

CREATING CAPITAL, JOBS AND WEALTH IN EMERGING DOMESTIC MARKETS

FINANCIAL TECHNOLOGY TRANSFER TO LOW-INCOME COMMUNITIES

Glenn Yago
Betsy Zeidman
Bill Schmidt

Research Report

JANUARY 2003



MILKEN INSTITUTE

FORD FOUNDATION

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ACKNOWLEDGMENTS

The authors wish to acknowledge the generous support of the Ford Foundation, particularly Michele Kahane, in the research and development of this report. We also appreciate the many individuals who contributed important information and insights, as well as valuable time, through participation in Working Group sessions in Los Angeles, New York and Washington, DC, through interviews with our staff, and by reviewing and commenting on drafts of the report. In addition, we thank our editor, Judith Gordon, researchers Liya Brook and Deana Carillo, administrative support Muriel Poussin and Megan Sharpless, and graphic designer and print production coordinator, Sallylynn James.

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KEY FINDINGS

The United States experienced such an extraordinary surge in wealth during the 1990s that even after the stock market decline of 2000-2001, Americans' total net worth in 2002 remains almost 75 percent greater than it was just 10 years ago. As with previous episodes of economic expansion, entrepreneurship and innovation, both technological and financial, fueled much of this growth. However, this growth was unbalanced, with higher-income entrepreneurs more easily accessing the full array of financial technologies and a wider range of sources of capital than smaller firms in emerging domestic markets (EDM).

This circumstance is ironic, since small businesses represent the vast majority of all firms and a driving force behind economic output and job creation. Ethnic-owned firms grew at twice the rate of all firms during the past decade, yet face capital gaps that limit their ability to expand and generate jobs in urban and low-and moderate-income (LMI) markets, home to a disproportionate amount of the increasingly diverse U.S. population.

Resolving the EDM capital gap is critical to national economic health as we experience a seemingly jobless recovery from a recession threatened by the constriction of consumer demand. Closing this gap necessitates the transfer of financial technologies and market-based public policy innovations from mainstream applications to emerging domestic markets, carving channels of capital from investors to entrepreneurs.

I. Low- and moderate-income, minority- and women-owned businesses have always faced greater challenges to accessing capital than the mainstream. Some are due to blatant discrimination, but others arise from imperfect information about the firms and the nature of their business models and environments. These include:

- Lack of performance data on loans to these borrowers, leading lenders to perceive them as riskier and beyond their legal risk tolerance.
- Smaller sized loans, leading them to be more expensive for lenders to service.
- Firms' need for mentoring and technical assistance services in addition to financing, increasing costs to lenders.
- Lack of professional and social networks linking borrowers and financial institutions.
- Historical concentration of business in the retail and services industries, with little collateral to secure loans.

The United States experienced such an extraordinary surge in wealth during the 1990s that even after the stock market decline of 2000-2001, Americans' total net worth in 2002 remains almost 75 percent greater than it was just 10 years ago.



However, growth was unbalanced, with higher-income entrepreneurs more easily accessing sources of capital than smaller firms in emerging domestic markets (EDM).



Resolving the EDM capital gap is critical to national economic health.

EDM and LMI areas offer many features desirable to an investor seeking a market with quantifiable risk and return on investment.



With their growing rates of business ownership, ethnic entrepreneurs and consumers significantly impact the overall economy.



The current slowdown in the economy is likely to impact smaller banks, and hence smaller firms, more severely.

- Lack of a viable secondary market for small-business loans.

II. Nonetheless, EDM and LMI areas offer many features desirable to an investor seeking a market with quantifiable risk and return on investment.

- There is a large, untapped market for financial institutions servicing LMI populations. Advances in technology have made it more affordable to access the market.
- The lower cost of real estate – land and buildings – in LMI areas, whether urban or rural, offers a major advantage to businesses and investors.
- By partnering with Community Development Financial Institutions that have an extensive knowledge of their local market, mainstream providers of capital can evaluate, mitigate, and price risk appropriately and expand into LMI markets with new products.

III. Several major trends in legislative and regulatory policy, financial services industry development, demographic shifts and economic conditions provide the backdrop for considering and inventing the future.

- The U.S. is shifting from a bank-based to a capital-market based financial system, disproportionately impacting small businesses because they have fewer nonbank options than larger companies.
- Servicing EDM communities can be difficult for large, mainstream banks. The information asymmetries, and banks' segmented organizational structure separating wholesale and retail products into separate divisions, run counter to the flexibility required to build relationships with small firms in LMI areas.
- Over the next 50 years, 90 percent of U.S. population growth will occur among ethnic groups, reducing white Americans to less than 50 percent of total population. With their growing rates of business ownership, ethnic entrepreneurs and consumers significantly impact the overall economy.
- A slowing economy, uncertainty, and regulatory changes tighten credit and reduce business formation among all groups. Reduced entrepreneurial activity translates into reduced job creation and retention rates, and polarizing income and wealth distributional trends. The current slowdown in the economy is likely to impact smaller banks, and hence smaller firms, more severely.

IV. Adapting financial innovations to EDM/LMI small-business financing can help overcome many of the challenges to serving these markets, and enable a range of investors to tap into the opportunities.

Examples of financial innovations that could increase capital flows fall into three broad categories:

- A. Systemic innovations:** Innovations that affect the financial sector broadly, e.g., changes in business structures, new types of financial intermediaries, new legal or regulatory frameworks. Systemic innovations include securitization, consortiums, nonbank financial institutions, government programs, liquidity vehicles, and new ownership models.
- B. Product innovations:** Innovative financial products that better serve the market, including both the suppliers and the users of the products. Product innovations include credit enhancements, blended fund structures, angel pools and networks, equity equivalent investments, and tribal bonds.
- C. Process innovations:** Innovations that introduce new business processes, which may increase efficiency and expand markets using tools such as information technologies. Process innovations include collecting data, credit scoring, and mentoring and providing business advisory services.

V. This report provides a compendium of best practices in addressing the gap between capital supply and demand among small businesses in low-to-moderate income communities. The systematic piloting and rollout of financial innovations would address the mismatch between the nation’s sources of job creation and capital formation, and enable the financial services industry to expand its reach into new markets. The report concludes with several practical, scalable pilots that would address specific financing obstacles, leverage existing resources, expertise and interest and incorporate incentives for all relevant parties to participate.

Model One: EDM Data Network A comprehensive, integrated, reliable repository of information on EDM/LMI businesses and their loan performance, intended to help researchers track market activity and financial services providers price risk and finance entrepreneurs.

Model Two: Securitization and Credit-Enhancement The pooling and purchase of individual small-business loans from multiple lenders and packaging these loans into a security to be sold to a third party, reducing lenders’ credit risk by providing liquidity and freeing them to make additional loans, thus increasing the size and scope of EDM/LMI lending by mainstream institutions.

Model Three: EDM-targeted Mezzanine Fund A privately managed, public purpose equity/mezzanine fund targeting business and project financing in LMI areas and among EDM firms, offering much-needed flexibility to the capital structure of small businesses.

Financial innovations that could increase capital flows fall into three broad categories: Systemic innovations, Product innovations and Process innovations.



Systematic piloting and rollout of financial innovations would address the mismatch between the nation’s sources of job creation and capital formation, and enable the financial services industry to expand its reach into new markets.



Scalable pilots would address specific financing obstacles, leverage existing resources, expertise and interest and incorporate incentives for all relevant parties to participate.

Traditionally, government programs and philanthropic donors have been the primary sources of capital for EDM and LMI communities.



Financial technologies facilitate funding sustainability by matching investors with investments based on risk-tolerance.



As with all new markets, information asymmetries provide an opportunity for profit to those who craft innovative solutions.

Model Four: Financial Innovations Lab & Learning Consortium A structured approach to adapting financial technologies and sharing industry and community expertise, intended to advance innovation, increase learning and build relationships to facilitate EDM/LMI lending and investment by diverse financial services providers.

Model Five: Bank/Community Lender Exchange A continuous flow network through which registered banks, community-based lenders (including CDFIs) and service providers (such as technical assistance providers) would exchange information, deal flow and expertise, intended to grow customer bases, improve deal quality, appropriately match investors/lenders with entrepreneurs and reduce financing risk.

VI. Traditionally, government programs and philanthropic donors have been the primary sources of capital for EDM and LMI communities. As growing deficits reduce federal, state and local agency budgets, and stock market losses shrink foundation portfolios, the size of these contributions will fall accordingly. Private capital must step in to fill the void, and can do so most effectively using market-based, risk-priced mechanisms. Financial technologies facilitate funding sustainability by matching investors with investments based on risk-tolerance. As a next step, the report's authors recommend initiating one or more of the recommended pilots, each of which is elaborated below.

It is clear that community development finance organizations and LMI entrepreneurs would be interested in exploring these innovations as they could bring needed support to a resource-constrained field. But there are also strong motivators for financial services firms:

- The shift in the financial services industry, from a bank-based to a capital markets-based structure, is producing both dislocation and dynamism, all amidst a slowdown in national economic growth. As Schumpeter noted, these periods of turmoil bring “creative destruction” – the replacement of old products and technologies with new ones.
- Small businesses represent the vast majority of American companies, and a large pool of potential customers. New technologies and financial innovations provide cost-effective means of reaching the market.
- Emerging domestic markets are the fastest growing segment of the population, and EDM firms are growing far faster than the national average.
- As with all new markets, information asymmetries provide an opportunity for profit to those who craft innovative solutions.

- First-movers will have a significant competitive advantage given the size and diversity of the market.
- The recent business scandals in American corporations will bring greater scrutiny of the industry from government and the public. Proactive exploration of the opportunities in emerging domestic markets will not only yield valuable business opportunities, but may limit new regulatory controls. It will also appeal to consumers and investors seeking good corporate citizens.

Below are several recommendations for pilot projects, based on the findings in this report. The choice of these pilots is based on several criteria:

- They address specific, identified obstacles impacting LMI entrepreneurs' access to capital.
- They are based on tested concepts, even though the concepts may have been applied in different situations.
- They are not applied wholesale, but tailored to account for both the market demands of mainstream firms and the public purpose of the community finance field.
- They leverage existing resources and expertise.
- They have attracted interest from both the mainstream financial services companies and community finance organizations.
- They incorporate incentives for all parties to participate.
- They are easily scalable.
- They can be implemented in a reasonable period of time.
- They will increase capital flows to small businesses in LMI and emerging domestic market communities.

MODEL ONE: EDM DATA NETWORK

GOAL: Create an effective mechanism for the financial services industry to reasonably and efficiently price EDM/LMI entrepreneurial risk, and enable investors to make more informed decisions about financing EDM/LMI businesses.

STRATEGY: As this report documents, the current pools of data are fragmented, with many insufficient in size and/or format for this purpose. An EDM Data Network (Data Network) would create a repository of information on EDM

The recent business scandals in American corporations will bring greater scrutiny of the industry from government and the public.



Proactive exploration of the opportunities in emerging domestic markets will not only yield valuable business opportunities, but may limit new regulatory controls.

Creating a Data Network would facilitate critical data assembly, generate a continuous learning process for lenders supplying the data, standardize the process and reduce the cost of information management, and potentially, create a pool of loans that could be securitized.



There are several potential approaches to building the Data Network: A Government Affiliated System and a Bank-Managed System.

businesses and their loan performance, and share that information with financing institutions (masked to preserve confidentiality). Creating the Data Network would facilitate critical data assembly, generate a continuous learning process for lenders supplying the data, standardize the process and reduce the cost of information management, and potentially, create a pool of loans that could be securitized.

PROCESS: There are several potential approaches to building the Data Network:

GOVERNMENT-AFFILIATED SYSTEM

Both the SBA and the CDFI Fund have existing programs that support large numbers of small-business loans. Many of these loans (all loans in the case of the CDFI Fund) would be representative of the EDM market explored in this report. In conjunction with the Data Network and Fair Isaac, these agencies could develop a standard reporting protocol to collect the information needed to develop credit scoring and securitization, and require all participating lenders to file on a regular basis. (As an initial incentive, lenders could be compensated for filing.)

BANK-MANAGED SYSTEM

Recognizing the challenges in launching a new program within a government entity, an alternative would be to create an independent network of participating banks, both large and small. These banks would agree to: make loans to borrowers at the lower end of the credit scale, use a standard loan application, and regularly provide specified data in a standard format on loan applicant and performance data. The Data Network would collect the data and, initially at least, compensate the banks as an incentive to participate. In addition to the incentive fee and the loan fees, participating banks would benefit by obtaining CRA credit, receiving continuously updated data on new markets, and gaining access to a new risk assessment tool – the EDM credit scoring model.

Data Network data could be used to develop other products, credit enhancements and liquidity mechanisms for this market. The loans in the Data Network could be securitized. At a later stage, the Data Network could possibly expand to receive EDM loan applications, and based on their credit score, send them out to “bid” among participating banks.

Conceivably, banks could structure their transaction and default costs as a CRA investment by contributing to the Data Network, or issuing a long-term note for the amount of expected losses. These funds, plus foundation contributions, could support the Network’s operations.

Once a pool of sufficient size is collected, the data could be used to create credit-scoring mechanisms reflective of the EDM market. Fair Isaac, the leading developer of credit scoring, is interested in working on this project. A pool must contain at least 1,000 “bad” loans for Fair Isaac to consider it a statistically significant sample (assuming a 5 to 8 percent delinquency/default rate, this requires a pool of 12,500 to 20,000 loans). Once the 1,000 “bads” have been collected, Fair Isaac could analyze the pool and create a reliable EDM credit-scoring model. By identifying those whose repayment likelihood falls below acceptable levels, the process also identifies the noninvestment grade tranche of a securitization.

MODEL TWO – SECURITIZATION AND CREDIT-ENHANCEMENT

GOAL: Offer lenders a path to liquidity in order to reduce their risk in issuing credit, and free them to extend additional loans.

STRATEGY: Securitization – the pooling and purchase of individual small-business loans from multiple lenders and packaging these loans into a security, or a Collateralized Loan Obligation (CLO), to be sold to a third party – has played a key role in increasing access to capital in the home mortgage, auto loan, and consumer finance markets. While small business loans, community development finance loans in particular, are less easily securitizable, opportunities do exist and could increase the size and scope of EDM lending by mainstream institutions. Several generic structures and some specific examples appear in this report.

PROCESS: A viable securitization in this market requires several factors:

- Performance data: Model One presents an approach to collecting the necessary data.
- Loan pool of sufficient size and homogeneity (although complete uniformity is not necessary): Pools could be created from several programs targeting LMI

Securitization and Credit-Enhancement offer lenders a path to liquidity to reduce their risk in issuing credit, and free them to extend additional loans.



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Capital Access Programs (CAPs) serve EDM borrowers.



The mission, size, scope and structure of the CAP program make it an excellent model for LMI-related securitization.



CAPs have facilitated over \$1.6 million in loans in over 20 states and cities around the country, demonstrating a pool across which to diversify risk.

and EDM borrowers, including the nonguaranteed portion of SBA 7(a) loans, Capital Access Programs, community development loans backed by state and Federal guarantees, community development credit unions and loan funds.

- Strong credit enhancement to offset the added risk: Several models are presented in this report, as well as the reserve funds in loan programs such as the CAPs.

As noted in the report, Capital Access Programs (CAPs) serve EDM borrowers. The mission, size, scope and structure of the CAP program make it an excellent model for LMI-related securitization. Mainstream lenders issue most of the loans, which reach borrowers who would not otherwise have access to capital. CAPs have facilitated over \$1.6 million in loans in over 20 states and cities around the country, demonstrating a pool across which to diversify risk. The size of the state-held reserves continually exceeds the actual loan loss, providing credit enhancement and enabling an investment-grade rating for the security. States manage their own CAPs, but legislation authorizing a National Capital Access Program has been introduced in Congress. The sample CAP securitization structure below is based on the California Capital Access Program (CalCAP), but could be replicated in or pooled with other states.

When a loan is made under CalCAP, the borrower and lending bank each pay two percent into the loss reserve account, and the state adds 4 percent, for a total reserve of 8 percent of the loan amount. Loans can be up to \$2.5 million, with short or long terms, have fixed or variable rates, be secured, and bear any type of amortization schedule. The economics for securitization of these loan products are compelling:

- Verifiable 12-year history of defaults averaging 3.7 percent; 3.5 percent in California
- Bank underwriting and servicing standards
- Lucrative spread of 6 to 8 percent for warehouse facility during loan accumulation
- Off-balance sheet, riskless 20 percent profit return to CAP lender on each deal after all expenses
- 1 to 3 percent high-yield profit margins for investment banker on high-grade bonds

- Lending underwriting standards superior in quality to SBA requirements.

In order to create a private capital markets link to the CAP program, the State of California passed legislation in 1999 permitting the securitization and sale of CalCAP loans as asset-backed bonds. Additional legislation created by the Milken Institute and others in 2000 opened the door to most classes of small-business borrowers and included some finance companies in the lending class. A regional financial institution has structured a deal to securitize these loans in pools of at least \$100 million.

The securitization of this product offers institutional investors a highly attractive investment vehicle. The bond structure accommodates an AAA investment grade rating backed by a 25 percent level of bond protection that is maintained throughout the life of the bond. The bond coupon could be fixed or float with investor call protection and provide approximately 200 basis points of spread to a benchmark U.S. Treasury security. CRA credit would be available on 30 to 50 percent of the bonds issued, as further inducement for institutional purchase.

Under the model, the loans would be real estate or plant and equipment based, with an 80 percent recovery history, 25-year maturity, five years non-refund, 7.75 years average life and float at prime+1. The loans would be 85-to-90 percent LTV and have coverage of 1.2 times. No working capital loans will be securitized. The bonds would float at approximately 30 day Libor +75-80. It is expected that 90 percent of the loans would be rated AAA and the remaining 10 percent rated A.

MODEL THREE: EDM-TARGETED MEZZANINE FUND

- GOAL:** Bring private management to investments with a public benefit (e.g., job creation, capital access), while introducing much needed flexibility to the capital structure of small businesses, and structuring transactions that capture the risks unique to these investments (e.g., management constraints, debt service capacity).
- STRATEGY:** Create a privately managed, public purpose equity/mezzanine fund that could target business and project financing in LMI areas and among EDM firms.
- PROCESS:** With an asset composition of debt and equity instruments, a fund can employ liabilities consisting of both equity and

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EDM-Targeted Mezzanine Funds could bring private management to investments with a public benefit.

With an asset composition of debt and equity instruments, a fund can employ liabilities consisting of both equity and long-term debt to magnify return on contributed capital.



The Fund could receive investments from investors seeking risk-adjusted market rate and/or double-bottom line returns.



The Fund's investors would accept different levels of risk, and associated levels of return.

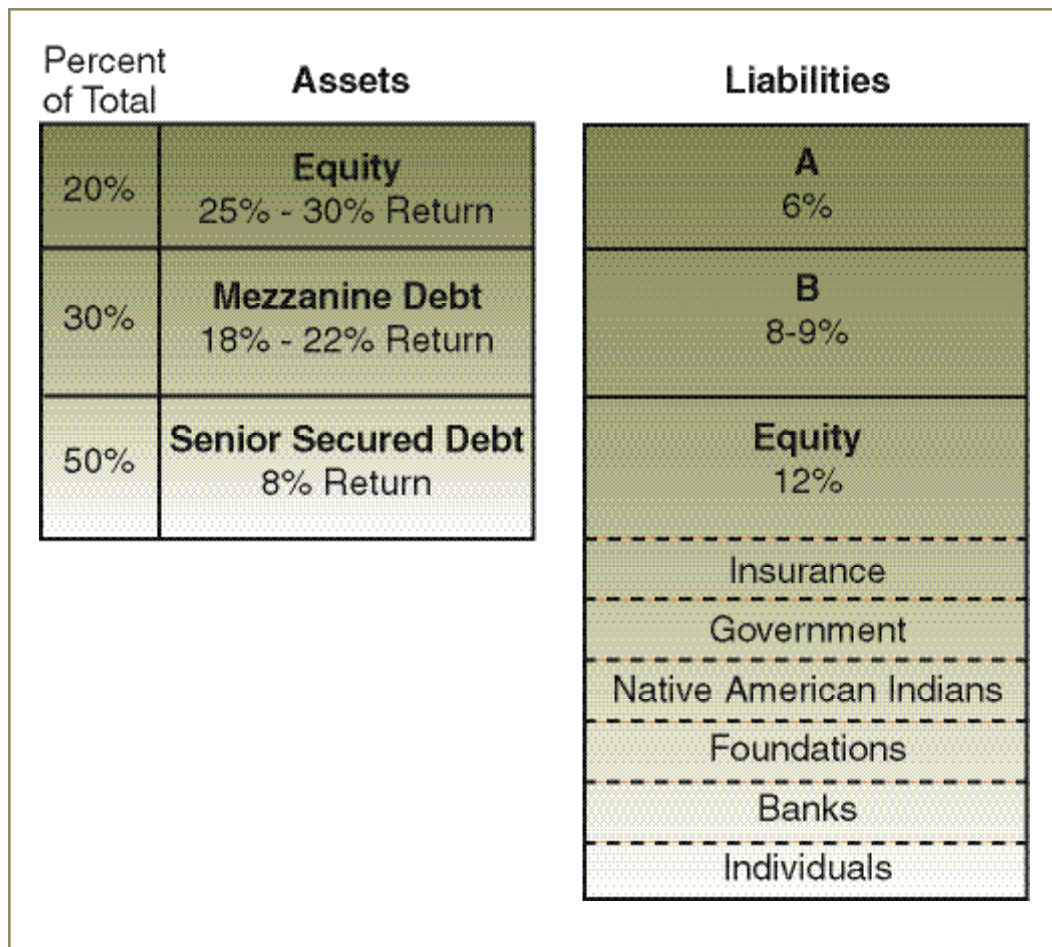
long-term debt to magnify return on contributed capital. The diagram on the following page illustrates a hypothetical mezzanine fund model (Fund). (NOTE: return rates and asset allocation are for illustrative purposes only.) The Fund could receive investments from investors seeking risk-adjusted market rate and/or double-bottom line returns, e.g.:

- Financial institutions and private equity investors
- Other banks seeking Community Reinvestment Act (CRA) credit
- Insurance companies
- Foundations interested in mission-related or program-related investing
- Corporations with EDM business strategies
- Socially motivated investors
- Other pension funds
- Government or government-sponsored enterprises
- Native American Tribal Councils

Additional sums could be raised by an investment grade (Single A) issuance at Treasury plus 150 basis point return, and a high yield issuance (BB-) at 600 basis points above Treasury yields. The asset side of the Fund balance sheet could include senior secured debt issued at one interest rate, mezzanine investment yielding a higher rate return, and direct equity yielding the highest return rate. Equity might also be returned in the form of an ongoing "royalty" payment.

The Fund's investors accept different levels of risk, and associated levels of return. Those that are less risk-tolerant or more double-bottom-line oriented, such as foundations, governments and social investors, subsidize the higher returns demanded by others, such as banks and institutional investors. The Fund could enhance its deal flow and impact by linking with one of the networks described as Model Four and Model Five below.

Figure A
EDM-Targeted Mezzanine Fund Model



MODEL FOUR: FINANCIAL INNOVATIONS LAB & LEARNING CONSORTIUM

GOAL: Address the information challenges involved in linking financial innovation to community development finance, including:

- The ongoing refinement of financial technologies, and their application to ever more areas, information not likely to reach those involved with LMI businesses;
- The lack of contact between mainstream financial professionals and EDM businesses and communities
- The lack of regular, structured learning sessions for those professionals engaged in meshing financial technologies with EDM and LMI financing opportunities.

A Financial Innovations Lab and Learning Consortium would address the information challenges involved in linking financial innovation to community development finance.



The Financial Innovations Lab & Learning Consortium would link those active in the relevant fields to advance innovation, increase learning and provide networks to facilitate increased lending and investment.



Some programs would be open to all allowing for cross-fertilization; some would be reserved for specific subsets, enabling peers to share information.



Engaging both the potential suppliers and users of capital would maximize the likelihood of developing a viable product serving the interests of both parties.

STRATEGY: Create a formal structure – the Financial Innovations Lab & Learning Consortium (Lab/Consortium) to link those active in the relevant fields to advance innovation, increase learning and provide networks to facilitate increased lending and investment. Community investment lenders at major institutions (e.g., Wells Fargo, Bank of America, Goldman Sachs) note that they rarely have the opportunity to discuss these issues among themselves, much less with the businesses and communities seeking financing.

