

Sowing Leveraging and Reaping

*Small business loan part of
Bank Enterprise Award application*

*Carlos and Minnie Silva (right), co-owners of CJ
Machine, Inc., show Dora Segura of the
Bank of America one of the machines
refinanced by the bank's SBA loan.*



Leverage—the use of cash or credit to enhance one's financial capacity—is important in the business world. In fact, banks are constantly on the alert for ways to leverage the money they lend or invest into even larger sums of money. And sometimes a relatively small amount of money can be leveraged in a wide range of projects with far-reaching and long-lasting impacts.

This particular story of leverage began with a cold call from Dora Segura to Minnie Silva in early 1996. Segura, vice president and community development loan officer with the Bank of America in San Antonio, called to ask if the bank could provide financial services to CJ Machine, Inc., owned jointly by Carlos and Minnie Silva. As it happened, CJ Machine—which Carlos, a master tool and die maker, and Minnie had started in 1981 with two tool-making machines in a 2,000-square-foot building—could indeed make use of the bank's services. Over the years, the busi-

ness had grown steadily; it now employs more than 20 craftsmen and occupies three buildings, comprising over 19,000 square feet of workspace. CJ Machine had also qualified for government contracts.

However, in spite of the company's growth, the Silvas still had trouble qualifying for traditional bank financing. Moreover, the Defense Department's decision to privatize nearby Kelly Air Force Base would likely have an unfavorable impact on the Silvas' business. To meet their existing needs and help them prepare for future growth, Segura developed a financial package that helped the Silvas in a number of ways. "Actually," says Segura, "Minnie made it easy. She was responsive and did an excellent job of providing information required by the bank to make a credit decision. She was as knowledgeable about specific programs and their requirements as most bankers."

Continued on page 2

INSIDE

Mortgages with Authority



Developing a Strategic Plan
Under the CRA



CDFIs and the
Future of Microlending



Did You Know...?

Public & Private Partnership

Continued from page 1



Bank of America Leadership Academy attendees Raymond Hatter (left) from Flint, Michigan, and Philip Dochow from San Francisco demonstrate their financial analysis and project design skills in a lighter moment at one of the academy's intensive workshops conducted by DTI.

The key element in the package the Bank of America provided to CJ Machine was a \$300,000 loan for equipment refinancing that was made in April 1996 under the U.S. Small Business Administration's Defense Loan and Technical Assistance (DELTA) Loan Program. The program was designed to assist small businesses that are dependent on defense contracts as prime contractors or subcontractors and are adversely affected by defense reductions. According to Segura, being able to leverage the loan through the DELTA program, which guaranteed 75 percent of the amount, was a major factor in getting the loan for the Silvas.

With CJ Machine's equipment refinanced, the Silvas could face the future more confidently and plan for their next growth phase. Further, with their finances restruc-

ture, they were able to qualify for an unsecured line of credit. This reaffirms Minnie Silva's faith in the financial system. "Too many small or minority-owned businesses," she explains, "fear the paperwork or worry that neither the banks nor the government are all that interested in them. That's just not true; they wanted to help us with financing and with information. And a small business shouldn't be afraid to address the system."

CJ Machine is now on stable financial footing, thanks to the Bank of America's ability to leverage the loan through the SBA. But our story doesn't end here.

On the basis of their community development activity in distressed communities, including the loan to CJ Machine, the Bank of America applied for a Bank Enterprise Award (BEA). Administered by the Community Development Financial Institutions (CDFI) Fund of the U.S. Treasury Department, the BEA program encourages banks and thrifts to invest in CDFIs or to increase their provision for lending and services within distressed communities—those in which the poverty rate is at least 30 percent (based on 1990 census figures) and the unemployment rate is 1.5 times the national rate. As it turns out, in the first six months of 1996 the bank had increased its loans in distressed communities by nearly \$27 million over the six-month baseline period in 1995 that was used to establish lending and investment performance. Because of this increased lending activity in distressed areas, in October 1996 the Bank of America received a \$2.6 million Bank Enterprise Award.

