regulatory changes requiring increased capital cushions are also posing challenges.

The current banking and credit crisis is exacerbating the capital acquisition problem. Mergers and acquisitions of financial institutions such as Wachovia, Washington Mutual, and National City have reduced the number of large financial institutions that were active sources of capital to CDFIs. It is unclear how these acquisitions will affect overall levels of bank funding to CDFIs, but history indicates that consolidated banks fund community development financial institutions at levels below what the banks provided separately. In addition, the global financial crisis has caused capital markets to seize up, likely making access to capital extremely challenging and more costly for CDFIs.

As one response to the shortage of low-cost capital, CDFIs have attempted to streamline operations to become less reliant on operating grants, allowing them to focus their outside support on building their loan funds. In the past, although community development banks and credit unions had to break even or generate a profit to satisfy regulators, most small business loan funds thought themselves fortunate to cover 75 percent of their operating costs with earned revenues. Indeed, in fiscal year 2006, the average microenterprise loan fund covered only 47 percent of its operating costs with earned revenues.[4]

CDFIs have differed in strategies to reduce reliance on operating grants. ACCION Texas, for example, has attempted to automate as much of its lending as possible and has focused on loan volume to compensate for the relatively small amount of income generated from individual loans. In effect, CDFIs taking that approach have minimized the amount of "high-touch" technical assistance provided to borrowers. Other CDFIs have actively sought to make larger loans (in the $70,000 to $100,000 range), with the intent of using the greater interest and fee income to subsidize less lucrative microlending.

That approach threatens to bring CDFIs into more direct competition with conventional banks, a showdown in which the banks have distinct advantages in pricing loans and offering accompanying financial services. Both strategies also run the risk of shifting the CDFIs away from those fledgling small businesses that they were initially designed to serve—another example of the tension between the financial bottom line and social mission goals. If policymakers value what CDFIs bring to economic development in distressed communities, they need to make low-cost capital available for operations like technical assistance, and they need to help CDFIs build their capital pools.

Geoff Smith *is vice president of the Woodstock Institute, a Chicago-based nonprofit working to promote economic development in lower-income and minority communities.* **Sean Zielenbach** *is a Woodstock Institute senior consultant.*

Endnotes

[1] CDFIs make loans to support development in economically distressed communities. See http://www.cdfi.org/index.php?page=info-1a.

[2] The Community Reinvestment Act has contributed to heightened competition in low-income areas, yet direct financing is only one manifestation of the competition. Banks work diligently to attract small businesses as depositors. Not only do the deposits help increase the bank's low-cost capital base, but they also offer the opportunity for current and future cross-selling opportunities-major sources of bank revenue.

[3] It is not uncommon, however, for CDFI depositories to lend in partnership with conventional banks to companies that require larger loans than either of the participating institutions is willing to make by itself. Conventional lenders may also support or cosponsor financial literacy outreach efforts with community development banks and credit unions.

[4] See *Community Development Financial Institutions: Providing Capital, Building Communities, Creating Impact* (Philadelphia: CDFI Data Project, 2008), http://www.opportunityfinance.net/store/trackURL.asp?Doc=cdp_fy2006.pdf, which analyzes fiscal year 2006 data collected through the CDFI Data Project from 505 CDFIs.