PROCESS: Institutions, investors, entrepreneurs, community development financing organizations, and policymakers could participate in the Lab/Consortium. Some programs would be open to all regardless of affiliation or specialty, allowing for cross-fertilization; and some would be reserved for specific subsets, enabling peers to share information. Certain discussions would be confidential to encourage transparency. As it evolved, the Lab/Consortium could collaborate on projects such as the models described above, e.g., data collection, pooling loans for securitization, jointly funded mezzanine funds, etc. The Lab/Consortium could consist of several components, such as:

FINANCIAL INNOVATIONS LABORATORY

Brings together experts in structured finance, community lenders, entrepreneurs, researchers, regulators, etc., to work through specific challenges limited the flow of capital into EDM communities. Once problems were identified, a small group would build a market-solution by considering the appropriate financial technologies and the relevant adaptations needed for it to work in the LMI market. The solutions would be piloted, most likely by a participating financial institution, and deployed more broadly as applicable. Engaging financial institutions in the pilot design would increase their sense of ownership. Access to a potentially lucrative new product would incentivize them. Engaging both the potential suppliers and users of capital would maximize the likelihood of developing a viable product serving the interests of both parties.

CRA INVESTMENT SYMPOSIA

A regular meeting among those responsible for CRA at financial institutions would enable them to share challenges and solutions. Researchers and innovators

would present current data, new models and applications to build the group’s knowledge base, and to generate joint approaches to achieving CRA goals in a market-responsive fashion.

INSTITUTIONAL INVESTOR EDUCATIONAL ACTIVITIES

EDM businesses, and LMI firms in particular, are extremely challenging for large institutional investors. They do not have the regulatory incentive that CRA offers banks. For institutional investors, interest in the EDM market must derive from the investment proposition. Yet these entities represent the single largest source of capital globally. With the data gaps discussed throughout this report, most investors are at a loss to evaluate the market effectively. The Lab/Consortium could develop informational tools, products and programs tailored to the needs of institutional investors, and engage them in ongoing learning. This would be quite valuable, especially at the public pension funds, which, despite their extensive assets – nearly \$3 trillion – operate lean staffs with little room for niche expertise and in-house education. As noted above, a few funds have taken leadership positions in exploring the EDM arena, but many more will be seeking information.

MODEL FIVE: BANK-CDFI-TECHNICAL ASSISTANCE EXCHANGE

GOAL: Increase information sharing, leverage expertise, reduce risk and match funders and businesses more appropriately, ultimately increasing capital flow to LMI businesses.

STRATEGY: Within the LMI small business finance world, firms seek funding, banks seek deals, community lenders and investors seek deals and funding, and each could provide value to the others. However, most often, there is little crossover. With bank consolidation, territories are expanding and banks are reaching into unfamiliar communities. A Bank/Community Lender Exchange (Exchange) would break up the community financing value chain. There are excellent examples of Bank-CDFI partnerships, several of which are described in this report. There are also new models of Bank-Technical Assistance partnerships, the most extensive of which is *CommunityExpress*. A national network would bring these activities to scale and maximize impact.

EDM businesses, and LMI firms in particular, are extremely challenging for large institutional investors.



Bank-CDFI-Technical Assistance Exchange would increase information sharing, leverage expertise, reduce risk and match funders and businesses more appropriately, ultimately increasing capital flow to LMI businesses.



Banks that could not fund applicants due to credit quality could refer them directly to CDFIs or other community-based lenders in the appropriate location.



Ensuring quality technical assistance as part of the loan package would mitigate lender risk.



Without networks, the borrower's relationship to the mainstream sector might be lost, and the bank might lose a potential customer.

PROCESS: An Exchange could include several functions, such as:

- Banks that could not fund applicants due to credit quality could refer them directly to CDFIs or other community-based lenders in the appropriate location. While this is often done on a local basis, it is more difficult for national institutions. Additionally, local banks have only the local CDFI to tap. Given the number and diversity of community finance organizations, pooling the information could enable more appropriate referrals. Incentives for participation and referrals could be provided to launch the effort.
- Banks or CDFIs or other community lenders could tie loan acceptance to the entrepreneur receiving technical assistance (as CommunityExpress bank participants now do). The Exchange could include a national pool, and use a system such as CARAT's TACP to certify approval. Ensuring quality technical assistance as part of the loan package would mitigate lender risk.
- Once an applicant is referred to a CDFI, the CDFI could track the entrepreneur's progress and direct him to the bank when he is creditworthy. Without networks, the borrower's relationship to the mainstream sector might be lost, and the bank might lose a potential customer.
- Members could go directly to the Exchange to obtain interest in a deal, sources for deals, suggestions for or E-Bay-like ratings of service providers (e.g., technical assistance, CDFIs or Banks, other vendors), products and services, co-investors, etc. The comprehensiveness of the system would provide a valuable directory, and its transparency would support reliability, both of which are likely to expand financing activity.
- With a sufficient membership size, the Exchange could develop data collection processes (as in Model One), securitize loan pools (as in Model Two), invest in common funds (as in Model Three), or extend on-line learning programs (as in Model Four).

OVERVIEW

INTRODUCTION

The U.S. experienced a surge in wealth creation in the 1990s. Even after the stock market decline of 2000-2001, Americans' total net worth remains almost 75 percent greater than it was just 10 years ago (\$40 trillion up from \$23 trillion.)¹ As with previous episodes of economic expansion, entrepreneurship and innovation underlay much of this growth. Technological innovations helped generate new products and processes, and financial innovations (e.g., private equity and venture capital, mezzanine financing, securitization) helped broaden access to capital among entrepreneurs.

Unfortunately, these financial innovations often did not adequately reach the primary drivers of job creation. Small businesses (those with fewer than 500 employees) represent the bulk of businesses in the economy (99.7 percent of all firms) and are a driving force behind overall economic growth (50 percent of private sector output). These businesses constitute more than 50 percent of private sector workers and create 75 percent of new jobs annually². Yet, small business' share of measurable business financing is less than 10 percent.³

Persistent trends in income and wealth polarization are problematic not only as an issue of social equity, but because they limit growth in aggregate demand and labor productivity that stifle macroeconomic expansion. During the 1990s, income inequality grew by 17 percent, five times the rate of growth in the 1980s. In 1998, 90 percent of the U.S. population held barely 30 percent of the country's net worth.⁴ While the vast majority of the low- and moderate-income (LMI) are white, greater percentages of non-whites live below the poverty line, and households headed by single mothers (white and non-white) predominate in low-income communities.⁵

Minorities and women comprise the vast majority of growth in the labor supply and, hence, the source of potential labor productivity gains that drive economic growth. While the rate of total U.S. workforce growth is declining, falling from 2.7 percent in the 1970s to between 1.0 and 1.5 percent today,⁶ minorities represent up to 70 percent of expected growth over the next 20 years.⁷ Research demonstrates that minority- and women-owned firms are most likely to hire this emerging workforce.⁸ Without effective market-based patterns of job creation, retention and capital formation among the rapidly diversifying labor force, declines in labor supply, productivity and the investment levels necessary to support entrepreneurial growth will act as a brake on the economy.

As with previous episodes of economic expansion, entrepreneurship and innovation underlay much of this growth.



Unfortunately, these financial innovations often did not adequately reach the primary drivers of job creation.



Small business' share of measurable business financing is less than 10 percent.

Ethnic-owned firms grew more than twice as fast as all firms in the nineties, but still face critical capital gaps that impede their ability to grow and create jobs in urban and low-income markets.



Thus, a fundamental mismatch exists between the sources of capital formation and job creation.



The resolution to this mismatch requires mobilizing a continuum of financial technologies and market-based public policy innovations that can carve channels of capital from investors to EDM entrepreneurs – our most important source of job, income and wealth creation.

Ethnic-owned firms grew more than twice as fast as all firms in the nineties,⁹ but still face critical capital gaps that impede their ability to grow and create jobs in urban and low-income markets. The likelihood of a new enterprise surviving, growing, and creating jobs is directly related to the amount of start-up capital available to it at launch.¹⁰ While minorities represent 28 percent of the population, they own only 12 percent of firms; and while private equity investors targeting these companies received only three percent of funds under management,¹¹ the companies received just four percent of Small Business Investment Company dollars.¹² Banks make smaller loans to start-ups in minority areas than in non-minority communities, and to minority-owned firms than to nonminority-owned firms, even when controlling for financial equity, owner education, race, age and experience.¹³ Despite comparable demand for capital, analysis of loan applications reveals a higher denial rate for African-American- and Hispanic-owned businesses even after accounting differing firm characteristics.¹⁴

Women-owned firms represent 38 percent of all firms, twice as many as in 1987, with employment increasing 400 percent and revenues rising 500 percent. Yet these firms receive 12 percent of all small business loans, five percent of venture capital, and credit at lower rates and lower levels than male-owned firms (despite staying in business at least as long as the average firm).¹⁵

Thus, a fundamental mismatch exists between the sources of capital formation and job creation. This mismatch underlies a great public policy challenge – to achieve adequate growth that will lower inequality and extend economic prosperity to an increasingly diverse population, the emerging domestic markets (EDM). EDM refers to people, places or enterprises facing constraints in accessing capital due to systematic undervaluation as a result of imperfect information about these markets. Emerging domestic markets include underinvested small- and medium-sized firms, urban and rural communities, companies serving LMI populations, consumer markets in which the demand for goods and services exceeds supply, and ethnic and /or women-owned or operated small- and medium-sized businesses.

The resolution to this mismatch requires mobilizing a continuum of financial technologies and market-based public policy innovations that can carve channels of capital from investors to EDM entrepreneurs – our most important source of job, income and wealth creation. This is even more critical as we experience a seemingly jobless recovery from a recession that is threatened by the constriction of consumer demand. The situation makes the economic security of lower-income Americans even more precarious.

This report provides:

- Background on the current status of capital access among small

businesses in EDM/LMI communities, and the factors impacting lending and investment activity by financial services providers.

- A compendium of relevant financial and technological innovations either currently in operation, in development, or existing in related fields but adaptable to EDM/LMI markets.
- Recommendations for specific practical, scaleable pilots of innovation models intended to increase capital access for EDM/LMI small businesses and market opportunities for investors.

This report results from extensive literature reviews, interviews with a wide cross-section of investors and lenders (both mainstream and community development), small-business owners, corporate executives, professional and trade association principals, policymakers, regulators, researchers and philanthropic leaders; and a series of interactive working groups testing the concepts for the innovation models presented. A full list of sources appears in the Appendices.

THE CONTEXT

Low- and moderate-income, minority- and women-owned businesses have always faced greater challenges to accessing capital than the mainstream. Some are due to blatant discrimination, but others arise from the imperfect information about the firms and the nature of their business models and environments. They include:

- Lack of performance data on loans to these borrowers, leading lenders to perceive them as riskier and beyond their legal risk tolerance
- Smaller sized loans, leading them to be more expensive for lenders to service
- Firms' need for mentoring and technical assistance services in addition to financing, increasing costs to lenders
- Lack of professional and social networks linking borrowers and financial institutions
- Historical concentration of business in the retail and services industries, with little collateral to secure loans
- Lack of a viable secondary market for small-business loans

Small businesses have traditionally relied on a few key sources of financing: equity infusions from the owner, friends and family (including earnings generated by the business operations); and debt products in the form of bank loans, credit lines, leases, trade credit, credit

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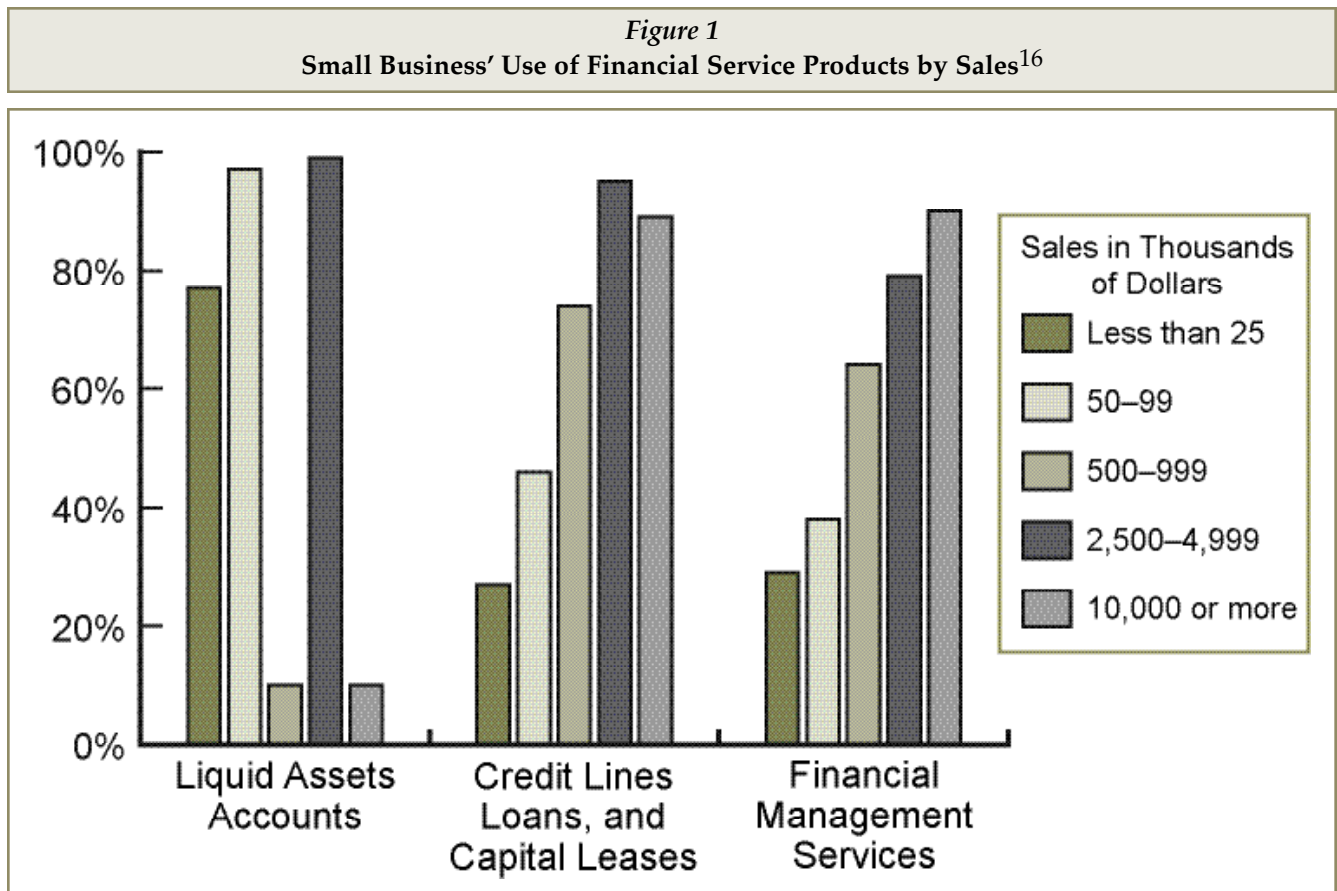
The difference in the use of checking and savings accounts by low-income entrepreneurs and larger businesses is greater than 23 percent.

■ ■ ■
Accessing and employing only a narrow range of financial products and services significantly increases the cost of doing business.

cards and factoring. There is significant evidence that these entrepreneurs do not access the same range of financial services as larger businesses, a gap that is particularly marked when considering businesses at the lower end of the revenue scale. Many small businesses finance their business solely from personal savings and expensive credit card debt. The difference in the use of checking and savings accounts by low-income entrepreneurs (sales less than \$25,000) and larger businesses (sales greater than \$100,000) is greater than 23 percent.

The difference is even greater for more complex financial services such as credit lines, loans, and capital leases. For example, only 27 percent of the smallest firms use these services, compared to 33 percent of firms with sales from \$50,000 to \$100,000, and 46 percent of firms with sales from \$100,000 to \$250,000.¹⁷ Accessing and employing only a narrow range of financial products and services significantly increases the cost of doing business.¹⁸

As the 21st century begins, the market for small business finance is changing. Several major trends – in terms of legislative and regulatory policy, financial services industry development, demographic shifts and economic conditions – provide the backdrop for considering and inventing the future.



LEGISLATIVE AND REGULATORY ACTIVITY

In the late 1960s, the federal government began to address the capital gaps confronting the underserved by funding community development corporations (CDCs), effectively launching the field of community development finance. The Community Reinvestment Act (CRA), enacted by Congress in 1977, scaled up activity by providing private sector financial institutions with a regulatory incentive to meet the credit (rather than only the depository) needs of all the communities they served, including LMI borrowers. Banks must file CRA performance reports, and their grade records may impact their ability to merge. Subsequent revisions to CRA strengthened enforcement, and allowed bank loans to and investments in community development financial institutions (CDFIs) to count for credit. CDFIs are independent financial institutions that act as intermediaries between conventional providers of capital and LMI users of capital. They include depository institutions (community banks and credit unions) and non-depository funds (loan funds, community development venture capital funds and microenterprise funds) that pass bank-invested funds through to target communities. (Note: There are a wide variety of community based financial service organizations, including CDFIs, revolving loan funds (RLFs), community development corporations (CDCs), community banks, etc. For the purposes of clarity and simplicity, this report will use the term “CDFI” to represent the full array of such groups.)

Between 1977 and 2000, banks operating under CRA committed more than \$1 trillion to minority and LMI communities, 96 percent since 1992. Of these commitments, 45 percent was in small business loans, and the balance went to housing and community development.¹⁹ Studies of CRA bank lending have generated myriad reasons for this surge in activity, including the tightened oversight, increased merger activity among financial institutions, and banks’ recognition that CRA-eligible activity was, contrary to pre-conceived notions, good business. A 2001 survey of depository institutions reported that 86 percent found CRA small business loans at least as profitable as non-CRA small business loans.²⁰ Financial institutions increasingly recognize the power of the minority market. Recent decisions by Wells Fargo and Citigroup allow undocumented Mexican residents to open accounts using a Matrícula Consular (Mexican citizenship card) as identification.

Servicing these communities can be difficult for large, mainstream banks. The challenge arises from the information asymmetries described earlier and the resulting higher relative cost of customer acquisition and servicing. Banking’s segmented organizational structure, with separate divisions for wholesale and retail products, runs counter to the flexibility required to build relationships with small firms in LMI areas. Because of their size, community relationships and public purpose, CDFIs can foster the relationships necessary to mitigate the risk banks face in community lending and provide below-market capital. This subsidy

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This shift disproportionately impacted small businesses because they have fewer non-bank options than larger companies.



Small banks – the traditional lenders to small businesses – decreased in number.

effectively acts as a credit enhancement for the conventional lender. With the ability to receive CRA credit for CDFI placements, many banks choose to use this network.

In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA), repealing the Glass-Steagall Act of 1933 (which separated investment banking and commercial banking activity). GLBA paved the way for increased consolidation among depository institutions, securities firms and insurance companies. The results include the creation of single institutions offering a wider array of products and services; however, this consolidation may lead to reduced competition as formerly distinct entities merge. The impact on small business financing is widely debated. Two provisions are criticized as having a potentially negative effect on lending in CRA-designated communities. Small banks (with assets less than \$250 million), representing 80 percent of all banks and thrifts, are now examined not every two years, but rather, every four or five years. Critics fear small banks will relax their CRA lending in the first two years, and then attempt to accelerate lending in the last two years before examination in an attempt to finesse the system. Furthermore, the “sunshine” provision, while requiring banks and community groups to report their CRA agreements annually to Federal agencies, prohibits federal agencies from verifying that banks are fulfilling these promises.²¹

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

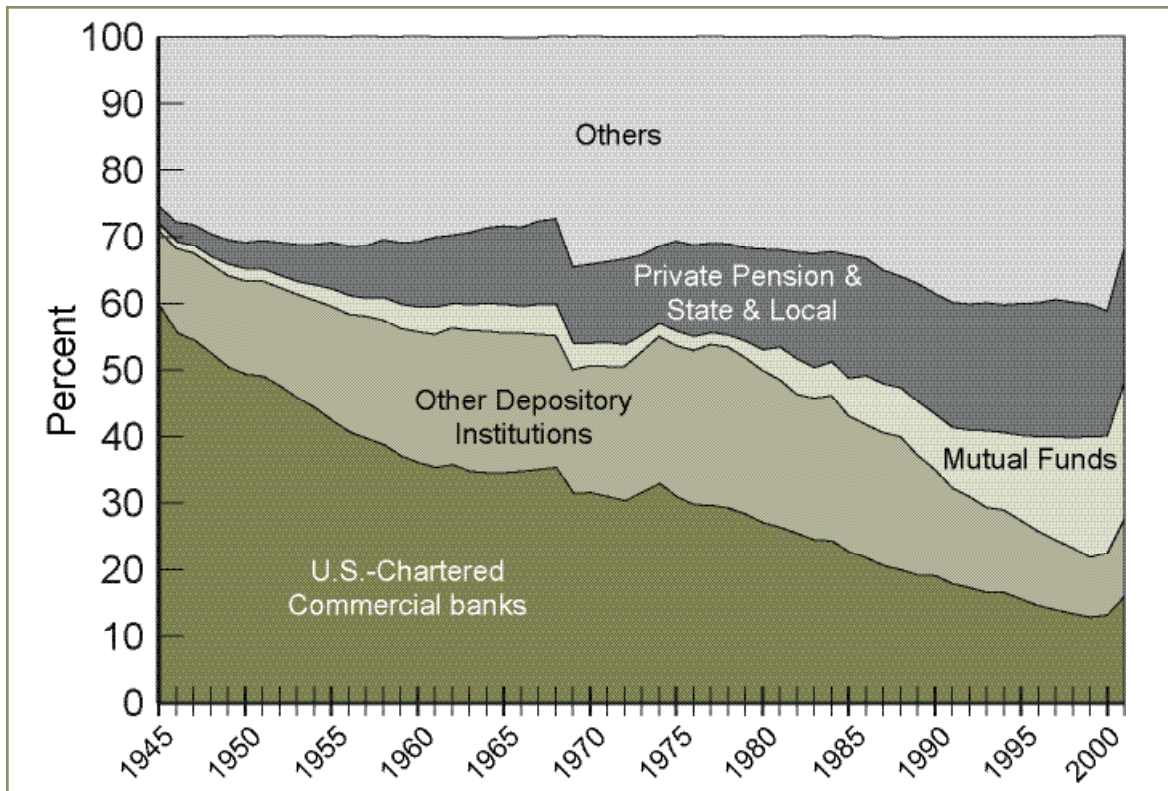
The U.S. is moving rapidly from a bank-based to a capital-market-based financial system. In the past thirty years, money has been flowing at a much greater rate into mutual funds than savings institutions. Additions to mutual funds have totaled \$1.7 trillion, far outpacing the \$500 billion added to savings accounts. While \$400 billion exited mutual funds in 1975, \$201 billion was added in 2001 alone. Money was pulled out of savings accounts through most of the 1990s, and, only with the recent stock market decline, have new deposits returned to their levels of the 1970s.

Between 1950 and 1998, commercial banks’ share of the financial services market declined from 50.9 percent to 23 percent.²² This shift disproportionately impacted small businesses because they have fewer non-bank options than larger companies – commercial banks are three times more likely than finance companies, five times more likely than leasing companies and about six times more likely than families and individuals to provide credit lines and loans to small businesses.

Furthermore, commercial banks are consolidating at a rapid pace. As little as a decade ago, there were 13,000 banks in the U.S.; by 1996, that number was down to 9,700.

With this shift, small banks – the traditional lenders to small businesses – decreased in number. Seventy-five percent of target banks in mergers

FIGURE 2
Percent of U.S. Assets Owned by Institutions²³



that occurred during this period held assets amounting to less than \$100 million.²⁴ As larger financial institutions acquire small ones, they tend to move away from small-business lending, eliminating already scarce venues for financing in LMI communities. From 1999 to 2000, the total dollar amount of lending from commercial banks to small businesses increased at lower rate than their lending to large firms (9.7 percent compared to 16.1 percent).²⁵ Without more cost-effective means of granting credit to LMI entrepreneurs, current financing options remain economically inefficient.

There is also evidence that mergers of large banks into even larger ones are associated with declines in small business lending as a proportion of total bank assets. Examination of mergers between 1977 and 1992 involving 6,369 banks showed a 41.6 percent reduction in small-business lending or \$20.2 billion in that time. The static effect (change in small business lending as an outcome of combining the balance sheet of the merging banks into a larger combined document) was a reduction in small business lending by approximately \$25.8 billion in 1995, or 16 percent of that year's small business lending.²⁶

A large determinant in this decline in lending was the decrease in relationship lending. Because many LMI entrepreneurs must rely more

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Under relationship lending, the strength (or length) of the relationship affects the pricing and availability of credit.



Mergers disrupt these relationships.