The Bank of America, which could have used the award in any way it chose, did something quite untraditional. The bank worked with its Community Development Advisory Board, which identified the training of new community development leaders as a critical need. "We've always thought of ourselves as leaders in community-reinvestment financing, and we wanted to do something meaningful that would have a long-term effect on community development," says Jim Richardson, senior community development officer in Texas for the Bank of America. "So we thought that we would use a portion of the BEA grant to provide leadership training to local community development executives throughout the country as a way of strengthening their organizations."

Bank of America Leadership Academy

The Bank of America allocated \$1.5 million of its award to various community development organizations around the country. In addition, the bank made a \$1.1 million grant from its award to establish the Bank of America Leadership Academy. Funding for the academy was also provided by the Local Initiatives Support Corporation (LISC), a national development organization that assists community-based development corporations with loans, grants and technical assistance. In addition, LISC helped the Development Training Institute (DTI) develop the curriculum. The academy's classes and workshops are conducted in Baltimore by DTI. "DTI is a premier development trainer for nonprofit housing developers and community-based organizations," says Richardson. "This

Fast Facts

The Power of Leverage

The cycle of leverage is a constant in the business world. In this case, through the effective use of leverage, the Bank of America was able to use \$26.9 million in loans it made within distressed communities—including a \$300,000 Small Business Administration DELTA loan for equipment refinancing to CJ Machine, Inc.—to apply for a Bank Enterprise Award. The bank received a \$2.6 million Bank Enterprise Award, part of which was then used to establish the Bank of America Leadership Academy. The academy provides leadership training to senior executives of community-based organizations, many of whom may one day turn to the Bank of America to secure funding for community development projects in distressed communities.

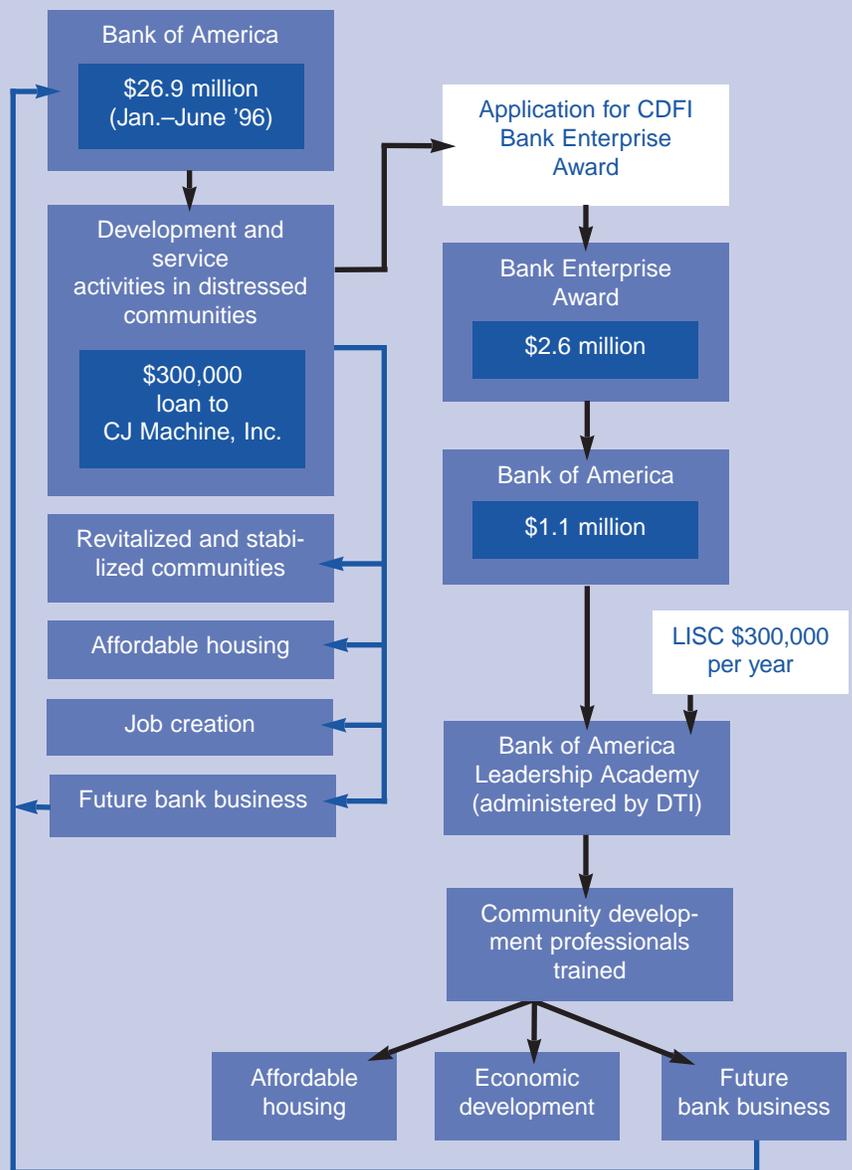
partnership gives us the chance to develop the leaders for a whole new generation of community organizations.”

According to Jeff Nugent, DTI's vice president, “The leadership academy will create a national network and promote innovative approaches to community building.” Participants in the academy are executive directors or senior staff from community-based development organizations; to be eligible, an organization must be at least four years old and have completed a minimum of two projects. Begun in April 1997, the academy consists of four workshops, each seven to nine days long, with 35 participants in each ten-month program. The academy covers community building and revitalization, organizational management, leadership development, project development and finance.

“The real accomplishment is capacity building,” says Nugent. The organizations represented by the graduates will have greater skills and more opportunities to be successful in achieving their organizations’ and communities’ goals, whether they are creating affordable housing or new jobs, or helping local businesses.

At that point, our story will have come almost full circle. Many of the graduates of the academy will be putting the lessons and skills they learned into practice in communities across the nation. And that's where the real payoff will take place for the Bank of America, since the bank will have an opportunity to invest in or make loans to future qualified projects developed by the community-based organizations whose leaders have attended the academy.

And the leverage cycle will begin again. ▼



For more information: Bank Enterprise Award (202) 622-8662

Mortgages with Authority

Partnership provides affordable house payments

The New Mexico Mortgage Finance Authority (MFA) is one of the sources of funds New Mexico lending institutions are using to provide affordable financing to low- and moderate-income families purchasing homes. Since its creation in 1975, the MFA and 90 of the state's lending institutions, working as partners, have financed homes for more than 25,000 families—2,134 of those last year.

The MFA offers two sources of funds to participating lenders that help them provide hard-working people—construction workers, food service professionals, clerks, teachers, police officers, firefighters, and industrial, service and agricultural workers—with affordable mortgage payments.

The MFA's Mortgage Saver program is funded through mortgage-backed revenue bonds that provide financing to participating lenders for 30-year fixed-rate mortgages. Generally the MFA mortgage funds run approximately 1 percent below the market rate. Although income and price limits apply, the lower monthly payments are available to qualifying first-time home buyers and people who have not owned a primary residence within the previous three years. The MFA funds can be used to finance conventional, FHA, VA and Rural Housing Service (formerly Farmers Home Administration) mortgages.

Approximately one-third of the Mortgage Saver applicants also use MFA's second source of funding—the HELP pro-



Nancy Ormon (second from left), mortgage officer for Citizens Bank of Clovis, New Mexico, tapped MFA funds to make an affordable mortgage for Socorro and Magdalena Granillo (seated, center) and their four children.

gram, which was designed to provide money for part of the down payment and/or closing costs. HELP loans have a \$4,000 ceiling and carry a 6 percent interest rate. They are repaid over 10 years. Applicants who use this option are required to complete a home buyer education program, provided free of charge.