Nonetheless, the eventual level of credit availability to small businesses depends upon several factors, including whether community and de novo banks will fill the gap left by large bank mergers, and improved technologies, such as credit scoring, can minimize the costs larger institutions incur in serving these businesses.

on their strong personal characteristics than their credit histories or firms' financial characteristics, face-to-face contact with loan officers is a necessary component of accessing reasonably priced credit. Under relationship lending, the strength (or length) of the relationship affects the pricing and availability of credit. Mergers disrupt these relationships. The larger, merged institutions are less likely to service small businesses with suboptimal credit quality, and often have stricter collateral requirements than smaller banks.²⁷

Nonetheless, the eventual level of credit availability to small businesses depends upon several factors, including whether community and de novo banks will fill the gap left by large bank mergers, and improved technologies, such as credit scoring, can minimize the costs larger institutions incur in serving these businesses. While mergers of large banks into larger banks are associated with declines in small business lending, increases in lending by other banks tend to offset this effect.²⁸ The total number of community banks is declining because of consolidation, but new community banks are entering the market. A niche has developed to serve small businesses that are dissatisfied with services they receive as a result of merger turmoil.²⁹ The size and adequacy of this niche is still unclear.

Along with the reduced number and increased size of financing institutions, traditional providers of capital confront additional issues motivated by the need to operate cost-efficiently:

- **A greater reliance on technology** – The advent of sophisticated computer systems has enabled lenders to automate processing and reduce transaction costs, to maintain detailed databases of information on borrowers and loan performance, and to generate predictive models of risk, i.e., credit scores. Credit scoring is an automated method of analyzing large samples of borrowers with similar characteristics to estimate the likelihood that a loan applicant will default. Long a staple of home mortgage lending, major U.S. financial institutions scaled up their use of the technology for small business loans in the 1990s. They found that personal credit performance correlates significantly with likely business loan performance.³⁰

With these technologies, institutions can service clients far beyond their traditional bank branch territories at minimal added cost. Many are closing branches and diverting customers to the Internet, kiosks and other “virtual” connections. LMI entrepreneurs, though, who don't have the credit records to receive adequate scores, may find it more difficult to access their traditional lenders, and the lenders may find that these labor-intensive, “high-touch,” LMI borrowers hold less appeal. Smaller banks serving LMI markets may not be able to afford competitive technology.

- **A move toward standardization** – To exploit economies of scale, providers of capital must rely on standardized products and services. To be competitive, they increase the number of products and services. But they cannot afford to tailor financial packages to individual borrowers, precisely the need of the LMI entrepreneur.
- **A breakup of the “value chain”** – There are a series of functions involved in any lending activity, identified here as a “value chain.”³⁰
 - Product development
 - Marketing and origination
 - Underwriting
 - Funding
 - Servicing and monitoring
 - Packaging
 - Generating liquidity

Conventional banks long managed all steps of the value chain. In the current era, a variety of institutions may handle one or several functions, leveraging expertise and reducing cost per loan. For instance, large banks, with their sophisticated information technology, are best able to underwrite and service. Smaller, community-based institutions are better positioned to source borrowers and originate loans. A niche market of specialized providers is developing to meet the needs of a splintered value chain.

DEMOGRAPHIC SHIFTS – THE RISE OF EMERGING DOMESTIC MARKETS

As noted above, an increasingly diverse population is generating increasingly diverse ownership of businesses. Over the next 50 years, 90 percent of U.S. population growth will occur among ethnic groups, reducing white Americans to less than 50 percent of total population. In California, Whites already represent less than half of the state’s residents. Businesses owned by minorities are growing at a faster rate than that of all businesses, and distribution across age, workforce size and industry concentration is growing more similar to that of all firms.

Ethnic entrepreneurs impact the overall economy in a number of ways:

- Minorities drive demand. They represent \$2.0 trillion in spending power in 2002 (Hispanics represent \$581 billion), projected to reach \$2.9 trillion by 2007 (Hispanics represent \$852 billion).³²

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A slowing economy, uncertainty, and regulatory changes tighten credit and reduce business formation among all groups.



Reduced entrepreneurial activity translates into reduced job creation and retention rates, and polarizing income and wealth distributional trends.



Among existing firms, a capital crunch will hurt small firms more than large ones, and impact LMI areas to an even greater degree.

- Minorities will spearhead supply. With 70 percent of workforce growth through 2020 occurring among ethnic minority groups, they constitute the major source of upcoming employees.³³
- Minority-owned firms tend to hire minority employees, stimulating job creation in largely minority communities.³⁴
- Minorities provide management talent. In just the two years between 1996 and 1998, the percentage of minorities receiving business degrees grew more than three times faster than the percentage of white graduates. Non-whites' share of total business degrees increased by 8 percent, while white recipients' share fell by 3 percent. Between 1990 and 2000, the number of executives and managers among ethnic groups has grown at over three times the rate of whites (94 percent versus 34 percent change).³⁵

This diverse pool of workers and owners is critical to the overall U.S. economy. The baby boomer generation is retiring, tapping pension earnings and reducing fund assets. These funds must be replenished to secure the future of the current, largely white, workforce. New, largely ethnic workers will supply new contributions, but only if they have secure jobs.³⁶

More than 15 percent of U.S. firms are over 30 years old – a stage at which business owners often retire and place their businesses on the market to be sold; 28 percent are 15-29 years old. Thus nearly 44 percent of businesses will seek new owners in the next 15 years. Given the demographics and assuming capital accessibility, many of these owners are likely to be ethnic and hire ethnic employees.

ECONOMIC CONDITIONS – A CAPITAL CRUNCH

A slowing economy, uncertainty, and regulatory changes tighten credit and reduce business formation among all groups. In 2001, 11.7 percent of adults started small businesses, a 30 percent reduction from the previous year. Reduced entrepreneurial activity translates into reduced job creation and retention rates, and polarizing income and wealth distributional trends.³⁷

Among existing firms, a capital crunch will hurt small firms more than large ones, and impact LMI areas to an even greater degree. A 1999 Levy Institute Survey of Small Business found 44 percent of interviewed firms planned to finance expansion with internal funds. However, they recognized that growth could be stalled by cash flow constraints – stemming from modest sales expectations, and an anticipated tightening of bank credit.³⁸ The SBA notes that many firms are using costly business credit cards in lieu of loans for sums below \$100,000. Banks prefer the profitability of the product, with its greater revenue (20 percent annual rate as compared to 12 percent for SBA loans) and low administrative

costs. Entrepreneurs may welcome the cards, despite the higher interest rates, since they provide easy access to capital and useful records of activity. However, the repayment period is brief, and the resulting increase in high-priced credit can limit an entrepreneur’s long-term ability to secure mainstream financing.³⁹

During the recession of the early 1990s, both large and small banks reduced their lending. Since small business represents a greater percentage of a small bank’s portfolio than that of a large bank’s, the capital crunch hurt small firms disproportionately. A supply-driven credit crunch resulting from regulatory and monetary restrictions precipitated economic contraction and reflects patterns of earlier barriers to capital formation as a drag on economic growth.⁴⁰ A study of 1989-1992 loans showed small banks reducing loan holdings by one and a half times as much as large banks. It also demonstrated that gross state product suffered a greater decline when small banks lost capital.⁴¹ This is not surprising, given the significant impact of small firms on employment. Accordingly, the current slowdown in the economy is likely to impact smaller banks, and hence smaller firms, more severely, and it is critical, to the firms and to the national economy, for these businesses to develop reasonably priced sources of capital and credit other than banks.

IMPLICATIONS FOR LMI SMALL-BUSINESS FINANCE

Given this context, small businesses in LMI communities face daunting challenges in finding economical financing products that would enable them to build the best capital structure for their size, phase and market. However, innovative investors and lenders willing to innovate with such products can find unique opportunities in the LMI market.

OBSTACLES

The obstacles to widespread mainstream financing of these business are relatively clear, and introduced earlier in this report. They include:

- Lack of consistent and complete data on EDM businesses impeding investment decisions. The development of every new market in the financial services industry (e.g., technology, corporate debt, risk management products, venture capital) was labor-intensive and research-driven. Capital market investors avoid opaque markets with little industrial, economic and loan performance data. Scaling up the financial services available to EDM firms requires rigorous, robust and systematic information.

Without loan performance histories, EDM loans cannot be credit-scored or securitized. Without credit scoring, lenders may overestimate risk, and overprice accordingly. Without a secondary

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Ironically, a federal law aimed at reducing discrimination in lending may be restricting capital access by limiting the collection of loan data and the information it would provide for risk analysis by lenders and secondary market credit analysts.



The lack of historical data on these markets saddles them with a higher perception of risk than may be accurate.



Industry and government data is also insufficient for measuring and monitoring the economic characteristics of emerging domestic markets.

market, lender liquidity is constrained, increasing lender risk, borrower cost, and often borrower access. In fact, contrary to conventional opinion, CDFI loan portfolios are not riskier than traditional commercial bank loans. A 2002 National Community Capital Association study of \$4 billion in financing, by 107 CDFIs in distressed urban and rural markets, found net charge-offs of 0.5 percent, compared to .9 percent for all commercial banks and 0.5 percent for commercial banks with less than \$100 million in assets.⁴²

Ironically, a federal law aimed at reducing discrimination in lending may be restricting capital access by limiting the collection of loan data and the information it would provide for risk analysis by lenders and secondary market credit analysts. Both the Home Mortgage Disclosure Act (HMDA) and CRA require lender reporting on mortgage and small business loans respectively. HMDA requires microdata on loan applications that reveal information on the numbers of applications, acceptances and rejections, and borrower characteristics such as income, race and gender. Federal Reserve Regulation B (Reg. B), passed by the Board of Governors of the Federal Reserve in 1977 to comply with the Equal Credit Opportunity Act Amendment of 1977, bans creditors from inquiring about the race or gender of a business loan applicant. By masking race and gender, Reg B does prevent blatant denials on the basis of prejudice, but it also prevents financial institutions from collecting statistical demographic information about the propensity of these borrowers to repay their loans. The lack of historical data on these markets saddles them with a higher perception of risk than may be accurate. Proposed revisions to Reg B in the Access and Openness in Small Business Lending Act of 2001 (currently in the House Finance Subcommittee) would help remediate this problem, by providing for voluntary collection of specific, relevant demographic information on small business borrowers.

- Industry and government data is also insufficient for measuring and monitoring the economic characteristics of emerging domestic markets. In defining LMI areas, investigators currently rely on census tract data, which measures income levels within defined geographic regions to determine whether a business is located in a LMI area. Not only is this data updated only once per decade, but well-to-do pockets may be located within larger tracts designated as LMI, and tracts identified as high-income may contain LMI areas. Using census data alone may thus be an inaccurate means of deciding that a business is in a LMI area.

Data on EDM entrepreneurs is even less comprehensive and reliable. The most complete public sources of information are the Survey of Minority-Owned Business Enterprises (SMOBE) and the Survey of Women-Owned Business Enterprises (SWOBE), released by the U.S. Census Bureau every five years. However, the reports are of limited

usefulness for investment purposes: they are generally dated by the time they are released (the 1997 surveys came out in June 2001) they do not provide firm level data, and often are not comparable over time. Private sources of data (e.g., Dun & Bradstreet) are also often incomplete – minority and women ownership is self-reported and thus significantly undercounted.

- Lack of networks and mechanisms for engagement. EDM firms have traditionally relied on relationships with their local banker. These firms are often more challenging to finance: they have less valuable collateral (e.g., smaller housing assets), often need unsecured working capital loans, and frequently don't meet credit scoring standards. Many have either an insufficient or unacceptable credit record when compared to the general pool of borrowers (which includes affluent borrowers.) The banker-borrower relationships serve as risk mitigators for the lender, and provide borrowers with advisory services and networks, in addition to financing. For many EDM entrepreneurs, the actual cost of a loan is less important than the actual access to the capital and the convenience of a bank with flexible hours located in their neighborhood. This helps explain the ongoing appeal of check-cashers and payday lenders. But relationship lending is on the decline, due to industry consolidation, decline in the number of small banks and large bank branch locations, increased competition and attention to costs and high-margin services, and the resulting reliance on technology.
- Lack of scale, efficiency and value-chain breakup within the community development financial institutions. As noted above, CDFIs often serve as effective intermediaries between mainstream financial institutions and small firms in LMI areas. While this report focuses on the end user, i.e., the small business, it is important to also identify obstacles generated at the intermediary level. At their best, CDFIs provide the relationship services that large banks no longer offer, and source deals that banks would never access. They also offer banks a mechanism to deploy CRA-eligible capital. Unfortunately, many CDFIs also have several characteristics that limit their appeal to market-rate investors. These include their small size, focus on customization and continued hold on the full spectrum of activities in the value chain. Ironically, as conventional depository institutions have embraced specialization, outsourcing functions to niche providers, CDFIs remain vertically integrated, maintaining all functions of the value chain in one, relatively high-cost, organization.⁴³

OPPORTUNITIES

Investors often overlook LMI communities because they do not appear to be profitable markets. Traditional investors do not have working

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LMI areas offer many features desirable to an investor seeking a market with quantifiable risk and return on investment.



Turnover among InnerCity 100 employees is lower than the national average, and almost 50 percent reside in urban areas.



Inner-city consumers represent \$85 billion in annual retail purchasing power, more than the entire country of Mexico, the U.S.'s largest trading partner.

relationships with entrepreneurs in these markets, as conventional metrics distort and minimize the markets' demand and supply potential, and misconceptions persist regarding crime, buying power, education and other features of inner city areas. Exposing the emerging domestic market demand and values remains a key challenge for research and economic development.

LMI areas offer many features desirable to an investor seeking a market with quantifiable risk and return on investment. Each year since 1999 Inc. magazine, in partnership with the Initiative for a Competitive Inner City (ICIC), ranks the top 100 inner city companies based on revenue. A snapshot of these firms highlights some of the opportunities:

- Turnover among InnerCity 100 employees is lower than the national average, and almost 50 percent reside in urban areas.
- Key industries include business products and services (24 percent), high tech (18 percent), consumer goods (16 percent) and construction (15 percent).
- The oldest company on the most recent InnerCity 100 list was 85 years old.
- Seventy-seven percent of CEOs surveyed held at least a bachelor's degree, and 38 percent had a master's degree. Forty percent of CEOs surveyed were minorities and 21 percent, women. Three-quarters live in the inner city.
- When asked about their plans for the next two years, 65 percent said they wished to acquire other companies, 38 percent planned to raise equity, 32 percent intended to institute succession planning, 19 percent planned to merge, 12 percent were preparing to go public and 8 percent hoped to sell.
- The key roadblocks cited were lack of capital, cost of customer acquisition, need for quality workers and need for appropriate partners.⁴⁴

Based on the experience of these and other companies, key opportunities in low-income small business markets include:

■ ***Significant unmet consumer demand***

Inner-city consumers represent \$85 billion in annual retail purchasing power, more than the entire country of Mexico, the U.S.'s largest trading partner.⁴⁵ With over 7.7 million households in densely populated inner cities, these consumers constitute a large purchasing power per square mile despite their relatively low average household income. Approximately 25 percent of retail demand is unmet in inner cities nationally,⁴⁶ due to such factors as low quality and untailed

product offerings, and substantially higher prices. Inner-city consumers spend as much as 40 percent more than suburban purchasers on groceries, and an additional 45 percent in drug stores and pharmacies. The current low level of competition in these markets presents profit opportunities to new entrants.⁴⁷

Several studies on LMI spending power have reconfigured traditional metrics to more accurately reflect the urban core. By adjusting for factors such as population density and adapting the method of assaying home ownership rates, a truer picture of inner city markets emerges. Shorebank Advisory Services and Social Compact both capture the undetected inner-city purchasing power of cash economies, estimating that approximately one-third of all consumer expenditures are made by households with income under \$30,000. Figures show that households in this income range spend roughly \$849 billion per year.⁴⁸ A comparison by Social Compact of two Chicago neighborhoods, the LMI urban Little Village, and the wealthy suburb Kenilworth, found that while Kenilworth's median household income exceeded \$100,000 and Little Village's was \$20,000, Little Village offers retailers \$85,018 in spending power per square acre, compared to Kenilworth's \$37,754. Extending the analysis through four Chicago areas, Social Compact identified 131,000 people undercounted by the Census, representing an additional \$2.21 billion in market expenditures – a 62 percent increase over the amount estimated using traditional measures.⁴⁹

Shorebank Advisory Services, through its MetroEdge service, has shown that urban neighborhoods, such as those in Atlanta, Georgia that are generally perceived to house lower income segments of a city's population, actually have an equal number of residents in the middle income ranges as other areas in the city.

■ *Untapped market*

Fringe banking services, i.e., check-cashing outlets, payday loan centers, pawnshops and rent-to-own stores – have experienced explosive growth in LMI areas in the United States, generating over \$78 billion in annual revenue. Many providers charge excessive fees and absorb potential bank customers for savings accounts and loan products. Despite the fees, many LMI residents continue to purchase fringe services because providers are present in their communities (unlike mainstream bank branches), stay open at convenient hours, and provide capital not offered by the banks. For many customers, having access to capital is more critical than the cost (i.e., interest rate) of that capital. In addition, a bank's minimum balance requirements and service fees often make the loan cost comparable to a fringe service.

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Mainstream institutions are increasingly focused on small firms in general as they absorb smaller institutions that serviced these customers, and as they recognize the business opportunity inherent in this large sector of the economy.



The paucity of institutions targeting EDM businesses, and the record of firms paying fringe providers for access and convenience, highlights the opportunity.



The lower cost of real estate – land and buildings – in LMI areas, whether urban or rural, offers a major advantage to businesses and investors.

The demand for these services indicates the potential market for financial services institutions. Mainstream institutions are increasingly focused on small firms in general as they absorb smaller institutions that serviced these customers, and as they recognize the business opportunity inherent in this large sector of the economy. Advances in technology have also made it more affordable to access the market. Small firms need access to loans, checking accounts, payroll services, and other financial services products, and historically tend to be loyal to full-service institutions. The paucity of institutions targeting EDM businesses, and the record of firms paying fringe providers for access and convenience, highlights the opportunity.

■ ***Less expensive real estate***

The lower cost of real estate – land and buildings – in LMI areas, whether urban or rural, offers a major advantage to businesses and investors. These areas are also often located in close proximity to suppliers and major transportation arteries.

To illustrate, the average rent for office space in rural Stockton, CA is \$18 per square foot compared to \$46.8 in California overall. Industrial rent in Stockton is \$3.10, less than half the California average. Per capita income and the cost of a home are also lower than the California average, offering a lower cost of living and a less expensive labor force.

■ ***CDFI market expertise***

While CDFIs' limitations pose obstacles to attracting capital to small EDM businesses, the presence of this network of local institutions can add great value. Most importantly, CDFIs know their markets. While market information is limited to the conventional investor and lender, CDFIs can evaluate, mitigate and price risk appropriately. Because they work outside the margins of the conventional finance system, they can experiment and innovate. Partnerships with mainstream providers of capital can help bring CDFI innovations and expertise to scale and use by traditional markets, and the availability of CDFIs as partners is a major advantage to mainstream capital providers seeking to expand into new markets with new products. As noted in a 2002 study by the National Community Capital Association, CDFI lending is as safe as commercial bank lending with comparable net charge-offs and delinquency rates, and investors in the sampled CDFIs (representing \$4 billion in cumulative financing) hadn't lost a penny of capital.⁵⁰

INNOVATIONS

In any industry, innovation occurs best under certain conditions. These include:

- The ability to experiment: By its nature, innovation requires experimentation. Partially for this reason, innovation occurs at the margins.
- Access to information: Innovation is an iterative process, each effort informing the next step. Without comprehensive information, the process cannot occur.
- Partnerships: Combining the best skills of two or more organizations creates more efficient means of achieving the goals of the organizations involved.
- Replication and scale: Effective innovations must be scalable, driving costs down and profit margins up, and replicable, requiring minimal alteration to fit various scenarios. Small transactions and those that require customization are costly, making the opportunity less attractive to investors.
- Cost-effectiveness: Reasonable costs maximize the likelihood of a project's profitability or sustainability, and probability for widespread uses. This can be achieved through streamlined activities, specialization and focus on specific activities.
- Leadership: At the core of any successful innovation, one finds a strong leader.

Financial innovation is no different. In seeking examples of innovation, we found places where these conditions occurred, and identified approaches that fostered sustainability and extended benefits to the widest possible audiences. In some cases, these places were sophisticated, mainstream institutions utilizing the latest financial technologies, and in others they were community-level organizations with dynamic leaders operating at the margins. For the purposes of this discussion, the innovations fall into three categories⁵¹:

- **Systemic innovations:** Innovations that affect the financial sector broadly, e.g., changes in business structures, new types of financial intermediaries, new legal or regulatory frameworks;
- **Product innovations:** Innovative financial products that better serve the market, including both the suppliers and the users of the products; and

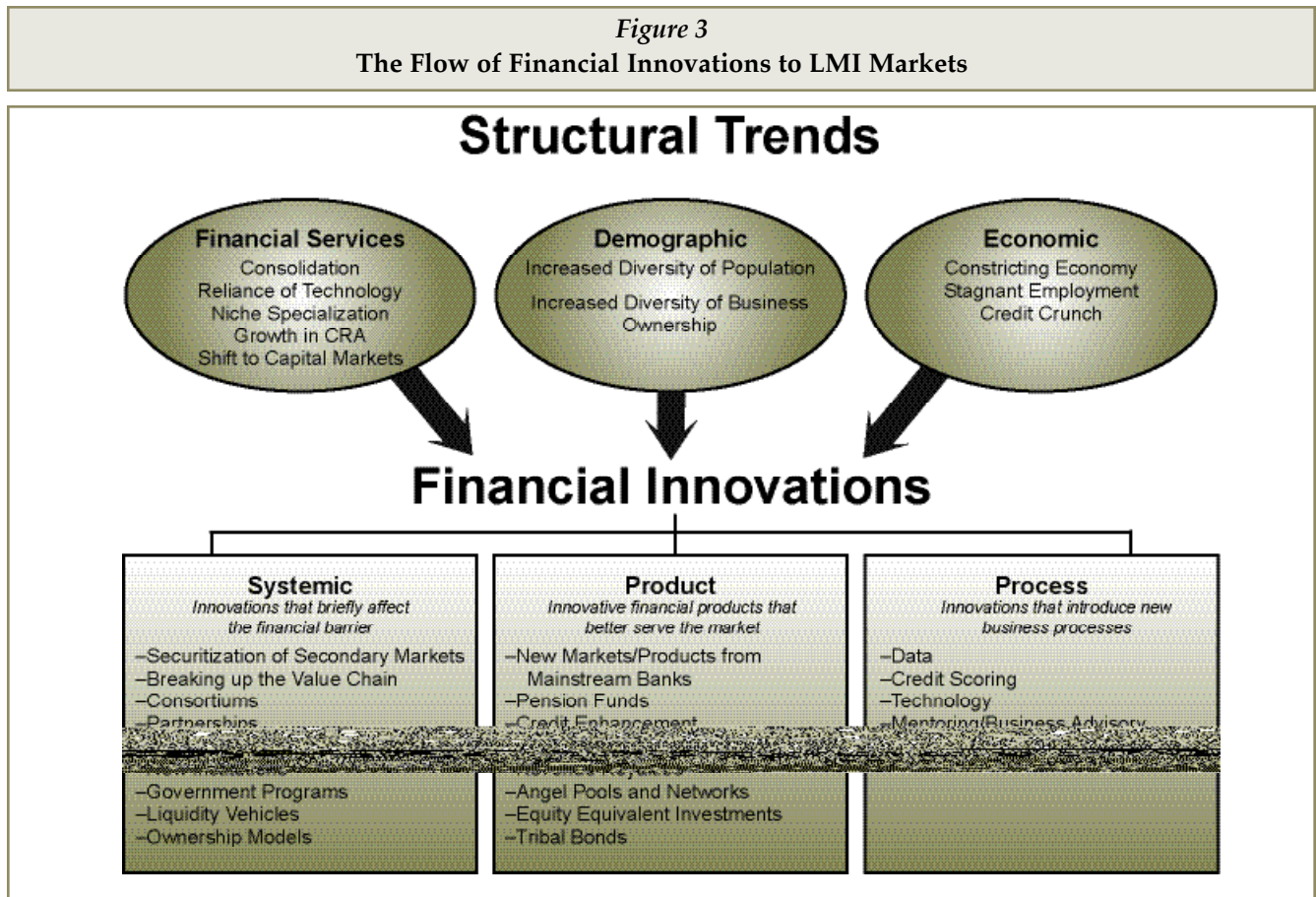
In any industry, innovation occurs best under certain conditions.



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By its nature, innovation requires experimentation.



- **Process innovations:** Innovations that introduce new business processes, which may increase efficiency, expand markets, etc., such as information technologies.

A discussion of several prime examples of these innovations follows. Some of these are currently in operation. Some exist in related fields and could be applied to the LMI small business financing market. Others are concepts in development that offer promising applications.