Rex Robinson, communications director for the New Mexico MFA, credits the programs' success in New Mexico to his agency's efforts to make the loans more accessible to lending institutions. "New Mexico's participating lenders are no longer required to commit to a set amount of money, as they are in many other states," he explains. "Rather, participating lenders apply to the MFA to reserve funds for a qualified buyer until the loan is approved. The funds are disbursed on a first-come, first-served basis."

The New Mexico MFA adopted the new

Continued on page 8

How MFA Worked for One New Mexico Family

Socorro and Magdalena Granillo moved to Clovis, New Mexico, in search of a better life for themselves and their four children, ages 7 to 18. When they applied to Citizens Bank for a home loan, the Granillos had saved for a down payment and their credit history, although limited, was good.

"In many ways, they are typical of the people helped by the Mortgage Saver program," says Nancy Ormon, assistant vice president and mortgage loan officer for Citizens Bank of Clovis. "They work very hard. Socorro is a farm laborer for a dairy, and Magdalena is a presser for a dry cleaner. Together, they support their family of six on \$27,600 a year.

"With the Mortgage Saver interest rate and their own down payment," Ormon continues, "they qualified under FHA guidelines for a three-bedroom, one-bath house. They were thrilled with their new home, and we are always happy when we can provide the financing that helps people make their dreams come true."

Developing a Strategic Plan Under the CRA

The Community Reinvestment Act (CRA) regulation allows a bank the option of developing a strategic plan detailing how the institution proposes to meet its community's credit needs. The plan must be developed with community input and approved by its supervisory agency. The bank may do this as an alternative to being evaluated under the lending, investment and service test, or the small-institution performance standards. As of August 15, 1997, eleven strategic plans had been approved. Three were submitted by "small" banks (with total assets of less than \$250 million and independent or an affiliate of a holding company with total assets of less than \$1 billion). The other eight plans were submitted by "large" banks. Of the eight large banks submitting strategic plans, three were affiliates of the same bank holding company.

To assist banks in developing their strategic plans, bank supervisory agencies have developed interagency Guidelines for Requesting Approval for a Strategic Plan Under the Community Reinvestment Act. The guidelines specify the types of information a bank will generally need to submit to its supervisory agency when requesting to be evaluated on the basis of a strategic plan.

The two sections of the strategic plan that generally require the most information are (1) descriptions of the performance context and (2) lending, investment and service goals. In the approved plans, the

information provided in these areas varies from plan to plan. However, many of the plans share some common elements.

The information in the performance context section of the approved plans was generally tailored to support the bank's lending, investment and service goals. In most cases, this section provided a brief history of the bank. While the specifics in each case varied from bank to bank, information that could be used to describe the bank's performance context includes demographic data on median income and household income; housing costs; local economic conditions; the bank's product offerings and business strategy; the bank's size, financial condition and past performance; and other relevant information from the bank's public file.

To establish a benchmark by which to measure and evaluate the banks' lending, investment and service goals, most of the approved plans included the number and amount of loans from the previous one or two years, and identified the amount and nature of previous years' community development investments and services.

In all cases, the lending goals in the approved plans were formulated to meet the banks' specific objectives. For example, one bank established a range for the number and amount of loans it would make for a satisfactory and outstanding rating; another bank set its lending goals by identifying a specific number and dollar amount for each loan category as well as a specific dollar amount for its investments goal; and another bank established a menu of activities, each with a weighted point value, from which its measurable goals were stated in point totals.