SYSTEMIC INNOVATIONS

SECURITIZATION & SECONDARY MARKETS

Securitization involves the pooling and purchase of individual small-business loans from multiple lenders and packaging these loans into a security, or a Collateralized Loan Obligation (CLO), which is then sold to a third party. This process, often called a secondary market transaction, converts illiquid individual loans into more liquid, marketable securities. The purchaser of the CLO is able to hedge against the risk of default on



A secondary market transaction converts illiquid individual loans into more liquid, marketable securities.

any one of these loans as they own just a small percentage of each loan in the security (see Figure 4 – Small Business Loan Securitization)

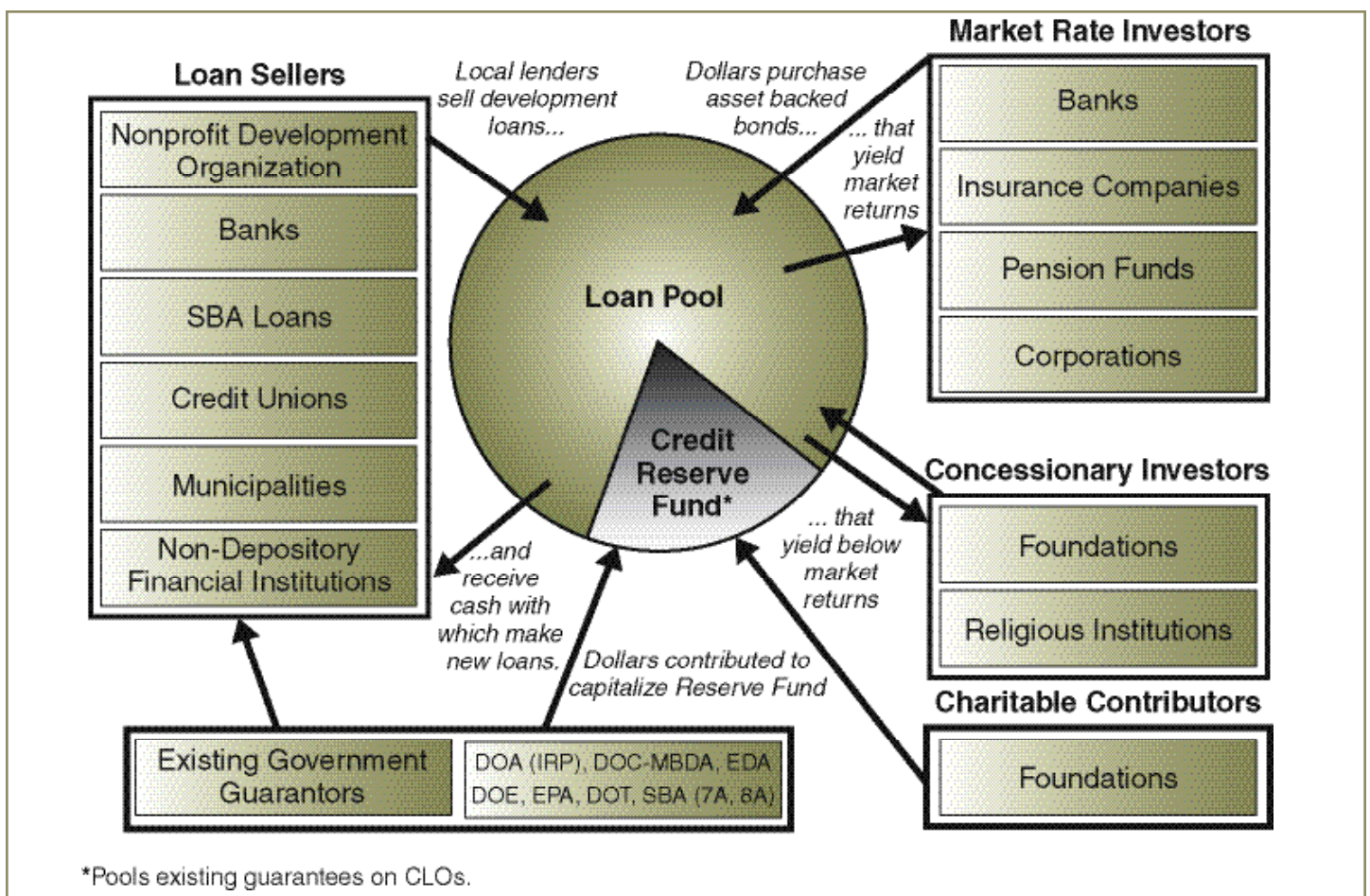
The availability of securitization and active secondary markets dramatically increased access to capital in the home mortgage, car loan and credit card markets. Providing lenders with buyers for these loans made extending credit to less traditionally creditworthy borrowers a less risky proposition. Furthermore, it enabled lenders to increase liquidity, reduce transaction costs and make additional loans, thereby providing to potential borrowers increased access to capital at lower financing costs.

Securitization of small business loans has been slower to develop. In 1999, only 0.3 percent (\$2 billion) of the estimated market was securitized. The potential small business loan market size is large, estimated at about \$675 billion in June 2000.⁵² Sixty percent of these loans are held by commercial banks, with 30 percent of the bank loans (i.e., 20 percent of the total market, or \$135 billion) held by smaller banks

The availability of securitization and active secondary markets dramatically increased access to capital in the home mortgage, car loan and credit card markets.



Figure 4
Minority Business Finance Model



Small-business loan securitization could substantially increase capital access among emerging entrepreneurs.



The need for specialty lenders in this market exists because the loans often require sophisticated personnel and resources to adequately analyze credit-worthiness.



Securitization increases the availability of capital to lend by returning the principal to the specialty lender, enabling it to make new loans to additional borrowers.

(those with less than \$500 million in assets). Finance companies issue the remaining 40 percent. While not all of these loans are securitizable, the fact that less than 1 percent went on the market in 1999 indicates considerable room for growth. Despite issuing a smaller pool of small business loans, nonbank financial institutions undertake the majority of securitizations – 73 percent in comparison with 27 percent by commercial banks.⁵³

Small-business loan securitization could substantially increase capital access among emerging entrepreneurs. The need for specialty lenders in this market exists because the loans often require sophisticated personnel and resources to adequately analyze credit-worthiness. Securitization increases the availability of capital to lend by returning the principal to the specialty lender, enabling it to make new loans to additional borrowers.

Several factors account for the discrepancy between securitization of small business loans, and other loans. A successful process includes these key factors:

- A pool of sufficient size and similarity
- Uniform loan underwriting criteria
- Standardized loan documents
- Sufficient performance data on loans reflective of the pool
- Information technology to estimate default probabilities and prepayment patterns more easily
- Available credit enhancement mechanisms
- Robust secondary market to purchase loans

The small business lending market lacks many of these characteristics. According to a 1999 report published by the Federal Reserve Bank of Atlanta, “widespread securitization of small business loans is unlikely to occur until underwriting standards and loan documentation for the loans become more uniform and better information for estimating the risk of loss becomes available.”⁵⁴

In addition, many banks prefer to hold, rather than sell, their small business loans. Reasons include maintaining CRA credits without expending the effort or cost to originate new loans; concerns about thin margins and the potential discount (on the face value of the loans) they would take by selling prior to maturity; a prohibition until 1997 against banks securitizing the nonguaranteed portion of SBA 7(a) loans, and a continuing concern about ongoing funding of the 7(a) program; a desire to keep bank asset levels high, particularly in an uncertain economic

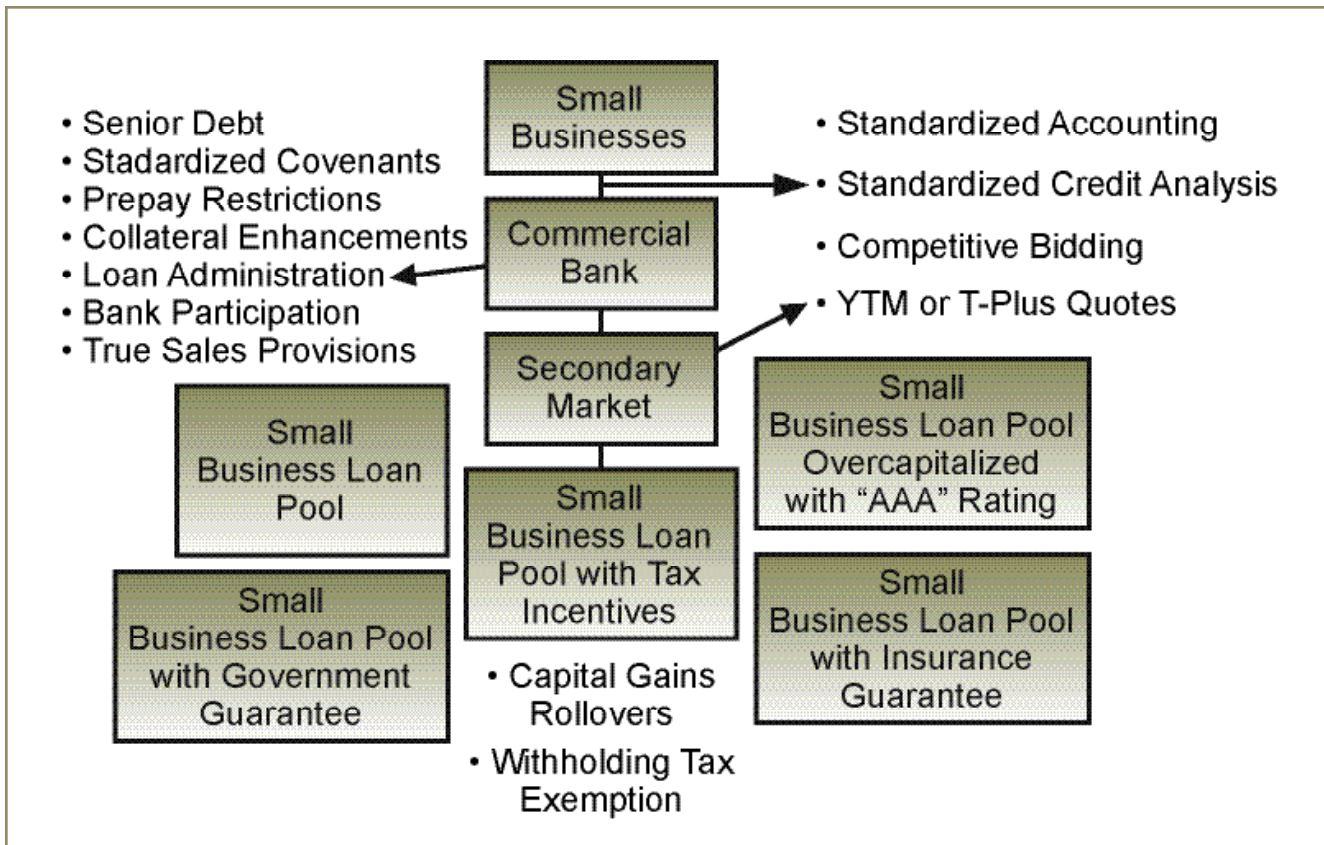
market, and a preference among small banks to maintain relationships with their customers – relationships that might depart once they sell the loans.

Figure 5 presents an overall view of potential secondary market structures that could carve new channels of capital into the EDM business sector. Collateralized loan obligations would be diversified by industry, geography, and other characteristics (startup, buyouts, etc.) in order to standardize and commoditize the risk that is in the loan pool. Standardization of credit analysis and accounting methods, standardization of prepayment risks, and application of credit scoring would increase cash flow predictability, reduce costs, and reduce contingent risks in such a loan portfolio. Credit enhancement could derive from a partial government guarantee (or pooling of existing guarantees for these instruments); tax incentives to enhance loan values; a private insurance guarantee; or overcapitalization of the loan pool to achieve an investment-grade rating. Specific elements of the securitization process are discussed throughout this report, and a model that can be implemented is presented in the recommendations section.

Figure 5 presents an overall view of potential secondary market structures that could carve new channels of capital into the EDM business sector.



Figure 5
Potential Secondary Market Issues



A significant amount of CRA-eligible small-business lending is conducted by community development finance organizations and revolving loan funds, which provide approximately \$270 million in financing annually.



These groups have been particularly slow to adopt such financial innovations as securitization.



The technology offers financial institutions the advantage of increasing the velocity of circulation of bank loan assets on their balance sheets, which could increase bank profitability over time.

Securitization of small-business loans specifically targeted at LMI entrepreneurs and communities poses additional challenges. A significant amount of CRA-eligible small business lending is conducted by community development finance organizations and revolving loan funds, which provide approximately \$270 million in financing annually.⁵⁵ These groups have been particularly slow to adopt such financial innovations as securitization. There are several reasons for this hesitancy:

- CDFIs are generally small (the median asset size is \$4.8 million, with the 10 largest institutions holding approximately \$1.2 billion, representing 26 percent of total CDFI assets^{56,57}, and do not hold pools large enough to securitize cost-effectively. In addition, the pools contain a heterogeneous mix of loans.
- CDFIs operate on a customized financing model, precisely the opposite of that required for securitization. Neither their underwriting standards nor their loan documents are standardized.
- Most CDFI loans are not credit-scored and adequate data is not collected at the firm level, reducing the information on the loans necessary for securitization. Since the lack of performance data perpetuates the perception of these loans as highly risky, strong credit enhancement would be required.

While these factors enable CDFIs to service their individual clients well, they prevent the organizations from selling their loans, and recycling the capital into new loans. There is debate within the field regarding the need to securitize CDFI loans. Some organizations would prefer to grow internally, using equity and “near equity” capital to support that growth. Others believe that their mission requires the customization that is a major factor in prohibiting securitization. Many interviewed do not feel they have a liquidity problem, and like the banks, prefer to hold their loans and maintain their customer relationships. The cultural gap between capital markets and community development finance – the former purely market-based, and the latter used to relying on concessionary capital, and the accompanying lack of capital market expertise among CDFI staff, may also contribute to the confusion.

Despite these challenges, securitization remains an innovation critical to the growth of small business lending in LMI communities. The technology offers financial institutions the advantage of increasing the velocity of circulation of bank loan assets on their balance sheets, which could increase bank profitability over time. In fact, CRA revisions in 1993 offered banks new flexibility to meet their obligations by investing in securitized instruments and other financial innovations targeted to the objectives of expanding capital access. Legislative initiatives such as the Riegle Community Development and Regulatory Improvement Act of 1994 removed regulatory restrictions on the securitization of small-

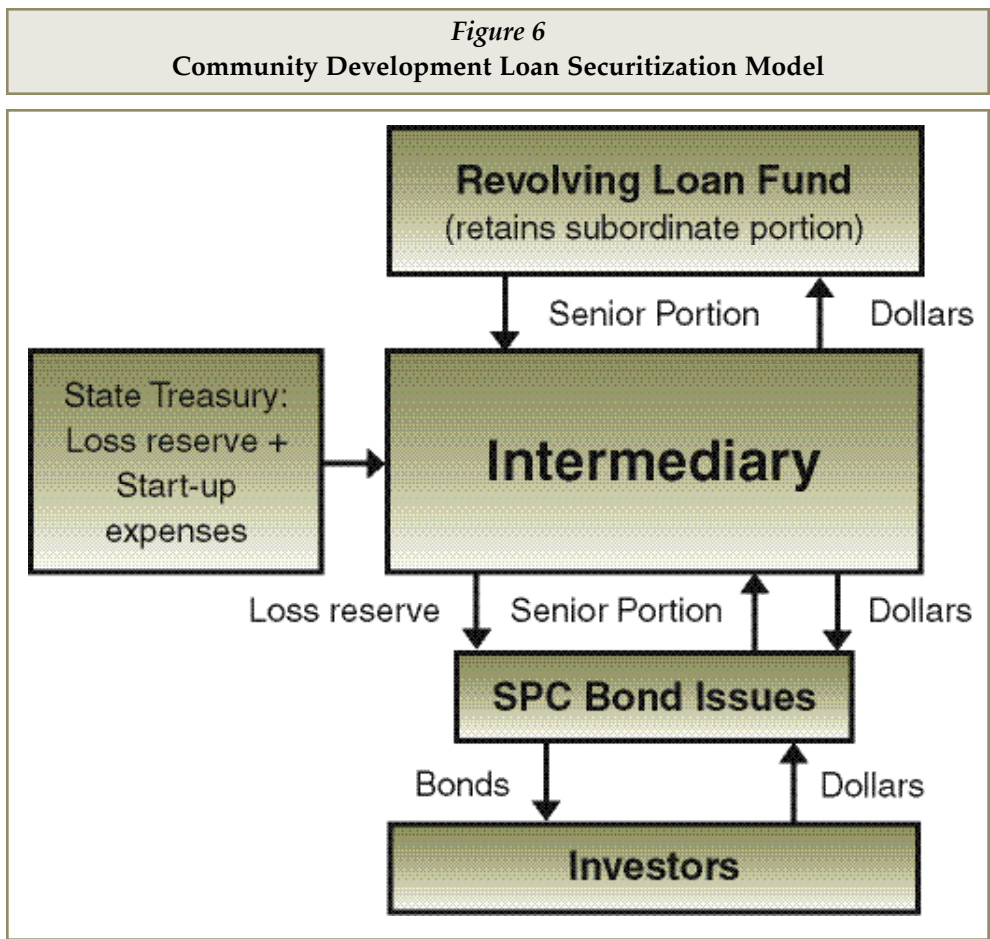


Figure 6 illustrates a generic model for securitization of community development revolving funds, credit enhancing them with loss reserves, and selling the senior tranches to private investors, enabling the fund to revolve more quickly.



If the community development finance field is to grow and to continue to serve LMI borrowers, CDFIs must consider the full range of financial technologies that would allow them to increase capital access.



Securitization is obviously a key technology, and much innovation is underway to make it workable for community development finance organizations.

business loans, and created investment opportunities for federally regulated banks, thrifts, credit unions and pension plans.⁵⁸

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COMMUNITY REINVESTMENT FUND

The Community Reinvestment Fund (CRF) has successfully securitized over \$91 million in small business loans, with loss ratios of less than 0.5 percent and delinquencies of 0.38 percent. The use of credit

Barclays Capital introduced a securitization model based on market issuance of Trust Preferred Securities (TPS).

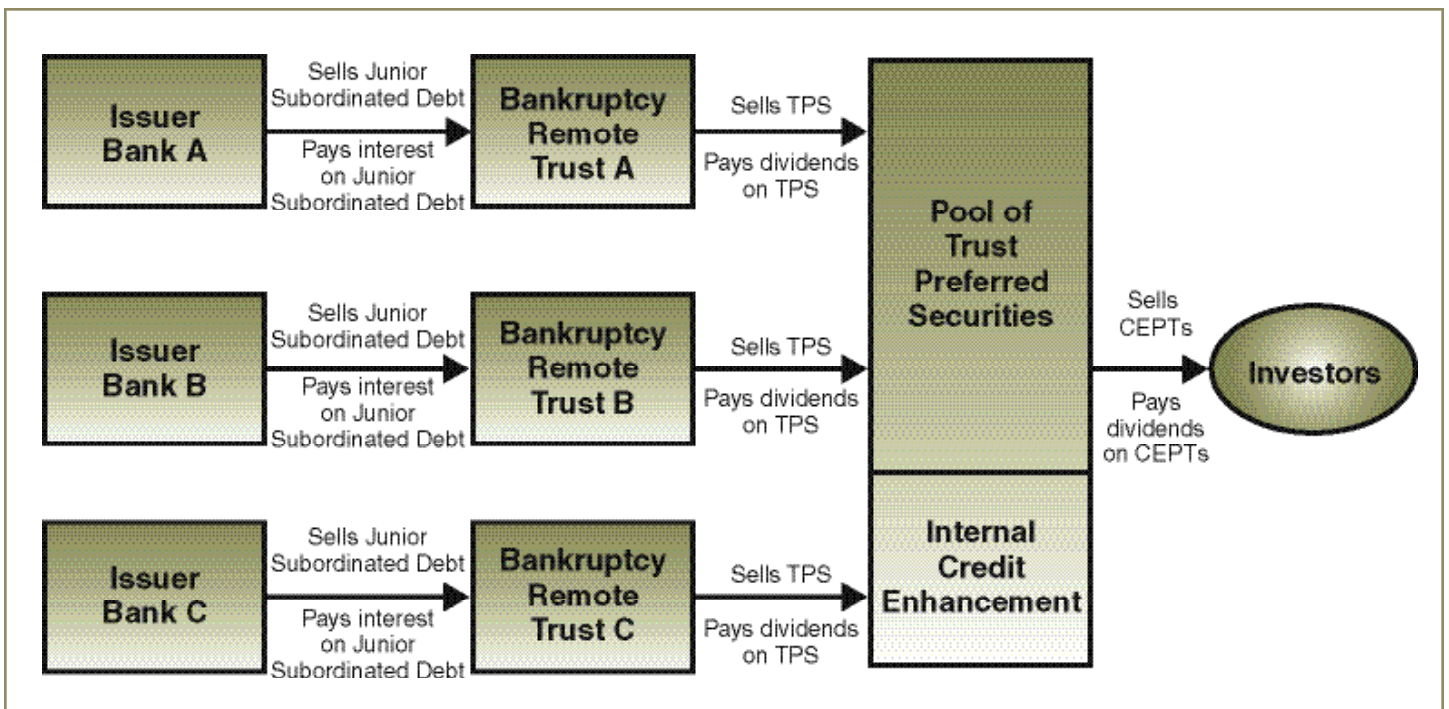


enhancements (through overcollateralization of the loan pools) has been important to the securitization’s viability. With such enhancements most investors can purchase investment grade securities while the risk is concentrated in a small number of speculative tranches. As an example, CRF overcollateralized its latest (13th) securitization, by issuing \$14 million in notes backed by a \$17.2 million loan pool. Class A (\$10.5 million) was privately placed with investors, Class B (\$2.8 million) held by Prudential, and Class C kept with CRF. Classes A & B pay scheduled principal and interest on a 14-year amortization, and Class C is interest only. Any sums above scheduled payments are paid first to Class A, then Class B. While the most successful securitizer of such loans, CRF faces challenges in assembling pools large enough to grow to scale and operate cost-effectively.⁵⁹

MULTI-BANK LENDER SECURITIZATION – BARCLAYS CAPITAL CEPTS MODEL

Barclays Capital introduced a securitization model based on market issuance of Trust Preferred Securities (TPS). TPSs work as follows: a bank sells its junior subordinated debt to a Bankruptcy Remote Trust (BRT), which receives interest on that debt; the BRT sells a TPS to capital market

Figure 7
Multi-Bank Securitization Model



investors, who receive dividends on the TPS paid out of loan repayments. A CEPTS (Credit Enhanced Pooled Trust Security) adapts the TPS model to small community banks using a credit enhancer. Normally these banks would not be able to securitize their portfolios, given the size and credit rating of their loans. A multi-bank lender securitization would amass a diversified pool of community bank debt, and adds an internal credit enhancement, creating an investment grade security – the CEPTS.

SELF-HELP VENTURES HOME LOAN SECONDARY MARKET PROGRAM

Through its Home Loan Secondary Market Program, Self Help Ventures (SHV) purchases nonconforming CRA mortgages from financial institutions and securitizes the loans with Fannie Mae. Because these loans have higher perceived risk, Fannie Mae would not normally securitize the mortgages. However, through a Program Related Investment from the Ford Foundation, SHV retains recourse for the credit losses, and Fannie Mae is able to broker the secondary transaction. The program is part of a project to expand the market for loans to residents with lower credit scores, with higher loan-to-value (a lower percentage down payment), and other nontraditional mortgages. By collecting data on loans that exceed the normal risk profile of most lenders and secondary market buyers, practitioners hope to show that community lending products perform at acceptable levels of risk. Furthermore, armed with a greater pool of data, lenders will be able to determine which factors are greater predictors of delinquency and default.

Fannie Mae has committed to purchase and securitize \$2 billion in loans over 5 years. To date, of the \$635 million in loans purchased, 4.7 percent ended in 90-day delinquency.⁶⁰ Of all of the factors expected to contribute to delinquency, a relatively low credit score was the only accurate predictor. Small-business lenders have noted a similar relationship between personal credit history and business loan delinquency.⁶¹ As noted, small-business loan securitization is not directly comparable to mortgage loan securitization; however, this pilot could provide a useful credit enhancement model and a means of estimating the risk of loans to LMI individuals.

NONPROFIT CAPITAL – COMMUNITY HEALTH FACILITIES FUND

The Community Health Facilities Fund is a nonprofit representing local community health organizations. The Fund seeks to serve as a link between nonprofits and the investment community. Bond houses typically do not understand nonprofits and the nature of health

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Some of the most interesting applications of securitization to community development finance have emerged from the Financial Innovations Roundtable.



Convened biannually over the course of two years, FINIR gathered conventional and community financial experts to consider innovative mechanisms that link conventional and nontraditional lenders, investors and markets to provide increased access to capital in LMI communities.