A bank requesting approval for a strategic plan will generally need to submit:

1. The name of each bank joining in the plan, a description of how they are affiliated and identification of each of the banks' assessment area(s).
2. The proposed effective term of the plan, which can be for no more than five years, and the proposed effective date for the plan, which should be at least 90 days after the plan is submitted for supervisory agency approval.
3. A description of the formal or informal public input received during development of the plan, including copies of all written comments received during the comment period.
4. A copy of the required public notice and the name(s) of the newspaper(s) in which it was published.
5. A copy of the strategic plan released for public comment if it differs from the strategic plan submitted for agency approval.
6. In order to establish a performance context for each assessment area for each bank covered by the plan, copies of any information developed in the bank's normal business planning that it wants the agency to consider regarding lending, investment and service opportunities in its assessment area, including a description of any legal constraints or limitations that affect the types of loans, investments or services the bank may make or offer.
7. For each assessment area of every bank covered by the plan, measurable annual lending, investment or service goals for helping to meet the credit needs of the assessment area, particularly the needs of low- and moderate-income geographies. The goals, if met, must constitute a "satisfactory" performance. (Generally, a bank will identify its plan regarding lending, investments and services, with an emphasis on lending and lending-related activities. However, the plan need not specify measurable goals in all three areas.)
8. An indication whether any bank covered by the plan elects to be evaluated under another assessment method (that is, "large" bank or "small" bank assessment method) if the bank fails to meet substantially the strategic plan goals for a satisfactory rating.

The strategic plan option may not meet the needs of all banks. However, for banks that choose this option, there is an opportunity to tailor their CRA objectives to the needs of their community and to their own capacity, business strategy and expertise. ▼

CDFIs and the Future of Microlending

George P. Surgeon

George P. Surgeon, CFO and executive vice president of Shorebank Corp. in Chicago, is directing Shorebank, its subsidiaries and affiliates in implementing a for-profit community development strategy in the bank's markets. In this article, Surgeon offers excerpts from his presentation at the Dallas Fed Symposium on Microlending, held July 23, 1997, in San Antonio.

Over the past decade, Micro-Enterprise Loan Funds (Micro-Funds) have become all the rage. Interest in Micro-Funds has been largely inspired—and heavily reported in the international media—by the success of Dr. Muhammad Yunus at the Grameen Bank of Bangladesh. At the Grameen Bank, millions of the poorest people on earth borrow incredibly small amounts of money at interest rates well in excess of the going rate for commercial loans and then repay like clockwork. Micro-Funds, one of the few antipoverty programs that appeal to the entire spectrum of political thought, have captured the imagination of bankers



and bureaucrats, not to mention politicians in Washington.

The hype surrounding Micro-Funds has obscured some basic facts about them and confused the relevance of microlending for the American banking industry. My first-hand experience as a banker joined at the hip to a Micro-Fund leads me to make the following observations. The first is that Micro-Funds are a highly variable lot. They come in many different types and sizes. They have different missions and focus on different target markets, and—like the banking industry—they are constantly evolving. Second, there is no one “right way” to organize a Micro-Fund. And finally, Micro-Funds are in your future. Recent trends in banking—specifically recent trends in small business finance—predicate expanded partnerships between banks and Micro-Funds to service the small business market.

Local markets demand local solutions

The local market for Micro-Funds varies by many factors, among them urban versus rural environment, ethnic and racial composition, local economic conditions, and welfare practices. Thus, what I learned first-hand during my eight-year tenure with Southern Development Bancorporation is that what worked fabulously well in rural Bangladesh at the Grameen Bank did not work nearly as well for the Good Faith Fund (GFF) in rural Arkansas.

In 1988, the Good Faith Fund was established as a nonprofit CDC affiliate of Southern Development Bancorporation. The GFF's mission was to deliver very small loans for business purposes to entrepreneurs whose credit needs were not being met by the traditional banking system—in particular, low-income women and minority entrepreneurs. At the outset, GFF tried to replicate the techniques and structure of the Grameen Bank as closely as possible. For example, no collateral or credit checks were required for GFF loans. GFF did not provide any training or technical assistance for its borrowers. And GFF relied on a strict peer group organizational structure for credit decisions, loan servicing and collections. To avoid being distracted by its more conventional banking affiliates, GFF was headquartered in an area of rural Arkansas far removed from the rest of Southern Development's programs.

This model did not travel well

Throughout its three-year start-up period, GFF suffered from very low loan volume, very high operating costs, high levels of delinquency and unsatisfactory levels of loan losses. As we searched for ways to improve GFF's performance, we

Micro-Funds . . . have captured the imagination of bankers and bureaucrats, not to mention politicians in Washington.

discovered that, in addition to our own failings in implementing GFF's programs, a key problem was that the rural South was a completely different environment from rural Bangladesh. The credit needs of the low-income residents of the two areas may not have been that much different, but the economies, the cultures and the social structures of the two places were literally worlds apart. The entrepreneurs GFF targeted in Arkansas had to confront a complicated regulatory, tax and legal environment that inhibits micro-business formation and that does not exist in Bangladesh. Low-income micro-entrepreneurs in America have a welfare safety net to fall back on that, no matter how inadequate, does provide benefits at a level only dreamt of in Bangladesh. There are attractive employment alternatives for low-income people in medium- and large-sized businesses in rural America that are absent in rural Bangladesh.

In 1992, GFF began a sweeping process to redefine itself to better meet the needs of its market and to adapt to its environment. To that end, GFF developed a high-quality training program (three hours per week for seven weeks) that was required for all peer group borrowers. The requirements for peer groups were relaxed to better reflect constraints on and needs of GFF's members. GFF developed a direct loan program to serve the credit needs of more established and modestly

larger small businesses that did not benefit from the peer group environment and needed slightly larger loans. GFF created a program that targeted welfare recipients separately from its peer group loan program and the new direct loan program. Finally, GFF tightened its underwriting standards, took collateral for its loans, did credit checks on its borrowers and vigorously pursued defaulted loans through the courts.

The redefined model really works

By the end of 1994, GFF went from assisting a handful of customers to having 206 members, while still serving the low-income, minority target population envisioned by GFF's founders. At the end of 1994, 67 percent of GFF's borrowers were women and 83 percent minority, while 31 percent had household incomes of less than \$13,956 per year (the poverty line for a family of four) and 9 percent were on welfare. GFF's loan portfolio had increased to \$253,000. Nonperforming loans dropped to 1.14 percent of loans outstanding, and loan losses fell to 2.4 percent.

Since 1994, GFF has continued to evolve. It has integrated its programs into those of its parent Arkansas Enterprise Group and tried to coordinate its activities with its for-profit affiliates at Southern Development Bancorporation. This has allowed GFF to realize greater operating efficiencies and achieve better market penetration. It has developed sectoral expertise in the child care industry and health care. During the second quarter of 1997, GFF's loan portfolio exceeded \$1.3 million, and it had originated more than a half million dollars a year in new loans for two years in a row. Loan losses had increased slightly to 4.5 percent on a rolling twelve-month basis, but nonperforming loans were still at the 1 percent level.

So what? As a banker, what do I care?

A somewhat dated monograph entitled *The Business of Self-Sufficiency* by Valjean McLenighan and Jean Pogge of the Woodstock Institute began by asking:

Would a commercial bank in Chicago lend a single mother with no collateral \$1,000 for working capital to expand her part-time, home-based catering business to a full-time operation? Would a rural lending officer approve \$800 to help a farmer with bad credit purchase seeds and repair a tiller?

The answer is obviously not. Commercial banks cannot afford to originate these loans, much less service them or absorb the associated losses. Take it from one who has tried.

If a banker was ever tempted to make these loans in the past, a powerful recent trend in the underwriting of small business credit will eliminate any such temptation in the future. That trend is credit scoring. It's here, it's growing, and it's not going away. All bankers are aware of how credit scoring revolutionized consumer lending and, not too long ago, did the same thing for home mortgage lending. Recently, it has reached small business lending.

The implications of credit scoring on

I predict that Micro-Funds . . . will take larger and larger roles in every bank's small business lending function.