Financial institutions are moving away from in-house management of all elements of the financing value chain.

organizations’ government funding. The Fund explains to financiers what makes this type of government funding stable – for instance, a residential care facility for the disabled is unlikely to lose its funding. The Fund targets small- and medium-sized nonprofits that, on average, only generate 20 percent of their funding from debt compared to larger nonprofits that generate 50 percent. By bundling the needs of the nonprofits and working with financial institutions to issue bonds, the Fund converts the debt of non-profits into investment-grade bonds for sale in the market. Bonds are used for new construction, purchase, or rehabilitation of facilities, and backed by real estate. The fund currently has an A-rating from Fitch with \$40 million in assets.⁶²

FINANCIAL INNOVATIONS ROUNDTABLE

Some of the most interesting applications of securitization to community development finance have emerged from the Financial Innovations Roundtable (FINIR), a project of the School of Community Economic Development at Southern New Hampshire University. Convened biannually over the course of two years, FINIR gathered conventional and community financial experts to consider innovative mechanisms that could link conventional and nontraditional lenders, investors and markets to provide increased access to capital in LMI communities. Still in development, FINIR’s proposals in the area of securitization include:

- **Community Development Financial Guarantee Corporation:** Raised capital would credit enhance pools of CDFI loans to be issued as investment grade (“A” or better) private placements
- **Pooling Mechanism for CDFI loans:** A cooperative or aggregation vehicle would join several separate CDFI issuers into a large pool of multi-issuers, to sell or collateralize a private placement in exchange for liquidity at a negotiated rate
- **CDFI “Mini-Federal Reserve” System:** A peer-to-peer short-term lending capacity managed by a custodian bank and supported by foundation credit. Funds in the system would be provided by CDFIs and RLFs with excess liquidity and lent to those with short-term liquidity crunches (30, 60, 90 and 120 day loans). While this would not increase the pool of total small business lending, it could increase the efficiency of delivering capital to those most in need of it at any given time.⁶³

BREAKING UP THE VALUE CHAIN

As noted above, financial institutions are moving away from in-house management of all elements of the financing value chain (product development; marketing and origination; underwriting; funding; servicing and monitoring; packaging, and generating liquidity). Instead,

they handle the functions best suited to their structure, and outsource the others to subcontractors or partners.

CDFIs and other community lenders have been slow to cede control of the full range of functions. This “portfolio lending” model can burden a small organization – taxing a lean staff, concentrating risk, and maintaining high transaction costs. A “seller/servicer” model breaks up the value chain, distributing functions (and their attendant costs) among brokers, agents, CDFIs, guarantors, and mainstream financial institutions.⁶⁴

**LIBERTY HILL FOUNDATION/CALFED BANK:
MICROENTERPRISE TRAINING AND FINANCING PROGRAM**

In Los Angeles, four organizations – Liberty Hill Foundation, CalFed Bank, the California Community Foundation and a local entrepreneurial training program – have developed a model for an innovative partnership that breaks up the value chain and delivers capital to LMI entrepreneurs. The pilot will provide microloans, though the model could easily apply to a range of financial products.

The underlying principle of the model is to leverage each partner’s expertise:

- California Community Foundation will cover the cost of a full-time staff person to manage the pilot.
- A leading provider of small business training and mentoring will identify potential entrepreneurs and put them through a standard training program. Upon completion, it will recommend graduates to Liberty Hill.
- Liberty Hill Foundation, a 25-year funder of grass roots organizations in Los Angeles’ LMI communities, will review and select entrepreneurs from the pool of graduates. Liberty Hill will also place a deposit in CalFed Bank representing 50 percent of the total amount the bank is willing to lend during the pilot phase. Thus, CalFed will only be at risk for half of the outstanding loans.
- CalFed will submit the entrepreneurs to the standard application process, including credit scoring. As long as there are no outstanding bankruptcies, CalFed will issue the loan regardless of credit score. The bank will consider the entrepreneurial training a risk mitigator, and the Liberty Hill deposit a credit enhancement. Entrepreneurs will receive market-rate loans, and CalFed will be able to tap Liberty Hill’s deposit if the borrower is 89 days late.

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Leveraging the expertise of diverse parties helps bridge capital gaps and achieve the goals of two or more distinct parties.



Multi-bank community development corporations are a popular type of consortium.



This structure enables large banks to deliver labor-intensive capital to LMI markets more affordably than if they operated a program internally, and provides smaller banks with access to expertise and capacity that they could not otherwise afford.

Through this model, borrowers will receive loans for which they would not otherwise be eligible, and gain access to the mainstream financing system. Negotiations are underway to finalize terms and launch the pilot.

INTERMEDIARIES – CONSORTIUMS AND PARTNERSHIPS

Financial institutions use a variety of intermediaries. Leveraging the expertise of diverse parties helps bridge capital gaps and achieve the goals of two or more distinct parties. Consortiums bring several firms together to create an intermediary that undertakes activities each firm cannot, or will not, do alone. Partnerships are specific relationships forged between parties (often from different sectors, e.g., public, private and nonprofit) to undertake a specific project or projects.

Multi-bank community development corporations (CDCs) – independent community development lender entities funded with debt or equity from multiple financial institutions – are a popular type of consortium. This structure enables large banks to deliver labor-intensive capital to LMI markets more affordably than if they operated a program internally, and provides smaller banks with access to expertise and capacity that they could not otherwise afford. Joining multiple institutions diversifies the risk across the new entity, and enhances the impact of each contribution. Accessing multiple sources of capital enables the CDCs to operate portfolios large enough to achieve economies of scale, a factor critical to the success of a CDC.

Below is a review of several efforts that pooled resources and skills to increase capital access for small businesses in LMI communities.

CONSORTIUMS

CEDLI

The California Economic Development Initiative (CEDLI) is a multi-bank for-profit community development corporation whose shareholders include 45 major financial institutions and four corporations throughout California. Organized in 1995, it provides credit to businesses that do not have adequate collateral to qualify for banks' normal lending programs. Member banks refer potential borrowers to CEDLI, which funds 50 percent of the loan requirement, while the bank funds the balance. To date, CEDLI has made over \$65 million in subordinated debt and mezzanine financing commitments in both urban and rural areas, and offered significant leverage. On average, every dollar that CEDLI invests results in an additional \$3 provided in senior debt from partners, with a loan loss of one percent. In addition, over one-third of borrowers have

graduated to achieve subsequent financing independent of CEDLI support.

NYCIC

The New York Community Investment Company (NYCIC) is an investment firm created in late 1995 by the then-member banks of the New York Clearinghouse Association to provide long-term capital to hard-to-finance small businesses in New York. NYCIC provides equity and near-equity funding (venture capital using the community development venture capital model, and loans in the form of subordinated debt) for business expansion (and the accompanying job creation) with a special focus on companies that are women-owned, minority-owned or located in LMI areas. Presently, NYCIC has about \$45 million under management, has funded 58 companies with \$28 million and leveraged an equal amount from banks and co-investors.

NYCIC's structure enables its investing banks to provide capital (ranging from \$50,000 to \$1,000,000) to companies under terms they could not offer in their mainstream systems, e.g., longer repayment terms, customized products, additional technical assistance. Recognizing the range of needs of its portfolio companies, NYCIC also partnered with Industrial Technical Assistance Corporation, (ITAC) to create "Bridge to Capital." This program provides qualified recipients with a small level of funding to engage a consultant or a boutique investment bank that helps the company raise working capital. These firms repay the loans with interest within one year, and "Bridge to Capital" investors retain an equity share in the company after repayment.

CALIFORNIA COMMUNITY REINVESTMENT CORPORATION

CCRC is a nonprofit lending consortium that provides long-term mortgage financing and bond financing for affordable housing for LMI families and seniors throughout California. Through two primary loan pools, CCRC manages a multi-bank line of credit from 45 banks with current commitments of \$240 million. Bankers sit on the loan committee and approve loans from a blind pool. This direct participation at the ground level leads the banks to take greater risk: it educates the individual bankers, builds their buy-in and enables them to do "story" deals. Lenders participate in each deal based on their pro-rated portion of the total credit line. The pool offers geographic diversification for smaller banks without having to build a line of business to serve each neighborhood in which CCRC operates. All banks are given CRA credit for their participation, and have obtained market returns on their investments.

Through an active management of its portfolio and annual reviews for each loan, CCRC has kept its loss rate extremely low. Of the \$260 million

NYCIC provides equity and near-equity funding for business expansion with a special focus on companies that are women-owned, minority-owned or located in LMI areas.



NYCIC's structure enables its investing banks to provide capital to companies under terms they could not offer in their mainstream systems.



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The Community Reinvestment Act requires banks to service LMI customers in their areas.



The higher relative cost large institutions face in working with such small businesses makes partnering with community-based intermediaries a popular option.



CDFIs can cost-effectively build relationships and meet the local customer's financing and technical assistance needs.

in loans since inception, there has been only one default (and only \$622,000, yielding a 0.28 percent loss rate). To maintain liquidity in the consortium, CCRC sells loans in the secondary market to groups such as the Community Reinvestment Fund, Impact Community Capital, and CDT. The loans are pooled in blocks of \$30 to \$40 million and sold in a block sale every 18 months. Because 85 to 95 percent of most loans are backed by low-income tax credits, securitization has been quite successful. Last year CCRC sold \$150 million in loans. CCRC also engages in private placements of tax-exempt bonds. The deals are structured in much the same way as loans made through an investment committee with each member participating approximately 3 to 4 million in the private placements.⁶⁶

Though CCRC finances housing, the direct engagement consortium structure could easily apply to small business lending. An additional advantage is the consortium's continual innovation and extension deeper into the LMI market.

BANK-CDFI PARTNERSHIPS

As noted above, the Community Reinvestment Act requires banks to service LMI customers in their areas. The higher relative cost large institutions face in working with such small businesses makes partnering with community-based intermediaries a popular option. CDFIs can cost-effectively build relationships and meet the local customer's financing and technical assistance needs. This effectively acts as a credit enhancement for the conventional lender.

In addition, 1993 CRA revisions allowed investments in CDFIs to qualify for CRA credit. The result has been a dramatic upsurge of such investments, increasing from 12 percent of CDFI borrowed capital in 1994 to 21 percent in 1999, in the form of senior and junior loans, equity equivalent investments, capital grants, secondary capital investments in community development credit unions, deposits in community development credit unions, and equity investments in community development venture funds. Large banks use intermediaries as a cost-effective way of reaching the funds. JP Morgan Chase and Citigroup have well-developed intermediary programs, targeted at areas in which they have strong customer bases. Wells Fargo, JP Morgan Chase and Bank of America have placed substantial sums with high performing private equity funds aiming for double-bottom-lines. Most of this work is done through a fund of fund structure to minimize cost and maximize impact, but some banks and CDFIs engage in specific partnerships, several examples of which follow.

BOSTON COMMUNITY CAPITAL

Faced with a liquidity crunch and a growing demand for a greater number of community development deals, Boston Community Capital (BCC), a CDFI, sought out local bank partners to help finance some of its deals. Through an affiliation with PNC Bank and other regional banks, BCC sold participation interests in certain qualified loans, enabling the CDFI to finance larger deals and pass on the lower transaction costs resulting from working with fewer lenders. The banks received CRA credit.

KEYBANK AND COASTAL ENTERPRISES

These two Maine institutions worked on a HUD tax credit program to provide incentives for financial institutions to invest in CDFIs and other community development organizations. Under the pilot partnership, Coastal Enterprises (CEI) (a CDFI) sold tax credits to KeyBank. KeyBank initially invested \$2 million in CEI, in the form of an \$800,000, 10-year loan and a \$1.2 million grant, enabling CEI to capitalize a Revolving Loan fund to finance start-up and expanding businesses, social services, and job-generating community projects for LMI residents. The initial \$2 million investment helped leverage \$10.8 million in community development financing, helping more than 20 area businesses.

CORPORATE PARTNERSHIPS

SHELL COMMUNITY BANKING INITIATIVE

Through the Shell Community Banking Initiative, Shell Oil expands the lending capacity of minority- and women-owned banks and stimulates the creation and expansion of small businesses in underserved urban communities. With each participating bank, Shell makes a \$250,000 passive preferred stock investment, deposits \$1 million in an interest-bearing money market account, and extends \$7.5 million to purchase participation in community development loans made by the bank. These funds enable the banks to support significantly larger transactions than they would ordinarily fund. Currently the Initiative is operating with banks in Los Angeles, Houston, New Orleans, Washington DC and Miami.

Under the program, the bank passes screened applicants (credit scoring is used so this program would not alleviate all the barriers faced by LMI borrowers) to Shell's credit committee. If Shell chooses to participate, it provides 40 percent of the amount. It may also provide 40 percent of the bank's share of syndicated loans. Shell agrees that its loan pool will reflect the bank's portfolio, i.e., it will not cherry-pick only the highest quality loans. Piloted in 1998, the program has bolstered business development in target areas, and shown no defaults. To avoid competing with community banks, the Initiative only funds loans perceived as too risky to be funded otherwise. ⁶⁷

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Initially launched as a micro-loan program, FAME Renaissance now operates a \$5 million venture capital fund, an entrepreneurial training program and a technology business incubator.



Financial partners view the faith-based oversight as a risk mitigator.



Recent pressure and the threat of CRA-type regulation have spurred nonbank financial institutions to address the issue of community development finance. Some have pooled their resources to make double-bottom-line investments.

FAITH-BASED PARTNERSHIPS

FAME RENAISSANCE

FAME Renaissance is an economic development initiative of Los Angeles' First African Methodist Episcopal Church (FAME). Initially launched as a micro-loan program (with \$1 million in seed money from the Disney Corporation) in the aftermath of the city's 1992 civil unrest, FAME Renaissance now operates a \$5 million venture capital fund, an entrepreneurial training program and a technology business incubator. FAME's venture capital fund, in partnership with Hancock Park Associates, a private venture capital firm, invests in businesses that are located in LMI areas in Los Angeles County that can potentially create and anchor jobs in the area. The fund makes investments ranging from \$250,000 to \$1 million, an investment too small for most mainstream institutions, in primarily expansion stage companies. With a growing track record of investments, FAME plans to close on additional financing to eventually operate a \$20 million fund. Financial partners, including Wells Fargo (which operates a full-service banking branch adjacent to the incubator and is the primary investor in the venture fund), Washington Mutual and State Farm Insurance, view the faith-based oversight as a risk mitigator.

NONBANK FINANCIAL INSTITUTIONS

INSURANCE COMPANIES

Recent pressure and the threat of CRA-type regulation have spurred nonbank financial institutions to address the issue of community development finance. Several insurance companies have pooled their resources to make double-bottom-line investments.

IMPACT COMMUNITY CAPITAL

Impact Community Capital (IMPACT) is a limited liability corporation owned by eight major insurance companies representing in excess of \$14 billion in annual California direct written premiums. The firms invest shares in IMPACT, mirroring their proportionate share of the California market.

The company purchases loans made by banks, nonbank financial institutions, and non-profit organizations in LMI and underserved communities and packages them into loan pools. Loans of all sizes are considered, either individually or as securitized packages or pools. One or more of the major credit rating agencies rates portions of these pools, allowing IMPACT to market them to its members as investment-grade securities. The non-investment grade portion remains in IMPACT's investment portfolio. This structure enables insurance companies to

invest in emerging domestic markets, while meeting demands for risk-adjusted market returns on investments.

To date, IMPACT has only securitized LMI housing loans (simpler to structure than small business loans), but the firm plans to generate secondary market transactions for small business and community development. Current IMPACT members include Allstate Insurance Company, Farmers Insurance Companies, Pacific Life Insurance Company, PMI Mortgage Insurance Company, SAFECO Insurance, State Farm Insurance Companies, Teachers Insurance and Annuity Association, and 21st Century Insurance Company.

CERTIFIED CAPITAL COMPANIES (CAPCOS)

After 10 years of experimentation with more state-directed programs, CAPCOs have become increasingly popular as a method of allocating tax credits to encourage and leverage investment in private venture capital firms certified under the legislation.

CAPCOs are venture capital firms designated by state governments to receive investment funds from insurance companies within a state. CAPCOs enable participating insurance companies to receive special tax credits against state taxes (generally states taxes levied against insurance premiums collected within the state) and foster investment in small businesses located within the state, with limitations on the revenues and number of employees of those businesses. CAPCOs are generally required to invest in traditionally unbanked businesses. They must disburse all of the certified capital on which the tax credits may be claimed. After the CAPCO has fulfilled its investment requirements, the CAPCO may decertify and distribute its investment to its shareholders without triggering credit recapture provisions.⁶⁸

Several states have established CAPCO programs. In 1983, Louisiana became the first state to adopt a CAPCO-type program to encourage venture capital funding of small businesses in the state. Missouri, New York, Florida, Wisconsin, Colorado and Texas have since enacted CAPCO programs.

There are a number of advantages to this privately managed, publicly supported approach to leveraging and diversifying the venture capital community. No current state budget expenditures or bond sales are required. The actual cost (present value) of a CAPCO program is reduced by the allocation of tax credits over time. Investments can be insulated from political pressure and limitations inherent in more government directed programs. Finally, the ability to leverage other private funds and increase syndication appears to be improved in this type of program.

However, some disadvantages exist for CAPCOs as well. The net cost of CAPCOs to state governments (tax revenues foregone – returns from

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Receivable-based financing is a common form of alternative financing among many companies.



Factors often provide liquidity to small firms that depend on timely payment from clients to keep their businesses running.



Recent industry consolidation has led factors to evolve into multi-functional, often bank-owned institutions that offer a number of financial services.

investments) is higher in almost all investment scenarios other than if the State Treasury placed money in a comparable investment in a privately managed venture capital fund. Furthermore, because most insurance companies invest in CAPCOs in exchange for a fixed debt instrument and do not benefit from any of the upside potential nor risk any losses on poor performing investments, they do not have the incentive to make investments in the most qualified venture capital funds, often choosing familiarity over performance.⁶⁹

FACTORS AND RECEIVABLE-BASED FINANCING

Receivable-based financing is a common form of alternative financing among many companies. By “converting” customer invoices into lines-of-credit, businesses can borrow against expected revenues and increase liquidity. Whereas large businesses can easily approach their banker for a receivables-based credit line, smaller firms work with factors – highly specialized firms that provide credit and collection services to groups of select small business based on criteria such as industry and size. Factors often provide liquidity to small firms that depend on timely payment from clients to keep their businesses running. They assist such businesses by purchasing accounts receivables from the client, advancing about 80 percent of the value of the receivables, and taking over billing and collection of the client’s accounts. When the client’s customers have paid the invoice, the remainder of the invoice is transferred to the borrower, less a fee ranging from one to five percent. Factor companies are usually low volume, high mark-up businesses, with the high costs offset by the additional billing and collection services offered by the factors.

Traditionally, factoring companies focused on providing services to the apparel and manufacturing market. The range of industries has since expanded to include such diverse fields as electronics, healthcare, and foreign trade. Recent industry consolidation has led factors to evolve into multi-functional, often bank-owned institutions that offer a number of financial services. The market size of factors grew rapidly in the 1980s, experiencing 8.6 percent annual growth, reaching \$50 billion in 1993.⁷⁰

Whereas large companies offset the traditional 30 to 90 day payment period for accounts receivable by waiting 45 to 120 days to pay their vendors and minimize the required working capital, small vendors rarely have the ability to make their suppliers wait, with many forced to pay C.O.D. This can prevent many women- and minority-owned firms from entering into procurement contracts, where the inventory required to fill a sizeable order can be impossible to finance. Recognizing this barrier, some corporations have experimented with using their credit record and bank relationship as the basis for their vendors’ receivable financing. This can cut the cost to the borrower, and enable the corporation to manage a robust procurement program. Corporations seeking to diversify their subcontractor base may find this approach quite beneficial.

ACTRADE'S E-TAD

Founded in 1987, Actrade was established to aid U.S. manufacturers and distributors export their products overseas using innovative payment systems. While not defining itself as a factor, the company functions similarly and introduced an innovative factoring product, E-TAD, in 1993. E-TAD works in much the same way as a credit card system. Actrade's E-TAD provides liquidity to small firms to allow them to serve larger contracts without having to worry about working capital constraints.

By providing liquidity and eliminating credit risk for small businesses, E-TAD allows them to service large contracts and achieve the scale necessary to expand their business into larger markets and employ more people. Using E-TAD, small firms need not reject large contracts due to capacity constraints.

In the case of a small business vendor selling goods to or servicing the contract of a larger client firm, Actrade first approves the small firm's client on the basis of the client's credit rating. Then Actrade makes an arrangement with the client for Actrade to pay the invoice minus a fee to the small firm within 48 hours after the service is completed. The client pays the full amount on the invoice to Actrade within 30 -180 days, depending upon the agreement. Under this arrangement, the small firm does not need to have a good – or any – credit rating because approval is based on the larger purchaser's balance sheet, not that of the small business vendor.

Because the market works as a network, more widespread use of E-TAD improves capacity and removes the capital barriers that small, LMI businesses face. E-TAD transactions are conducted electronically and can easily be brought to scale. At sufficient scale, E-TAD transactions could be securitized.⁷¹

NEW INSTITUTIONS

DE NOVO BANKS

The growth of de novo banks, or start-up financial institutions is the result primarily of the financial industry consolidation and economic expansion in the 1990s.⁷² As previously cited, when large banks merge, lending to small businesses falls as a percentage of the new banks assets.⁷³ The strong economic conditions of that era enabled emerging banks to acquire start-up financing.

De novo banks are important in the small-business community, particularly the LMI small-business community, because they tend to focus a larger share of their energies on financing small businesses.

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The Community's Bank is a de novo bank formed from three branches sold by Fleet Bank in the course of its merger with Bank Boston.



It is the only independent, ethnic-owned bank in Connecticut, with a mix of African-American, Asian, Hispanic and Caucasian ownership and management.



Its branches serve a racially, ethnically and economically diverse population, including both urban and suburban markets.

Research reveals an inverse relationship between bank size and the percentage of its assets spent on lending to small firms. This relationship is particularly strong for “seasoned” de novo banks that have been in business for at least three years.⁷⁴

Entry by de novo banks generally makes the banking markets more competitive and acts as a check against incumbent banks. Their focus on small business lending also allows de novo banks to develop important lending relationships with banking customers. They are more efficient at monitoring small business loans than larger, established banks because they have more inside information about their customers, a shorter chain of command than larger institutions, and less turnover in personnel, allowing them to form personal relationships with borrowers.⁷⁵

THE COMMUNITY'S BANK

The Community's Bank is a de novo bank formed from three branches sold by Fleet Bank in the course of its merger with Bank Boston. It is the only independent, ethnic-owned bank in Connecticut, with a mix of African-American, Asian, Hispanic and Caucasian ownership and management. Its branches serve a racially, ethnically and economically diverse population, including both urban and suburban markets.

Peter Hurst, Founder and CEO, recognized that the unmet needs and the unique mix of communities represented both profit and community impact potential, with the higher-income Bloomfield area subsidizing the more urban Hartford and Bridgeport markets. The bank offers services including low-fee checking and savings accounts, and reasonably priced consumer and business loans to replace the high priced product offerings previously sold by institutions sometimes engaged in predatory lending practices. The Community's Bank demonstrates how an innovative for-profit financial institution can emerge to serve a demographic that might have been left behind as banks have consolidated.

GOVERNMENT PROGRAMS

Federal and State government programs can provide credit enhancement and bridge financing support to leverage private capital. Below are a few innovative examples:

NEW MARKETS TAX CREDIT

The New Markets Tax Credit (NMTC) provides investors a Federal tax credit for equity investments in qualified Community Development Entities (CDEs). CDEs are organizations whose primary mission is to serve or invest in LMI people and communities, and who maintain accountability to those served by including community representatives on their advisory boards. CDEs may include existing CDFIs, or other community-based financing organizations applying for designation.

Private investors who invest in a CDE with NMTC allocations receive a credit of more than 30 percent (present value) of the amount invested over the seven-year life of the credit. The infusion of private capital will enable these organizations to increase loans, investments and support, and leverage additional capital support.

To be eligible, CDEs must invest in: (i) an area with a poverty rate of at least 20 percent of the state median, or (ii) an area with a median income that is 80 percent or less of the county or state median. The program is quite broad-based with approximately 40 percent of all census tracts eligible for the NMTC. The NMTC will spur \$15 billion in investment over six years to promote economic development in LMI communities. Only for-profit CDEs are eligible to receive NMTC allocations. They can then lend/invest directly, or lend/invest through other CDEs (for-profit and non-profit). Several mainstream financial institutions are among the numerous organizations applying to the CDFI Fund for NMTC allocations.

As the NMTC develops, innovative capital market applications will likely develop. FINIR discussed a model for three to five super regional CDEs to conduit NMTC allocations to larger deals, or to help smaller CDEs sell their equity in broader markets. Other discussions revolve around creating a NMTC “asset barter system,” through which CDEs would transfer NMTC credits to corporate investors providing donated/depreciated assets;⁷⁶ and a NMTC market through which CDEs that received allocations but did not raise equity, could sell them to CDEs in need of allocations and able to raise investment capital.