Continued on page 8

Surgeon *Continued from page 7*

small business lending for the community banker are significant. Credit scoring should be great for most small businesses. It should make small business lending decisions quicker and less bureaucratic. It should increase the availability of small business credit. And it should lower pricing, just as it has for consumer and home mortgage lending.

But there will also be unanticipated negative consequences, similar to the unanticipated consequences of blindly driving home mortgage lending by credit scoring. Even though Fannie Mae and Freddie Mac have strongly and consistently encouraged lenders to carefully review the files of marginal borrowers, there is anecdotal evidence that some mortgage lenders simply decline all applications that do not have a Fair Isaacs score of 620 or higher. Regrettably, all things considered, some minority groups and low-income people appear to score lower than other segments of the American population on most credit scoring programs.

One can only anticipate that, no matter how careful the banker and no matter how committed the banker to fair lending, in the not too distant future there will be income and racial disparities in small business lending stemming from the blind implementation of credit scoring.

One can further anticipate that those disparities will not be tolerated by the communities we serve, bank regulators monitoring CRA compliance, or the Department of Justice enforcing fair lending laws. That is just one reason why I predict that Micro-Funds and other Community Development Financial Institutions (CDFIs) will take larger and larger roles in every bank's small business lending function.

Micro-Funds and CDFIs have proven track records of not just targeting but delivering credit to very small women-owned and minority-owned businesses, especially those owned by low-income individuals. These are credits that conventional commercial banks have historically had a hard time making. The advent of credit scoring will make these customers even more difficult to reach for the banking industry. Once credit scoring has taken the margin out of small-business lending, banks will not be able to afford to take a chance on lending to micro-businesses.

But this is a market that banks need to reach—not just for public relations, CRA and fair lending reasons, but in order for banks to remain competitive. Out of this market will come the next generation of small and large businesses that are the backbone of national and local economies. In the future, banks will reach most of this market directly, as they always have. However, a growing share of this market will be increasingly difficult and unprofitable to tap. That is where Micro-Funds and other CDFIs come in—not as competitors, but as allies through which banks will exploit this market, make it their own and make a profit. ▼

Did You Know..?

The Federal Financial Institutions Examination Council (FFIEC) has made available on the Internet a geocoding system (www.ffiec.gov/geocode). The system allows the user to retrieve Metropolitan Statistical Area (MSA), State, County and Census Tract/Block Numbering Area (BNA) codes as well as limited demographic information for most U.S. street addresses.

Mortgages with Authority

Continued from page 4

policy to resolve two issues lending institutions had with the former policy: (1) In the past, to participate in Mortgage Saver funds, lenders were required to commit to a specific amount of money and then match that amount to loans. That meant some lenders would have too few qualified applicants, while other institutions would have more requests than they had MFA funds available. Now, participating lenders submit applications whenever they have qualified buyers. (2) Lenders are not affected if market mortgage interest rates fall below the rate set on MFA funds, because they no longer commit to a specific amount of money at a set interest rate.

Together, New Mexico lenders and the MFA are helping more people to make their dreams of home ownership come true. ▼

For information contact: New Mexico MFA at (505) 843-6880

Perspectives

Federal Reserve Bank of Dallas
Community Affairs Office
P.O. Box 655906, Dallas, Texas 75265-5906
214-922-5276

Gloria Vasquez Brown
Vice President
gloria.v.brown@dal.frb.org

Nancy C. Vickrey
Community Affairs Officer
nancy.vickrey@dal.frb.org

Ariel D. Cisneros
Community Affairs Specialist
ariel.cisneros@dal.frb.org

Jim V. Foster
Community Affairs Specialist
jim.foster@dal.frb.org

Bobbie K. Salgado
Houston Branch, Community Affairs Specialist
bobbie.salgado@dal.frb.org

Publications Director: Kay Champagne
Writing: Lee Shenkman, Barbara Beverlin
Design: Gene Autry

The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System. Articles may be reprinted on the condition that the source is credited and a copy is provided to the Community Affairs Office. Internet website: www.dallasfed.org