FAMILY SELF-SUFFICIENCY PROGRAM

The Family Self-Sufficiency Program was enacted in 1990 by the first Bush Administration to help LMI families receiving Section 8 public housing assistance achieve self-sufficiency. FSS provides educational development and technical, trade and vocational skill training over a five to seven year period. To encourage participation, FSS offers families a financial incentive in the form of an escrow account that becomes available to them upon program completion. Under current public housing assistance programs, families pay 30 percent of their income for rent. As each family’s income goes up, its rent goes up. Under FSS, the Housing Authority opens a special savings account for each family. As a family’s income increases, a portion of the coinciding rental increase is deposited into a savings account and matched by funds from the Housing Authority. When the family graduates from the FSS program, they receive the funds in the savings that can be used to buy a home or as capital to start a business.

As of November 2000, the Family Self-Sufficiency Program enrolled 3,140 participants. Roughly 48 percent of FSS participants who were enrolled in FSS for 12 months or more had positive escrow balances.

The infusion of private capital will enable CDEs to increase loans, investments and support, and leverage additional capital support.



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CRA aims to direct capital to LMI communities.



Introducing a market-based solution similar to that used to combat air pollution could increase the amount of CRA compliance and lending, while lowering the cost, more effectively realizing CRA's mission.



CRA credit swaps would encourage specialization and niche lending among those most expert in community finance.

These families had an average escrow balance of about \$2,400 and were adding to their accounts at the average rate of about \$300 per month. Some 45 percent of the families that successfully completed the FSS program between Fall 1999 and November 2000, received escrow funds averaging nearly \$5,000 per family.⁷⁷ This model could be applied to other government support programs.

COMMUNITY REINVESTMENT ACT CREDIT SWAPS

CRA aims to direct capital to LMI communities. While it has been quite effective, and led many financial institutions to expand into businesses they may have previously overlooked, it does have drawbacks. Incomplete information on EDM markets can make reaching them expensive; the CRA "tests" are vague, and there are no clear incentives for compliance other than the fear of a merger being prohibited, and general community protest. While some banks have built significant business lines with CRA-eligible products, others make poor quality loans, a rushed attempt to meet CRA goals. With consolidation and the rise in Internet banking, the concept of a bank's CRA assessment community as a fixed geographical location is increasingly dated.

Introducing a market-based solution similar to that used to combat air pollution could increase the amount of CRA compliance and lending, while lowering the cost, more effectively realizing CRA's mission. In carbon trading, firms are given a certain number of "credits" that correspond to a level of sulfur compound emissions, a pollutant. Firms that are efficient in their emissions can sell their credits to companies that pollute more than the number of credits they have. The government is thus able to manage emissions, and firms internalize pollution's external cost imposed on society.

CRA "voucher" trading could work in a similar manner. Regulators could require banks to acquire a certain number of vouchers annually, representing a certain level of investment in CRA-eligible products. CRA vouchers could be traded among banks much like firms trade carbon emissions credits. Thus, banks specializing in CRA-related lending could trade, or "swap" with banks short of adequate CRA credits.⁷⁸

CRA credit swaps would encourage specialization and niche lending among those most expert in community finance. Institutions familiar with the area could focus on this market, achieving greater economies of scale. Less familiar banks could partner with the CRA-leaders, or contribute capital to their pool. With market-based incentives to pursue EDM customers, CRA-designated levels could be maintained or increased, but in a more efficient and accountable manner.

THE TELECOMMUNICATIONS DEVELOPMENT FUND (TDF)

TDF was created by the Telecommunications Act of 1996 to promote access to capital for small businesses in the telecommunications industry,

to stimulate the development of new technologies, and to support the delivery of universal service and telecommunications services to underserved rural and urban areas. The fund was initially capitalized with interest earned from up-front deposits made by the bidders in the FCC's spectrum auction, and has leveraged that investment to attract additional private capital, building a \$50 million fund. TDF serves as a source for loans and investments in small communications businesses as they seek to start up or expand. The Telecommunications Act required the Chairman of the FCC to appoint a seven-member board of directors to administer the Fund, four representatives from the private sector and three representatives from the public sector. The Act further stipulated that the Chairman appoint directors who have experience in finance, investment banking, government banking, communications law and administrative practice, and public policy areas. TDF provides a good model of using public funds as leverage in a market-based financial system.

LIQUIDITY VEHICLE – PUBLICLY TRADED HOLDING COMPANY

Many community development venture capital funds face a tough problem: how to exit an investment and re-deploy funds in other projects. Because many double-bottom-line investments in LMI communities do not grow as fast as traditional venture investments, fund managers are locked into longer time horizons and find it difficult to find buyers of equity stakes.

BOSTON COMMUNITY CAPITAL

One of the central challenges to the growth of CDVCs is the absence of reliable exit mechanisms. Boston Community Capital, a leader among CDVCs, was commissioned by the Ford Foundation to explore possible liquidity-enhancing vehicles. After reviewing a number of options, the fund recommended and designed a publicly traded holding company.

Much in the same way that holding companies such as Berkshire Hathaway invest in several different companies with diverse lines of business, the community development holding company would own shares of stock in targeted double-bottom-line companies (such as businesses owned by LMI entrepreneurs). This investment vehicle offers several benefits. Small and individual investors could make small investments with the risk diversified over a large pool of businesses. The costs of individual CDVCs taking companies public or selling to other investors would be spread over a larger group of businesses, reducing the individual costs of each exit. More funds would be available for new community development investments. Finally, if the holding company received CDE designation and an NMTC allocation, investors would be eligible for a substantial tax credit, enhancing the holding company's

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Worker-owned enterprises can be a valuable tool in growing economically disadvantaged regions by anchoring capital, retaining jobs and placing capital in the hands of employees.



Two to three thousand dollars of additional wealth is created per person per year in ESOPs.



Over \$400 billion in shareholder corporate wealth has been generated by employee participation through ESOPs and other financial innovations related to employee ownership.

financial return. While more research must be conducted to implement the holding company strategy, it is a promising idea that could bring much needed liquidity to this market.

OWNERSHIP MODELS

EMPLOYEE STOCK OWNERSHIP PLANS

Worker-owned enterprises can be a valuable tool in growing economically disadvantaged regions by anchoring capital, retaining jobs and placing capital in the hands of employees.⁷⁹ An employee stock ownership plan (ESOP) functions as a trust representing the employees of a company. The company contributes to the trust new shares of its own stock or the cash to buy existing shares. Shares of the stock are allocated to the individual accounts or workers as the company “earns” blocks of shares by borrowing from future profits. Workers receive the shares when they retire or leave the company. ESOPs provide an incentive to business owners to sell the firms to their employees by offering significant tax benefits.

ESOPs are a powerful mechanism to increase the wealth of LMI workers. Two to three thousand dollars of additional wealth is created per person per year in ESOPs. By making workers owners, the retirement benefits of employees in an ESOP, on average, increases threefold. Hourly earnings of owner-workers in ESOPs are 8 percent higher than in non-ESOP companies.⁸⁰

Given the costs and legal complexities of setting up an ESOP, they are most appropriate for companies that:

- Have a market value of at least \$1,000,000
- Have ten or more employees
- Are in good financial condition.

Since the birth of the revolution in ownership that began with Louis Kelso in the 1950s, the number of ESOPs in the United States has risen above 11,000 with more than 8.8 million employee owners. Over \$400 billion in shareholder corporate wealth has been generated by employee participation through ESOPs and other financial innovations related to employee ownership.⁸¹

BLUE RIDGE PAPER PRODUCTS (BRPP)

In 1997, Champion International, a soft paper packaging goods company decided to put up its Canton, Ohio mill and Dairy Pak division for sale as part of a downsizing effort. When no serious bidders emerged, PACE Smokey Mountain Local 507, facilitated by the Southern Appalachian

Center for Cooperative Ownership, decided to create an ESOP to purchase the plant. With financing from KPS Special Situations Fund, a private equity fund specializing in employee buyouts, and a loan package from a syndicate of traditional banks, the union was able to purchase the paper mill, an extruding plant, and five converting plants. The new Blue Ridge Paper Products Company has 2,200 employee owners across six states. The company's ownership is divided as follows: 40 percent employee-owned, five percent reserved to attract new management, and 55 percent owned by KPS. The employees will have the first right to purchase KPS's share when the fund eventually exits the investment. Since the ESOP was created, BRPP has become one of the most cost competitive mills in the country.

FRANCHISES

Under a franchise agreement, a company (franchisor) licenses the rights to market a product or service to an entrepreneur (franchisee). The franchisor retains all ownership of the trademark, and requires the franchise to operate under strict guidelines that maintain the quality and image of the brand. For the franchise fee, the franchisee gains access to a proven business structure, advisory services and, in some cases, franchisor financing. The franchise model can help mitigate risk among emerging entrepreneurs – the proven business model, known brand and ongoing assistance help reduce the risk inherent in launching a new firm.

Numerous mainstream banks (e.g., Deutsche Bank, Fleet) have noted the unmet demand of the urban market – \$300 billion in annual consumer spending, much of it in other neighborhoods because of the inadequate product offerings and high prices in many inner cities. Recognizing that urban entrepreneurs are often best able to reach this customer market but lack the capital to launch a business, some banks have developed programs to provide affordable capital to such enterprises. Franchise companies and retailers have acted similarly.

BLIMPIE'S URBAN INITIATIVE FOR LEADERSHIP DEVELOPMENT

Blimpie Subs & Salads launched Blimpie's Urban Initiative for Leadership Development (BUILD) to serve the inner city market. Through a public-private partnership with the U.S. Small Business Administration and the U.S. Department of Housing and Urban Development, the Initiative waives the standard \$18,000 Blimpie franchise fee for qualified entrepreneurs who apply to open restaurants in one of the nation's 89 federally designated Urban Empowerment Zones or 53 Enterprise Communities.

Empowerment Zone and Enterprise Community tax breaks further aid the franchise's sustainability. Blimpie works with the SBA to identify

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Minority-owned banks provide a unique path into the largely under-banked, and often LMI, minority niche markets.



Many LMI minority entrepreneurs are uncomfortable approaching mainstream firms for reasons such as culture, language, and expectation of rejection.



The most recent Economic Census (1997) estimates that the minority-owned banking sector has revenue of approximately \$770 million annually.

possible candidates and conducts training courses to help potential owners write business plans. The SBA One Stop Capital Shops, located in 21 cities, are also available to these entrepreneurs, giving them free access to computers and the Internet, and legal, accounting, and business advice. BUILD opened five stores in Detroit, Los Angeles, Newark, and Seattle/Tacoma in 2001 and plans to open 200 to 400 by 2010.

MINORITY-OWNED BANKS

Minority-owned banks provide a unique path into the largely under-banked, and often LMI, minority niche markets. Many LMI minority entrepreneurs are uncomfortable approaching mainstream firms for reasons such as culture, language, and expectation of rejection. In addition, while banks are recognizing the growing strength of the ethnic markets, LMI minorities are frequently left out. The most recent Economic Census (1997) estimates that the minority-owned banking sector has revenue of approximately \$770 million annually.⁸³

EAST WEST BANK

In August 2000, East West Bank, a subsidiary of East West Bancorp, Inc. launched its Chinese-language Internet banking product, along with providing its customers with a discount on Pacific Bell High-Speed DSL Internet Service with Prodigy or free SINA.com dial-up access. The service enables consumers to open accounts, check balances, transfer money, access transaction history and pay bills online. This service follows East West Bank's longstanding tradition of catering to ethnic communities: East West was among the first financial institutions to offer ATM service and 24-hour automated telephone banking in Chinese, English, and Spanish.

ONEUNITED BANK

OneUnited Bank (formerly Boston Bank of Commerce) recognized the value of establishing a nationwide network of African-American-owned banks with the capital access, depth of management and technology found at larger banks. While the nation's four dozen black-owned banks have remained focused on the small regions they serve, with its acquisition of Family Savings and Founders Bank in Los Angeles became the largest black-owned financial institution, controlling \$468 million in assets. Its size will allow OneUnited Bank to achieve the scale necessary to effectively serve the communities currently reached by the smaller banks. The Bank will continue with its strategy of having each acquired institution retain its management structure allowing a focus on local needs. For instance, Family Saving's branches will continue to offer services in Spanish for their Hispanic customers.

COMMUNITY OWNERSHIP

B.I.G. WASH

Recognizing the need for a coin laundromat in their LMI community, residents of Columbia Heights, an LMI neighborhood in Washington D.C., raised the necessary capital themselves. By selling \$100 shares throughout their neighborhood and through outside investment from churches and foundations, the residents were able to secure a \$300,000 loan from Riggs bank and launch B.I.G. Wash. The laundromat never missed a single payment on its loan, retiring the debt in 2001. Shares in the laundromat now sell for \$6,000 and B.I.G Wash provides the neighborhood with vital services as well as part-time jobs for nine residents.

PRODUCT INNOVATIONS

NEW MARKETS/NEW PRODUCTS FROM MAINSTREAM BANKS

CRA provides most mainstream banks the necessary incentive to service LMI customers. Most business units have CRA targets, and the community investment groups create key relationships. Primary areas of activity include issuing small business credit cards (often an entry point to credit lines and revolving loans), looking for those who fail the credit scoring, with referrals to alternate programs provided by partners such as state guarantee programs and Capital Access Programs (described in detail below), and making investments in and collaborating with intermediaries. As noted earlier, large banks often perceive intermediaries as more cost-effective than generating and maintaining direct relationships with businesses likely to be seeking smaller loans and requiring greater customer assistance.

During the economic boom, customer competition increased and credit was extended “down market.” In fact, many banks serviced LMI customers previously regarded as only CDFI candidates. While the current downturn is leading many institutions to pull back, several innovative banks recognize the market potential and have partnerships, products and business lines targeting these customers.

FLEET BANK

Fleet Bank approaches community investment as a business opportunity, not merely a compliance obligation. With the formation of Fleet’s Community Bank, a true “bank within a bank,” the Fleet institutionalized its holistic approach to the market. It combines the “high touch” of a small bank, reaching the LMI community through more than 100 branches in local neighborhoods, with the “high tech” of

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Fleet Bank has added multilingual, multiethnic bank personnel to offer personalized service to the growing immigrant community, and leverages its understanding of the inner-city market by investing in neighborhood small businesses.



Fleet Development Ventures invests equity capital in businesses and real-estate projects benefiting LMI communities and residents.



The joint venture model with Nix allows Union to enter a new market with a viable structure already in place, and to add bank services to these markets over time.

a large, technologically advanced financial institution. Fleet Bank has added multilingual, multiethnic bank personnel to offer personalized service to the growing immigrant community, and leverages its understanding of the inner-city market by investing in neighborhood small businesses.

Fleet Bank has always been a leader in providing small business lending, focusing on businesses with annual revenues of \$2 million to \$10 million. In recent years, Fleet added a focus on those with revenues of less than \$2 million. The bank has more than 500 full-service branches and 146 small-business centers specializing in this growing market segment. Fleet has become a full-service provider, developing savings, insurance, investment, credit card, credit card processing, loan, employee-benefit, cash-management, payroll and insurance products specifically for small business owners. Furthermore, the bank launched a service called Small Business Credit Express, which allows owners to complete a one-page application for credit lines of \$10,000 to \$100,000.

Fleet Development Ventures invests equity capital in businesses and real-estate projects benefiting LMI communities and residents. The bank partners with individual and small business customers, community- and faith-based organizations, developers, investors, and local leaders for economic development projects. Fleet's Technical Assistance Program, a five year \$17.5 million research and development effort, identifies profitable CRA-related long-term business opportunities. The programs areas of interest include CDFIs, emerging domestic markets, financial literacy, and pre-development grants leading to community-development loans, rural areas, and small-business development. Fleet also participates in the Community Express program, co-sponsored with the SBA and National Community Reinvestment Council (NCRC) (described in detail later in this report).

UNION BANK OF CALIFORNIA

Recognizing the hidden market of potential customers currently using fringe banking services, Union Bank of California entered into a pilot partnership with Nix Check Cashing of Los Angeles and Operation Hope in March 2000. Through the venture, Union Bank operates separate teller windows at existing Nix locations. Local inner-city residents can open accounts and gain access to mainstream bank services in a familiar setting, as well as continue to conduct check-cashing transactions. With a \$10 deposit and a commitment to deposit \$25 a month for a year, customers at the partnership can open an interest bearing savings account. Business owners can drop deposits at Nix offices, and can use the Union Bank phones there to apply for loans.

Richard Hartnack, Union's Vice Chairman, believes the joint venture model with Nix allows Union to enter a new market with a viable structure already in place, and to add bank services to these markets over

time. Operation HOPE, a community-based organization specializing in youth and adult economic education, home ownership counseling and small-business lending, leads a Community Advisory Board through Navicert, Nix’s parent company, to oversee community education and consumer protection. Thus far, the pilot appears to be successful. The number of Union Bank accounts at Nix locations increased 500 percent from 2000 to 2001. If success continues, other banks may take the initiative to enter the heavily unbanked LMI neighborhoods.

Under the terms of the agreement, Union Bank of California acquired preferred stock convertible into 40 percent of the common equity interest in Navicert, with an option to purchase the remainder of the company between 2000 and 2010. Union converted three check-cashing locations to bank hybrids in 2000, added 10 in 2001, and plans to increase the total to 30 this year.

UNIVERSITY BANK

After receiving a “needs to improve” rating by the Community Reinvestment Act (CRA), with only 14 percent of its loan portfolio in CRA-designated LMI areas, University National Bank, redirected its efforts to St. Paul’s inner city. The bank now has 79 percent of its outstanding loans in LMI areas, concentrating its efforts on St. Paul’s lowest-income, racially mixed, immigrant neighborhood. University National Bank focuses its effort in three areas:

- **Cash:** Recognizing that many first-generation immigrants in the community are mistrustful of mainstream financial institutions, University National purchased a check-cashing business, cut its fees in half, and placed it in the lobby of the bank, gradually guiding check cashing customers to mainstream financial services.
- **Capital:** The bank formed several partnerships with local government agencies and community development organizations to help LMI entrepreneurs. The *Neighborhood Lending Partnership* provides financing for real estate acquisition and equipment for neighborhood businesses through loans guaranteed by the City of St. Paul. Loan guarantees are available for up to 50 percent of a project’s cost, up to \$100,000. The program has leveraged the city’s investment by 700 percent. The *Frogtown Large Loan Fund* combines the forces of a five-bank consortium to provide loans to businesses that are too risky for individual banks to fund. The *Selby Exterior Loan and Grant Program* provides loans that are matched with up to \$10,000 grants to redevelop a troubled, predominantly African-American, commercial and residential area.
- **Communication:** Each bank officer at University National works with at least one local not-for-profit organization to gain working knowledge of community loan and grant programs. The bank

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U.S. pension fund assets total \$7 trillion, the largest single source of capital in the world and a growth of almost 4,000 percent in the last 30 years.



As investors' concerns about corporate governance grow, double-bottom-line investments offer funds the ability to generate financial and social returns.



Emerging domestic markets, effectively a new asset class, provide such opportunities.

realizes that the more lenders know about these programs the more likely they are to create financing solutions that get capital into the hands of the community.

PENSION FUNDS

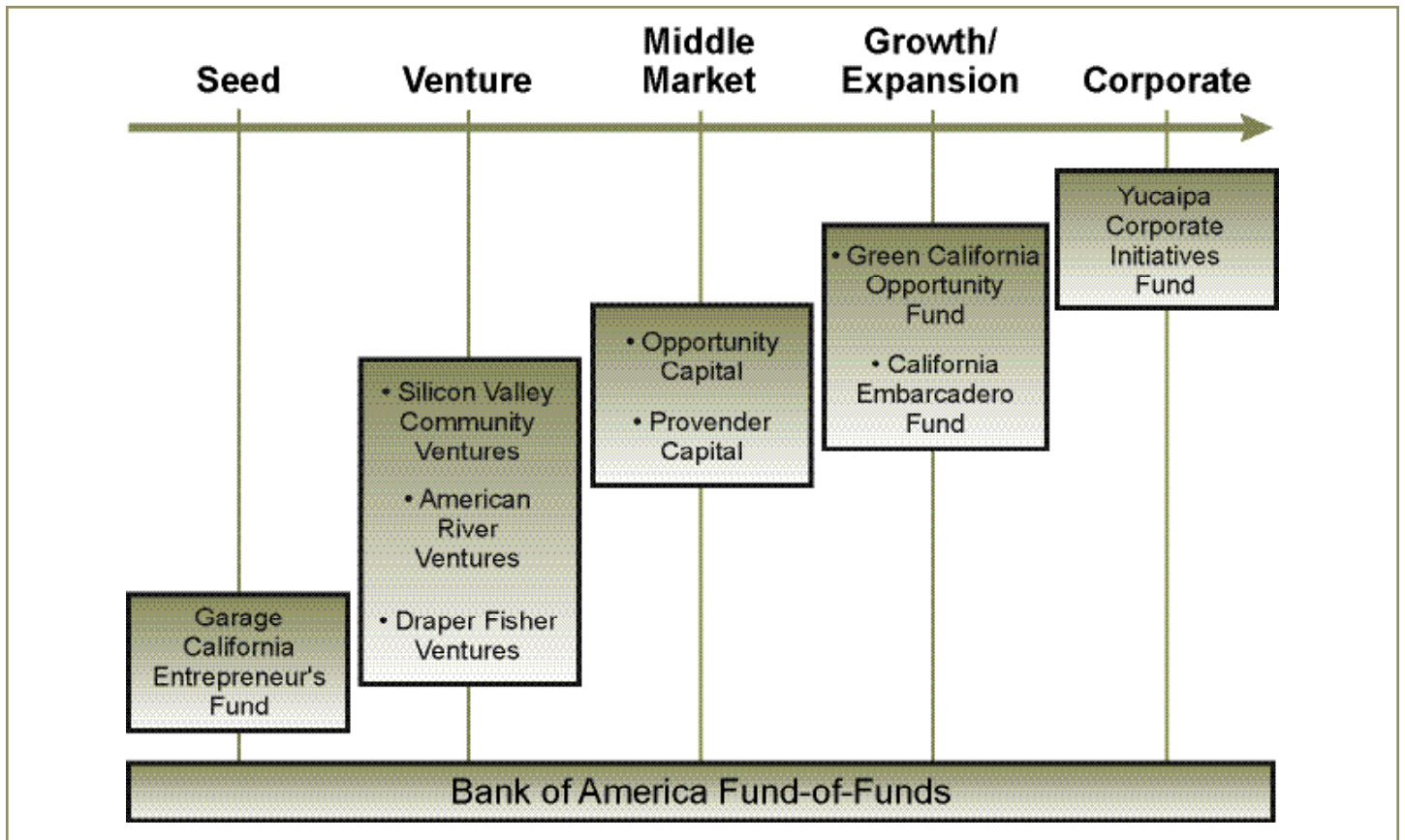
U.S. pension fund assets total \$7 trillion,⁸⁴ the largest single source of capital in the world and a growth of almost 4,000 percent in the last 30 years. Even after the recent fall in the public equities markets, these funds remain the critical player in the financial markets. With the market decline, and the ongoing need to maintain growth to meet their obligations to retiring beneficiaries (a growing pool as the baby-boomer population ages), funds increasingly look to alternative asset classes for investment opportunities. Furthermore, as investors' concerns about corporate governance grow, double-bottom-line investments offer funds the ability to generate financial and social returns.

Emerging domestic markets, effectively a new asset class, provide such opportunities. Several public and private pension funds (e.g., New York State Common Retirement Fund, Raytheon Corporation) have allocated assets to urban real estate projects, private equity managers targeting minority- and women-owned businesses and other innovative debt and equity vehicles targeting these markets. The California Public Employees Retirement System (CalPERS) made one of the most significant investments into business development.

CALIFORNIA INITIATIVE

In 2000, CalPERS committed \$500 million from its Alternative Investment allocation to the "California Initiative," targeting emerging markets primarily, but not exclusively, in California. The Initiative aims to uncover investment opportunities generally overlooked by more traditional capital, and demonstrate attractive, risk-adjusted returns in accordance with asset class. CalPERS engaged multiple fund managers representing a range of strategies that include corporate partnerships, co-investments with existing CalPERS partners, funds of funds, funds that target minority-owned enterprises and new models, and seed through venture, middle market, and growth/expansion investment capital. Their experience ranges from existing private equity firms, to new managers, to innovative funds from experienced managers. Silicon Valley Community Ventures, a community development venture capital fund profiled in this report, received a \$10 million investment through the Initiative. CalPERS' Alternative Investment staff manages the managers, and obtains research and monitoring support from outside vendors. The California State Teachers Retirement System (CalSTRS) has launched a similar program, with \$350 million targeted at businesses in these markets. Both pension funds have also initiated a new and emerging managers program to identify women and minority fund managers.

Figure 8
California Initiative Funds Support Companies in Each Stage of Life-Cycle



CALSTRS CREDIT ENHANCEMENT PROGRAM

The California State Teachers Retirement System (CalSTRS) launched a credit enhancement program in 1994 to explore whether the Fund could use its substantial asset base and liquidity strength to generate fee income while assisting California public school construction finance efforts. The program has since been expanded to provide enhancements for housing projects, municipal finance, and industrial development. Through the provision of letters of credit, CalSTRS uses its strong balance sheet and credit rating (AA+ from S&P) to help reduce the default risk and cost of bonds it supports. The bond issuers pay upfront fees to CalSTRS to cover the credit risk for the term of the bond. In 2001, the Credit Enhancement Program generated \$2.6 million in fee income for the pension fund and supported over a billion dollars in bond commitments. While this program has been used primarily for school construction and housing financing, the model could be expanded to increase access to financing for small businesses. By providing a credit enhancement, pension funds both reduce the borrowing costs for firms as well as enable them to obtain capital from private sector institutions that would normally consider them too risky.



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A credit enhancement is a financial technology that increases the credit quality of a security beyond that of the underlying asset(s).



The enhancements increase the likelihood that investors in the security will receive their expected return, reducing the perceived risk of the investment and often enabling them to be rated.



Once enhanced, many of these investments can be securitized, increasing the pool of potential investment capital.

CREDIT ENHANCEMENT

A credit enhancement is a financial technology that increases the credit quality of a security beyond that of the underlying asset(s). Examples include collateral, reserve funds, insurance, third-party guarantees, letters of credit, overcollateralized asset pools and subordination of risk – breaking the security into tranches of varying risk, enabling tranches to be sold to investors based on their risk-tolerance. The enhancements increase the likelihood that investors in the security will receive their expected return, reducing the perceived risk of the investment and often enabling them to be rated. (Rating a security increases its marketability.) Once enhanced, many of these investments can be securitized, increasing the pool of potential investment capital. Credit enhancements are used regularly in conventional finance and are an appropriate mechanism to make community development finance “market ready.” Several interesting innovations follow.

STATE CAPITAL ACCESS PROGRAMS

Capital Access Programs (CAPs) are state-run programs that encourage small business lending by banks to emerging entrepreneurs. CAPs establish a reserve account in each participating bank that enable the bank to make higher risk loans than its conventional underwriting would support. Loans have reached businesses outside the scope of standard bank programs (e.g., building contractors and wholesale trade firms) and needs (e.g., working capital for start-ups), as well as entrepreneurs rejected by the standard loan application process (e.g., LMI entrepreneurs with a negative, or no credit record).

The bank and borrower each pay an upfront insurance premium (two to seven percent of the loan amount, at the bank’s discretion) into the reserve, the total of which is matched by the state. CAPs have historically required minimal administrative costs, and any federal or state-chartered bank, savings association or credit union is eligible to offer loans through CAP, if its state has a program.

Currently, 22 states and two cities offer CAPs. Since introduction of the first CAP in Michigan in 1986, about \$1.6 billion in loans (averaging \$61,000) have been made to small businesses. Total loan loss nationally has been 3.7 percent. Low loss rates have enabled banks’ reserve accounts to grow, allowing them to increase loans. Reserve sizes net of these losses were 4.1 percent of cumulative volume, generating a loan dynamic multiplier estimated at 24 times. The CDFI Act of 1993 included a provision for federal reimbursement of state contributions to CAP reserve funds (enabling the states to make additional deposits supporting new loans), pending a \$50 million appropriation that has never been made. Bi-partisan legislation authorizing the SBA to develop a National Capital Access Program was also introduced in 1993, but was referred to the Senate Small Business Committee and never advanced.

The credit enhancement in a CAP not only incentivizes mainstream financial institutions to make loans, but also would enable the loans to be securitized. Under current regulations, CAP loan reserves must be held at the originating bank until program liquidation. If securitized, the reserves would be released when the bonds mature, usually in five to 10 years from issuance. In fact, the reserves themselves would vastly improve the bond rating agency's view of the securities, resulting in investment-grade ratings and an extremely marketable product. For more information, please see the Recommendations section of this report.

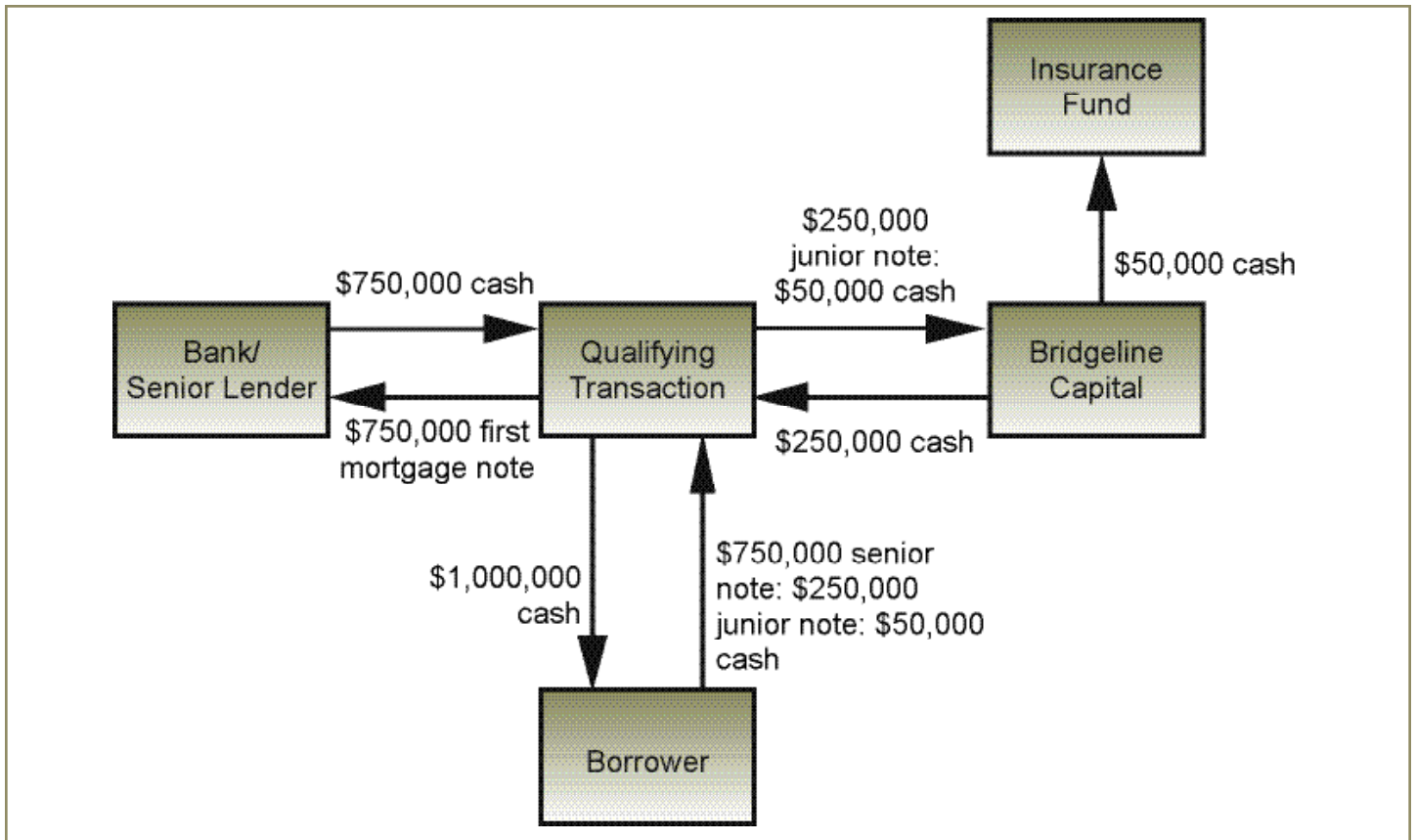
SUBORDINATE-LIEN LOANS – BRIDGENOTES™

BridgeNotes™, developed by Capital Access Group, are subordinate-lien, “companion” loans designed to “bridge” the gap between the amount a bank is willing to lend a small business and the borrower’s total financing need. As subordinate debt and a form of “quasi-equity,” BridgeNotes™ absorb most of the default risk, reducing bank risk and enabling lenders to extend credit to borrowers deemed marginal by conventional rating systems. Loan loss reserves funded by borrowers

BridgeNotes™ are subordinate-lien, “companion” loans designed to “bridge” the gap between the amount a bank is willing to lend a small business and the borrower’s total financing need.



Figure 9
Sample BridgeNote™ Transaction



BridgeNotes™ are particularly useful in providing working capital, which, since unsecured, is often difficult for entrepreneurs to obtain.



With an initial capital base contributed by foundations or double-bottom-line investors, a credit line of three times the base could be established to successfully securitize BridgeNotes™.



Each year the U.S. government auctions off approximately \$10 billion in “dead” or unclaimed assets from organizations such as HUD, the IRS, the USDA, and the SBA.

and socially motivated lenders provide credit enhancements for BridgeNotes™ and would allow them to be sold to investors in the form of asset-backed securities.

BridgeNotes™ are particularly useful in providing working capital, which, since unsecured, is often difficult for entrepreneurs to obtain. Increasing the leverage of a small business can lead to more rapid growth as well as ensuring the firm’s survival by providing necessary working capital. From the borrower’s standpoint, BridgeNotes™ often make the difference between success and failure in pursuing financing for expansion.

In a sample BridgeNote™ transaction of \$1,000,000, the BridgeNote™ might be from \$250,000, or 25 percent, of the total. The repayment of the companion note would be seven to ten years and would be secured by a junior-lien on business assets and personal guarantees. The borrower would pay an upfront fee (\$50,000) to cover the default risk of the transaction to an intermediary (BridgeLine Capital), which then pools the fees through an insurance fund that supports all of the BridgeNote™ transactions. The assumption of first loss by the intermediary reduces the bank’s repayment risk, which can then issue a senior note of \$750,000 to the borrower.

With an initial capital base contributed by foundations or double-bottom-line investors, a credit line of three times the base could be established to successfully securitize BridgeNotes™. For example, because securitization transactions can occur on quarterly basis, a \$25 million credit line can support \$100 million in an annual BridgeNote™ origination program. Finally, every \$1 in BridgeNote™ financing is expected to support at least \$3 to \$4 in senior loans. Thus, \$100 million in BridgeNote™ lending could leverage another \$375 to \$500 million in bank lending to underserved companies.

FINANCIAL INNOVATIONS ROUNDTABLE MODEL – “DEAD” ASSETS

Each year the U.S. government auctions off approximately \$10 billion in “dead” or unclaimed assets from organizations such as HUD, the IRS, the USDA, and the SBA. If a small portfolio of these assets could be set aside to be used as a credit enhancement for about two-to-five percent of the total value of community development finance transactions (\$50 to \$100 million), the government could leverage an additional \$2 billion in community development financing. By using the dead assets as collateral, CDFIs could improve the credit quality of their transactions and create investment grade, rated debt securities.

OVERSEAS CHINESE CREDIT GUARANTEE FUND (OCCGF)

As part of an effort to reduce the impact of regional financial crises and promote the deepening and broadening of its financial markets, the

Taiwanese government set up the Overseas Chinese Credit Guarantee Fund (OCCGF). The OCCGF was created in association with the Taiwan Government to respond to frequently identified needs of small Chinese-owned businesses across the world. The program provides less restrictive credit standards than are available under SBA programs through loans and letters of credit. The fund operates as a loan facility that is guaranteed up to 70 percent by the Taiwan government. Use of the fund is restricted to immigrants of Chinese ancestry who own at least 60 percent of their businesses. Banks across the world participate in the program, including Cathay Bank in Los Angeles that targets Asian customers and business owners.

BLENDED FUND STRUCTURES

MEZZANINE FUNDS

A mezzanine security represents the layer of capital between senior debt and equity. It is generally structured as subordinated debt or preferred stock with a common equity component provided through the use of warrants or a conversion feature. Ordinarily, mezzanine market security types (subordinated debt with warrants, convertible subordinated debt, and preferred stock) have longer terms, higher coupon rates and expected returns between those of equity and senior debt. In general, their covenants are more flexible than senior debt and enable the firm to withstand greater economic variability in market conditions and staying power to execute competitive strategies. Mezzanine fund structures can blend investors seeking different levels of returns, allowing the fund to take a risk position and leverage other sources of capital. Some community development banks, including Neighborhood Bancorp in San Diego, have developed or are exploring the use of mezzanine funds. Lack of expertise in structured finance can be a limiting factor.

BAY AREA COMMUNITY EQUITY FUND

The Bay Area Community Equity Fund is a new community development venture fund that will invest in profitable growing businesses capable of generating jobs and wealth in 46 target LMI neighborhoods in the Bay Area. The fund will most likely close in early 2003 with \$50 million in equity investments from private sources as well as foundations. A second round will close shortly thereafter, bringing the total fund to \$75 to \$100 million. The fund will invest in two types of projects. Ninety percent of investments will be made in emerging growth companies in the technology, health care, and specialty consumer industries. These investments are projected to make market rate returns. The remaining 10 percent of the fund will be invested in patient capital investments in neighborhood-oriented businesses that are seen as anchors. These investments will offer measurable social returns such as creating good jobs and providing neighborhood economic benefits, but

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The fund will most likely close in September 2002 with \$50 million in equity investments from private sources as well as foundations.

The Sustainable Jobs Fund (SJF), a community development venture capital fund organized to fund businesses that create, retain and enhance long-term jobs for the residents of economically distressed communities, has developed a unique model for repayment of debt.



Seeking to design a repayment structure for the subordinated debt that matches a company's stage of growth and ability to make cash payments, SJF designed a royalty agreement for one of its investments.



Royalties work well for a company that is expanding, yet in a temporary downturn in the market, the firm may be saddled with fixed costs it cannot reduce, while still being forced to pay a substantial part of its gross profit.

are projected to earn a slightly less financial return.

The fund will imbed itself in a job creation, wealth creation, one stop regulation/permit assistance, and environmental/workplace regional network supported by a variety of community and government supported organizations. JP Morgan H&Q will manage the investment process while the Bay Area Council works with portfolio companies to create individual double-bottom-line strategies for each business. Several foundations have pledged Program Related Investment (PRI) funds charging a minimal interest rate (1 to 2 percent). If the fund meets its community development and environmental goals within the first year, the PRIs will be converted to grants to offset the operating costs of the fund.

REVENUE ROYALTIES

SUSTAINABLE JOBS FUND

The Sustainable Jobs Fund (SJF), a community development venture capital fund organized to fund businesses that create, retain and enhance long-term jobs for the residents of economically distressed communities, has developed a unique model for repayment of debt. The fund typically makes half of its investments in the form of preferred equity and half in subordinated debt. Seeking to design a repayment structure for the subordinated debt that matches a company's stage of growth and ability to make cash payments, SJF designed a royalty agreement for one of its investments. With the firm paying a percentage of its top-line revenue, as the company expanded, it was able to make relatively larger payments to SJF. However, SJF admits the structure has its faults. Royalties work well for a company that is expanding, yet in a temporary downturn in the market, the firm may be saddled with fixed costs it cannot reduce, while still being forced to pay a substantial part of its gross profit. This can exacerbate short-term market declines, and a company's ability to repay.

SJF has experimented with more complex structures – setting floors for royalties, tiering payment structures based on certain targets for revenue, taking warrants in case of exits – all in the attempt to use creative deal structures to align its financial and community development goals.

ANGEL POOLS AND NETWORKS

“Angels” are wealthy individuals willing to take an equity stake in a company in exchange for providing working capital. The Center for Venture Economics estimated that in 2000, angel investors – defined as high net-worth individuals who typically invest \$10,000 to \$150,000 in small start-ups – numbered close to 400,000. Angels invest approximately \$60 billion a year.⁸⁵ The SBA estimates that three to five times as many individuals have the wealth, entrepreneurial experience and interest in

becoming angel investors. The obstacle cited most often to angel investing in LMI communities is not unwillingness to invest, but lack of sufficient sources of information about businesses in those areas to make well-informed investments there. Moreover, the current economic downturn has restricted the amount of investment funds, as accredited investors have had less liquid capital to invest in outside businesses, often having to invest in their own companies.

Angel networks bring together group of individuals to source and consider deals more cost-effectively than single investors could do alone. Accredited investors are defined as individuals with annual incomes at or above \$200,000, joint investors with incomes at or above \$300,000 or an individual with a net worth at or above \$1 million. Activities may range from identifying deals of interest to members and undertaking due diligence, to investing pooled funds, to co-investing with members.

RAIN

The Minnesota Investment Network Corporation (MINCorp), a community development venture capital fund, established an angel fund network, the Regional Angel Investor Network (RAIN), whose goal is to invest in companies located in rural LMI areas in Minnesota. Pooling capital into a RAIN fund allows a relatively small amount of money to be diversified among a larger number of companies, reducing the individual risk. Individual investors share due diligence responsibility and each provide a quarterly report to their investment group based on a template provided by RAINstreet, their application service provider. RAINstreet acts as a virtual hub where investors can store and track deal flow, due diligence, engage in member-to-member communication and conduct similar business transactions.

MINCorp's RAIN funds are capitalized at a minimum of \$500,000, 90 percent of which is provided by angels and 10 percent by MINCorp. Each target company receives funding from at least two different RAIN funds. There are two active RAIN funds, and MINCorp plans to establish another four in 2002. Both funds are capitalized at \$600,000. The first, launched in 1997, has invested nearly all of its capital, and the second, launched in December 2000, has invested close to \$300,000. Two states, Iowa and North Dakota, have plans to use the MINCorp's template and establish their own RAIN funds in their respective states. To date, Nebraska has established one RAIN fund, and Iowa has plans to establish ten. The MINCorp RAINs have had several successful exits, selling their investments to strategic partners.

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Historically, few resources have been made available for the financing of Native American Tribes, yielding tremendous poverty despite asset-rich land holdings.



By 1972, Indian financing requirements were estimated at \$1 billion.



By leveraging natural and other resources, Native American Indian tribes can access the capital markets and develop their finances to sustain the future of their tribal members.

EQUITY EQUIVALENT INVESTMENTS

The Equity Equivalent (EQ2) is an equity-debt hybrid capital product developed by Citibank and National Community Capital to finance CDFIs. The EQ2 works similarly as a convertible preferred stock with a coupon does in the for-profit finance world – it protects its investors from losses and must be repaid, like debt, but acts as collateral to further leverage senior debt, like equity. In addition, banks that make EQ2 investments can claim a pro rata share of the community development loans that are made in the bank’s assessment area or a broader regional area that includes their assessment areas. The bank’s share is equal to the percentage of the sum of the permanent capital and EQ2 investments provided by the bank.

Since its inception in 1996, investors, including banks, have made more than \$70 million in EQ2 investments. CDFIs that have benefited from the EQ2 include: Chicago Community loan fund, which now makes ten-year loans and offers automatic rollover clauses that provide a 20-year term, where it once struggled to make seven-year loans; Cascadia Revolving Fund which uses EQ2 capital to finance its quasi-equity financing and long-term real estate-based lending; and Boston Community Capital, which has used EQ2 financing to help capitalize its venture fund.

TRIBAL BONDS

Historically, few resources have been made available for the financing of Native American Tribes, yielding tremendous poverty despite asset-rich land holdings. The prevailing form of financing that came from the federal government, predominantly in the form of loans and grants, was frequently inadequate. A 1935 study estimated Native American credit needs at \$65 million. The Indian Reorganization Act of 1934, which established a Native American revolving loan fund, along with the Oklahoma Indian Welfare Act originally authorized \$12 million – not fully appropriated until 1951. By 1972, Indian financing requirements were estimated at \$1 billion.⁸⁶

Revenue bonds are used much less frequently and have been traditionally issued as tax-exempt bonds for traditionally state sponsored activities such as infrastructure and public buildings or tribal bonds, which use the state or municipality’s tax revenue as a source of repayment. Rated revenue bonds are repaid based on the project that is being financed, rather than through recourse against other tribal ventures.

By leveraging natural and other resources, Native American Indian tribes can access the capital markets and develop their finances to sustain the future of their tribal members. Tribes rarely receive the most favorable rating when they issue the bonds independently – the Southern Ute tribe is the only one to independently receive a AAA rating (highest rating).

However, A-rated municipal bonds achieved with the backing of insurance companies are an alternative that can save tribes millions annually in financing costs. Three tribes – Mashantucket Pequot, Grand Ronde and the Cow Creek Band of the Umpqua Tribe of Indians, received AAA ratings through AAA-rated insurance companies acting as guarantors.

American Capital Access is one insurance company that engages in tribal partnerships. Since ACA has an A rating (as opposed to the higher rated AA or AAA), it can be more flexible when choosing which tribal bonds to back. A-rated insurance companies can have 20 percent of their portfolio in unrated or below-investment grade entities. Presently, Fitch has recognized tribal bonds as sectors. Standard & Poor's, though initially reluctant, has taken steps to consider tribal bonds as sectors as well.

SOUTHERN UTE INDIAN TRIBE

In June 2001, the Southern Ute Indian Tribe made financial history when Fitch assigned "AAA" implied general obligation bond rating to the Tribe's bond issues. Standard and Poor's followed with another AAA credit rating three weeks later. The Southern Ute Indian Tribe is the first tribe in the country to receive the highest possible credit rating, higher than those assigned to Canada, Mexico or Japan. This credit rating was achieved through careful financial planning initiated to develop a stable and responsive tribal government, with a sound strategy and commitment to economic growth.

Many Native American tribes were exploited by outside investors paying minimal compensation for the tribe's natural resources. In 1992, the Southern Ute tribe took control of its own oil and gas production. The tribe acquired Red Willow Production Co., and the WestGas gas gathering assets, and in 1994 created the Red Cedar Gathering Co., a gathering pipeline company. In 1999, the Southern Utes reached a settlement with Amoco Corp, which gave the tribe 32 percent of all future profits from wells operated by Amoco within the reservation boundaries. That same year, the tribe put a financial plan into operation that included an aggressive Growth Fund. As a result, the official estimate of the tribe's income stands in excess of \$250 million per year.

One of the largest concerns the tribe faced was retirement. The tribe's financial successes resulted in a number of benefits for the tribe members, including \$50,000 a year for tribal members 60 years old or older, annual dividend payments on investment earnings to each member between ages 25 and 59, up to \$10,000 in annual scholarships for college students and higher amounts for graduate study.

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PROCESS INNOVATIONS

In a disintermediated financial services industry, relationships between the providers and users of capital become more distant. Lenders have less first-hand information on potential borrowers, which makes servicing small firms and LMI customers more challenging. There is no publicly available information on these businesses, and standard financial analysis may find them deficient. The loss of personal information provided by personal relationships removes a historical risk mitigator and introduces information asymmetries. Several process innovations have emerged to address the gap.

DATA

As noted earlier, smoothly functioning financial markets require robust data. The data on small businesses, and EDM firms in particular, is neither comprehensive nor reliable. Enhanced information would enable lenders and investors to service these markets with reasonably priced products. Eliminating information asymmetries would allow for appropriate product development, extended customer outreach, real risk-based pricing, liquidity mechanisms, and reduced likelihood of discrimination.

Two areas of data collection are necessary: loan performance data and firm-level data. While many current private, nonprofit, and public institutions have initiatives in place to collect this information, many fall short of what is necessary for EDM businesses to reach an optimal level of financing.

CRA REPORTED DATA

Institutions participating in CRA lending extend a substantial portion of small business credit annually – 84 percent in 2000.⁸⁷ As part of CRA regulations, banks must collect data on small business lending in designated LMI CRA-designated neighborhoods (a low- or moderate income census tract, defined as one with median family income below 80 percent of the median family income for the applicable Metropolitan Statistical Area or Primary Metropolitan Area). The Home Mortgage Disclosure Act (HMDA) requires similar lender reporting on mortgage loans. However, the scope of information demanded under HMDA is more detailed than that under CRA. Despite the promise inherent in accessing information on such a large group of small business loans, CRA-required data is insufficient in a number of respects:

- It does not measure the credit gap in EDM markets. CRA regulations mandate that banks report information on loans originated or purchased, but not on credit applications either declined by creditors or withdrawn by customers. It is therefore not possible to measure the actual demand for credit by EDM businesses. This information is

Smoothly functioning financial markets require robust data.



Eliminating information asymmetries would allow for appropriate product development, extended customer outreach, real risk-based pricing, liquidity mechanisms, and reduced likelihood of discrimination.



Two areas of data collection are necessary: loan performance data and firm-level data.

CRA data does not include information on the applicant's income, gender, race or ethnicity, illegal under Reg B.



With information on over 70 million businesses, Dun and Bradstreet maintains the most comprehensive information on firms' revenue, employment, industry, location and credit history.



The firm also maintains a women- and minority-owned business database, but inclusion depends on firms reporting themselves as women or minority-owned.

critical to determining how well the supply of CRA-related financing meets the needs of small businesses in these communities, and to demonstrating the scope of the demand to potential suppliers of capital.

- *It may be geographically inaccurate.* CRA requires lending institutions to report the geographic location of the loan recipient, identified as the firm's mailing addresses. This address determines CRA eligibility. Inaccuracies may occur for several reasons:

The mailing address may differ from the business' actual street address, or the borrower may use the funds received to support its offices in another location with different economic and demographic traits.

As noted earlier, census tracts are large. Higher income areas appear within LMI tracts, and vice versa. CRA reports do not establish whether a filer is located in an odd pocket within the designated tract.

Once a census tract is established, it remains designated as LMI for 10 years. The actual income levels in the area may change dramatically during that period, but the CRA data will not reflect the change until the next census. Filing businesses may be located in high-income areas, and LMI businesses may be overlooked.

- *It does not provide firm-level information.* Unlike HMDA, CRA data does not include information on the applicant's income, gender, race or ethnicity (illegal under Reg B as noted above), rather than reporting by application. Also unlike HMDA, CRA data is aggregated into three categories of loan size and reported at the census tract level.⁸⁸

FIRM LEVEL DATA COLLECTION

Dun and Bradstreet is one of the only organizations that currently collect firm-level data on EDM businesses in Emerging Domestic Markets. With information on over 70 million businesses, Dun and Bradstreet maintains the most comprehensive information on firms' revenue, employment, industry, location and credit history. However, Dun and Bradstreet tends to undercount firms, especially smaller ones, those less likely to seek credit, or those operating in the informal economy. The firm also maintains a women- and minority-owned business database, but inclusion depends on firms reporting themselves as women or minority-owned. Firms may fear discrimination or simply wish not to declare themselves in these categories, under-representing the total number of these firms. A final challenge to using Dun and Bradstreet data is that it is organized as a database for marketers and suppliers, providing the most recent "snapshot" of the firm. Historical, time-series

data used to establish the growth rate of firms' employment and revenue is more difficult to obtain.

U.S. CENSUS BUREAU

The U.S. Census Bureau collects the most comprehensive information on minority- and women-owned business through its Survey of Minority-Owned Business Enterprises (SMOBE), Survey of Women-Owned Business Enterprises (SWOBE), and Characteristics of Business Owners Survey (CBO). SMOBE and SWOBE provide data on the number of firms, employment, annual payroll and gross receipts, aggregated by the race, ethnicity and gender of the owner, and state of location, among other factors. However, as noted earlier, firm level data is not provided and information is often outdated by the time the reports are released (every five years). The CBO used census information to generate national data comparing selected economic, demographic, and sociological characteristics among minority, women, non-minority male, and all business owners and their businesses. It was last released in 1992 and is no longer produced due to Census budget cuts. Given the growing size and strength of the EDM business pool, it is important to take a regular census of these businesses, identifying characteristics at the firm level and comparable from year-to-year.

CDFI DATA PROJECT

In 2000, a consortium of CDFIs (funded by the MacArthur Foundation, the Ford Foundation, and the CDFI Fund, among others) established an initiative to collect data on financing in the community development finance field. Six partners (the major community finance associations and intermediaries) were designated as primary data collectors to collect and clean data from approximately 500 CDFIs. These include the Aspen Institute, Community Development Venture Capital Alliance, National Community Capital Association, the National Community Investment Fund, Corporation for Enterprise Development, and National Federation of Community Development Credit Unions.

While the Data Project is an important endeavor, it falls short of generating information that could help increase capital flows. The Project was not designed with the demands of the capital markets in mind, and collects information at the level of the individual CDFI fund rather than the business or the particular loans or investments.

Recognizing the critical importance of this data, several interesting initiatives are tackling projects.

FAIR ISAAC AND COUNT-ME-IN FOR WOMEN'S ECONOMIC INDEPENDENCE

Count-Me-In For Women's Economic Independence ("Count-Me-In") is an innovative online "lending and learning" microloan organization

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Given the growing size and strength of the EDM business pool, it is important to take a regular census of these businesses, identifying characteristics at the firm level and comparable from year-to-year.

Count-Me-In's breakthrough concept in providing capital to LMI entrepreneurs involved two elements common to mainstream institutions to reduce the cost of lending: processing all applications over the Internet, and adapting a standard credit scoring model to a population that would not qualify for loans under the traditional application.



The organization's nonprofit status allows it to obtain information otherwise prohibited under Reg B, i.e., gender, race and ethnicity.

serving women entrepreneurs, many of whom run home-based businesses. Co-founder Nell Merlino developed the model, cognizant of the difficulty women, LMI women in particular, faced in accessing business capital. Count-Me-In makes loans from \$500 to \$10,000 (with a \$5,000 cap for first time borrowers). In its first two years of operation, the program made 168 loans, with terms of one to three years and interest rates of 2 to 4 percent.

Count-Me-In's breakthrough concept in providing capital to LMI entrepreneurs involved two elements common to mainstream institutions to reduce the cost of lending: processing all applications over the Internet, and adapting a standard credit scoring model to a population that would not qualify for loans under the traditional application. In partnership with Fair Isaac (the nation's leading provider of credit scoring models), American Express Small Business and loan officers experienced in working with women entrepreneurs, Count-Me-In developed an alternative credit-scoring technique. This model measures a woman's economic life, personal experience and business development potential in evaluating loan eligibility by supplementing traditional credit scoring questions with inquiries about experience in the business, family participation and goals. (Count-Me-In's credit scoring model is described in more detail in the Credit Scoring section of this report.)

Count-Me-In's Internet application system simplifies the process of collecting and tracking applicant data, including income, business history and performance, and loan performance. The organization's nonprofit status allows it to obtain information otherwise prohibited under Reg B, i.e., gender, race and ethnicity. Engaging Fair Isaac in the design process enabled Count-Me-In to build an analytical framework that would accumulate data useful in assessing the true capital needs and lending risks of its target entrepreneurs, and in a format applicable to other, more mainstream lenders. Using Internet technology reduces the cost of collecting information, and enables the organization to collect larger pools of data.⁸⁹

APPLICATION SERVICE PROVIDER MODEL

Gathering the required critical mass of clean data requires incentivizing lenders to adopt fairly uniform collection models and to share information. The CDFI Fund, the SBA7(a) and 8(a) programs, and banks and nonbank commercial lenders contain a wealth of information on borrowers and loans but, as noted above, the loans are diverse and data has not been harvested effectively. One model for amassing data is an "application service provider" (ASP) system, commonly used in the Internet delivery environment. An ASP builds a web of relationships around a common processor site. In the hypothetical data collection model, originators and lenders, each with their own policies and procedures, would feed data into a central processing repository.

Personal information could be masked to preserve confidentiality. This model could be used simply to collect data, or be expanded to include funding mechanisms. In the latter example, an originator (e.g., intermediary, individual business) would feed information to the repository, which would add additional information relevant from the pool (e.g., credit score), and send the application to a capital provider (either a specific lender, or perhaps, a pool of participating lenders who could bid for the project.) The ASP would collect information on all transactions, and given the size of the data pool, be able to make statistical observations. The data and the findings would be a shared asset of participants as motivation for participating.⁸⁹

CREDIT SCORING

Credit scoring derives a single quantitative measure – the score – from a vast statistical sampling of past borrowers in order to predict the future payment performance of an individual loan applicant – the applicant’s propensity to repay.⁹⁰ With the increase in disintermediation, and the rapid improvement in technology, lenders find credit scoring a cost-effective means of offsetting the information asymmetries of the modern financial services environment.

Research has demonstrated that an entrepreneur’s personal credit history is the single best predictor of business loan repayment – far better than such financial factors as debt burden, cash flows and revenue growth. Critics of credit scoring argue that it reduces lending to LMI borrowers, since many LMI individuals have not had credit records, or have experienced payment gaps due to cash crunches. Furthermore, LMI loans may be underrepresented in data samples, weighting the pools in favor of higher income individuals and discriminating against LMI applicants.

In fact, recent studies reveal that applying credit scoring increases LMI lending. One study estimates that large banks using small business credit scoring lend \$16.4 million more, on average, to LMI census tracts than non-scorers (controlling for community and bank characteristics e.g., total businesses, bank branches, median income, lender asset size).⁹¹ While scoring banks’ levels of lending (dollar value) did not differ between LMI and higher-income areas, non-scoring banks lent significantly less in the LMI markets. Credit-scorers actually originated a larger number of loans in LMI areas than in higher-income markets, while non-scorers issued fewer. Finally, the existence of an LMI-based bank branch had no impact on the level of small business credit available from credit scorers, but significantly increased the level of lending from non-scorers.⁹²

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Credit scoring makes small-business lending more attractive to larger lenders because the probability of default for a given applicant can be predicted fairly reliably.



A digital divide remains between whites and non-whites in the United States.



In 2001, only 39.8 percent of African-Americans and 31.6 percent of Hispanics used the Internet, compared to 59.9 percent of whites.

predicted fairly reliably, and variations in risk assessment across loan officers or by a single loan officer is eliminated over time.⁹³ It may, however, discriminate against certain LMI borrowers who have little or no experience with mainstream financial institutions.

COUNT-ME-IN FOR WOMEN'S ECONOMIC INDEPENDENCE

As described above, Count-Me-In and Fair Isaac created an innovative credit-scoring model to assess low-income women entrepreneurs' propensity to repay in a way traditional scoring models could not. It predicts creditworthiness by including information regarding specific experiences that impacted the applicant's economic history, such as divorce, extended child or parent caretaker responsibilities, lack of personal credit or credit obtained in the name of a spouse, in addition to standard credit history data. The applicant receives additional points for work experience in industries similar to her business, making and selling the product or service (even if it was an avocation, not a business, i.e., baking cakes for church bazaars would count as experience running a baking service), completing a business plan, and accessing supplemental financial support and technical assistance. Once Count-Me-In has made 2,000 loans, Fair Isaac has agreed to review the credit scoring system and loan histories and determine which of the model's unique questions are predictive of women's lending risk. This could set the standard for a mainstream alternative product.

TECHNOLOGY

Advances in technology have enabled financial institutions to extend into diverse new markets, both geographically and demographically. Small business lending has traditionally been an expensive activity due to the relative size of loans, but technology can drive down costs and make the market more appealing. Technology gave birth to credit scoring, and the ability to gather and store market information. Without the use of the Internet and American Express' Small Business Services' back office technology, Count-Me-In would never have been able to function (even as a nonprofit). With access to technology, banks see small businesses as more viable customers, and are developing products and services to reach the market.

FLEET COMMUNITYLINK

A digital divide remains between whites and non-whites in the United States. In 2001, only 39.8 percent of African-Americans and 31.6 percent of Hispanics used the Internet, compared to 59.9 percent of whites. While Internet usage increased 15.0 percent for Hispanics and 20.7 percent for African-Americans from 1998 to 2001, the increase was still less than white's 22.4 percent. The divide is even more apparent between low- and high-income individuals. In a recent study, fewer than half (42

percent) of respondents with household incomes less than \$40,000 had computers in the home, and only 32 percent were connected to the Internet. In contrast, more than three-quarters (77 percent) of those with incomes over \$40,000 used a computer in the home and 61 percent are very comfortable using the Internet.⁹⁴

CommunityLink is a community economic development initiative created by FleetBoston Financial in collaboration with community-based organizations and technology partners. Initially, 3,000 Fleet customer participants, including individuals and small business owners, will receive computers and online services at no cost. Its goal is to help stimulate wealth creation through digital inclusion and greater access to online financial services in LMI communities. Fleet has identified three areas that are critical in increasing Internet usage: access, comfort, and content.

- **Access:** Fleet provides adult customers who do not have a home computer with state-of-the-art hardware, software, Internet services and Fleet HomeLink(TM) online banking with bill payment.
- **Comfort:** Training and technical assistance provided by in-home tutors and community technology centers helps individuals learn to navigate the Internet, build online communities and use technology to enhance skills and create financial well being.
- **Content:** To address the lack of online content considered relevant to LMI individuals and businesses, Fleet is mobilizing community resources to build localized information portals. These portals consider language, cultural and literacy barriers and offer links to nearby businesses and opportunities.

A three-year evaluation using focus groups, surveys and interviews will help determine how participation in this program affects participants' use of financial services and information technology. Control groups will be employed at three of the five sites. Should the findings of CommunityLink's pilot program demonstrate a link between Internet access and increased financial stability among LMI populations, this would make an important contribution to the industry and encourage creation of appropriate content for these communities.

ACE-NET

ACE-Net grew out of the 1995 White House Conference on Small Business. The delegates to that conference made access to capital their top priority and requested that the Administration develop a national marketplace for private offerings of small business securities. ACE-Net's aim is to promote entrepreneurs' access to seed and startup capital and to enhance the role of smaller investors or "angels" in the venture capital market.

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While many companies have valuable products or services, and some have adequate capital, a lack of basic business skills hinders a small business' ability to reach customers or access sufficient resources.



Many entrepreneurs rank lack of business training as high among the challenges they face.



Increasingly, financial institutions see training and mentoring as a risk mitigator, increasing a business' likelihood of success and repayment.

ACE-Net was developed by the Office of Advocacy, Small Business Administration in consultation with the U.S. Securities and Exchange Commission (SEC), the North American Securities Administrators Association, Inc. (NASAA) and experienced angels, SBICs and VCs. ACE-Net posts the securities offerings of small, growing companies located throughout the nation that are then viewed anonymously by accredited investors. ACE-Net also attracts special interest investors from across the country looking for woman- or minority-owned companies.

Over the past four years the process has assisted an estimated 2,500 entrepreneurs secure over \$4 billion to both start and expand their businesses. ACE-Net permits entrepreneurs to link their services to a national marketplace through a secure Internet-based listing service.

MENTORING/ BUSINESS ADVISORY

While many companies have valuable products or services, and some have adequate capital, a lack of basic business skills hinders a small business' ability to reach customers or access sufficient resources. Many entrepreneurs rank lack of business training as high among the challenges they face. Increasingly, financial institutions see training and mentoring as a risk mitigator, increasing a business' likelihood of success and repayment.

COMMUNITYEXPRESS

The Community Express Loan Program (*CommunityExpress*) pilot combines small business loan guarantees from the U.S. Small Business Administration (SBA), targeted lending by select banks (including Fleet as noted earlier), and technical assistance from local National Community Reinvestment Coalition (NCRC) members. It targets two principal markets – LMI geographies, and women- and minority-owned businesses regardless of location.

In addition to leveraging the strengths of its public, private and non-profit partners, *CommunityExpress*' key innovation is the technical and management assistance it requires for borrowers both before and after the loan has been made. This assistance acts to mitigate risk by improving the entrepreneur's skill base, and as collateral enhancement by demanding a time commitment from the borrower. The SBA was willing to raise its guarantee level for the pilot (from the normal SBA Express level of 50 percent to the 7(a) level of 75-80 percent, depending on loan size) to test the link between increased training and decreased default.⁹⁵ The five-year pilot began in 1999 and to date has facilitated \$77 million in loans.

Lenders work with NCRC to identify local technical assistance provider for the borrower (or offer assistance themselves) and compensate the

provider directly. They can use the streamlined SBA Express loan processing procedures. Applicable loans include term loans, lines of credit and commercial mortgages, and funds may be used to purchase inventory, machinery and equipment, land and buildings, and for working capital.

CALIFORNIA RESOURCES AND TRAINING (CARAT)

While many organizations provide technical assistance to small businesses and entrepreneurs, the quality of these services has not always been reliable. Practitioners have established few standards to guide providers, hindering the capability of economic and business development agencies to reach their full potential.

California Resources and Training (CARAT) aims to integrate and build the capacity of the technical assistance industry in California. Among CARAT's programs is the pilot Technical Assistance Certification Program (TACP), aiming to establish performance standards for technical assistance providers. This certification should help lending institutions identify high-performing providers and ensure that the business assistance industry adequately meets the needs of small businesses. The pilot program has generated \$22,290,403 in new capital invested directly in small businesses and community service organizations through referrals and packaging of loans. In 2001, CARAT provided capacity-building assistance to approximately 277 entities providing small business assistance throughout California.

Once tested and established in California, CARAT intends to expand the certification nationally. In partnership with the NCRC Best Practices Committee, CARAT is exploring linking TACP to CommunityExpress, providing participating lenders with easy access to certified providers.

In addition to TACP, CARAT administers the following programs:

- **Co-Lending Certification Community Partners Program:** Assists CARAT's partner California Economic Development Lending Initiative (CEDLI) by training business assistance providers to package loan applications.
- **Revolving Loan Fund Capacity Building Skills Program:** Provides capacity building training to revolving loan fund operators and CDFIs.
- **Customized Post Loan Technical Assistance Program:** Certifies and compensates business assistance providers to deliver analytic and consulting services to CEDLI's Co-lending borrowers statewide. The program has developed a financial analysis software tool to aid this effort.

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The Bay Area has undergone impressive economic growth over the last decade.



However, not all communities have experienced this boon, as many residents have been left aside.



Launched by venture capitalists conscious of the large number of Bay Area residents negatively impacted by the then-booming technology industries, SVCV aimed to “invest in and develop businesses that provide substantial economic benefits to LMI communities.”

Business advisory services and mentoring are even more important when equity financing is involved, as the source of financing becomes an owner. Several innovative models include:

SILICON VALLEY COMMUNITY VENTURES

The Bay Area has undergone impressive economic growth over the last decade. However, not all communities have experienced this boon, as many residents have been left aside. For example, while greater Santa Clara County has the highest median income in California at over \$74,000, communities such as East Palo Alto with a median household income of \$29,000, remain poor. There is a lack of capital flow and other critical resources into qualified businesses in these communities.

Silicon Valley Community Ventures (SVCV), led and founded by Penelope Douglas, provides capital, business advice and business resources to firms in LMI communities of the Bay Area. Launched in 1999 by venture capitalists conscious of the large number of Bay Area residents negatively impacted by the then-booming technology industries, SVCV aimed to “invest in and develop businesses that provide substantial economic benefits to LMI communities.” SVCV’s program is threefold:

- **Business Advisory Services** – Senior business professionals mentor portfolio companies one-on-one or in teams of two or three over a six to 12 month period. They focus on specific growth issues such as marketing, strategy, operations and information systems. “Soft skills,” such as eye contact, dress and handshakes, are also addressed. Any company interested in approaching SVCV for investment capital must first go through the Business Advisory program.
- **Financing Services** – SVCV Investment Partners (Funds I and II) makes equity and near-equity investments from its Business Advisory pool in select companies that offer financial returns (market rate targeted for portfolio) and social returns in the form of impact on distressed communities as noted in its mission. SVCV also makes loans to some of its businesses.
- **Resource Network** – This network sponsors forums and offers business planning tools, computer software, training courses, legal services, employee recruiting and retention services (many through web access), and creates a support network for emerging entrepreneurs.

THE RUNNERS’ CLUB

While African-Americans represent 12 percent of the country’s population, they own only four percent of businesses. Furthermore, the

growth of African-American-owned businesses has remained largely flat in the last five-year period reported by the U.S. Economic Census. Because a greater proportion of minorities are low income than non-minorities, the problem of low African-American business ownership is crucial for improving the plight of low-income people. Often, minority groups lack the networks to gain the necessary expertise and capital to start and maintain a profitable business.

The Runners' Club (based in Chicago and launched by Shorebank Neighborhood Institute (SNI), a nonprofit affiliate of Shorebank Corporation, is an entrepreneurial training program. Its goal is to create more jobs and build wealth in African-American communities by increasing the entrepreneurial capacity of qualified African-American business owners. Nine to 11 business owners participate in a yearlong series of monthly classes intended to spur their company's growth and accelerate success through coaching and mentoring, access to networks, and access to capital. As these companies grow, they create more jobs and contribute to the local and national economies.

The program includes:

- **Coaching and Mentoring:** "Runners" are advised by the Executive Director and the "Brain Trust" – a group of volunteer professionals who serve as advisors and a networking source. Entrepreneurs receive practical information about market opportunities, deal structuring, financing options, management team formation, corporate governance, and other issues facing entrepreneurs. The program offers coaching on what to expect and how to respond to questions from potential investors, as well as professional consulting on the "art and science of pitching a deal."
- **Access to Networks:** The Brain Trust is composed of successful entrepreneurs, bankers, attorneys, accountants, and venture capitalists. This group introduces the entrepreneurs to other professionals, including investors.
- **Access to Capital:** A mix of networking and capital access opportunities take place throughout the program and at its conclusion. The Runners' Club also sponsors a closing Investor Conference enabling its entrepreneurs to present their business plans to 50 venture capitalists and bankers. The conference is followed-up with meetings between entrepreneurs and interested investors.

Since its inception, the Runners' Club has graduated two classes, generated \$10 million in capital commitments, and added 21 members to the advisory boards of five companies. The Runners' Club has also contributed to creating 200 jobs within the Runners' companies, growing the revenue of one company five-fold, two companies two-fold, and launching three new start-up firms. The Runners' Club intends to extend its program beyond Chicago by 2003.

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RECOMMENDATIONS

Traditionally, government programs and philanthropic donors have been the primary sources of capital for EDM and LMI communities. As growing deficits reduce federal, state and local agency budgets, and stock market losses shrink foundation portfolios, the size of these contributions will fall accordingly. Private capital must step in to fill the void, and can do so most effectively using market-based, risk-priced mechanisms. Financial technologies facilitate funding sustainability by matching investors with investments based on risk-tolerance. As a next step, the report's authors recommend initiating one or more of the recommended pilots, each of which is elaborated below.

It is clear that community development finance organizations and LMI entrepreneurs would be interested in exploring these innovations as they could bring needed support to a resource-constrained field. But there are also strong motivators for financial services firms:

- The shift in the financial services industry, from a bank-based to a capital markets-based structure, is producing both dislocation and dynamism, all amidst a slowdown in national economic growth. As Schumpeter noted, these periods of turmoil bring “creative destruction” – the replacement of old products and technologies with new ones.
- Small businesses represent the vast majority of American companies, and a large pool of potential customers. New technologies and financial innovations provide cost-effective means of reaching the market.
- Emerging domestic markets are the fastest growing segment of the population, and EDM firms are growing far faster than the national average.
- As with all new markets, information asymmetries provide an opportunity for profit to those who craft innovative solutions.
- First-movers will have a significant competitive advantage given the size and diversity of the market.
- The recent business scandals in American corporations will bring greater scrutiny of the industry from government and the public. Proactive exploration of the opportunities in emerging domestic markets will not only yield valuable business opportunities, but may limit new regulatory controls. It will also appeal to consumers and investors seeking good corporate citizens.

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Private capital must step in to fill the void, and can do so most effectively using market-based, risk-priced mechanisms.

An EDM Data Network would create a repository of information on EDM businesses and their loan performance, and share that information with financing institutions.



Creating the Data Network would facilitate critical data assembly, generate a continuous learning process for lenders supplying the data, standardize the process and reduce the cost of information management, and potentially, create a pool of loans that could be securitized.

Below are several recommendations for pilot projects, based on the findings in this report. The choice of these pilots is based on several criteria:

- They address specific, identified obstacles impacting LMI entrepreneurs' access to capital.
- They are based on tested concepts, even though the concepts may have been applied in different situations.
- They are not applied wholesale, but tailored to account for both the market demands of mainstream firms and the public purpose of the community finance field.
- They leverage existing resources and expertise.
- They have attracted interest from both the mainstream financial services companies and community finance organizations.
- They incorporate incentives for all parties to participate.
- They are easily scalable.
- They can be implemented in a reasonable period of time.
- They will increase capital flows to small businesses in LMI and emerging domestic market communities.

MODEL ONE: EDM DATA NETWORK

GOAL: Create an effective mechanism for the financial services industry to reasonably and efficiently price EDM/LMI entrepreneurial risk, and enable investors to make more informed decisions about financing EDM/LMI businesses.

STRATEGY: As this report documents, the current pools of data are fragmented, with many insufficient in size and/or format for this purpose. An EDM Data Network (Data Network) would create a repository of information on EDM businesses and their loan performance, and share that information with financing institutions (masked to preserve confidentiality). Creating the Data Network would facilitate critical data assembly, generate a continuous learning process for lenders supplying the data, standardize the process and reduce the cost of information management, and potentially, create a pool of loans that could be securitized.

PROCESS: There are several potential approaches to building the Data Network:

GOVERNMENT-AFFILIATED SYSTEM

Both the SBA and the CDFI Fund have existing programs that support large numbers of small business loans. Many of these loans (all loans in the case of the CDFI Fund) would be representative of the EDM market explored in this report. In conjunction with the Data Network and Fair Isaac, these agencies could develop a standard reporting protocol to collect the information needed to develop credit scoring and securitization, and require all participating lenders to file on a regular basis. (As an initial incentive, lenders could be compensated for filing.)

BANK-MANAGED SYSTEM

Recognizing the challenges in launching a new program within a government entity, an alternative would be to create an independent network of participating banks, both large and small. These banks would agree to: make loans to borrowers at the lower end of the credit scale, use a standard loan application, and regularly provide specified data in a standard format on loan applicant and performance data. The Data Network would collect the data and, initially at least, compensate the banks as an incentive to participate. In addition to the incentive fee and the loan fees, participating banks would benefit by obtaining CRA credit, receiving continuously updated data on new markets, and gaining access to a new risk assessment tool – the EDM credit scoring model.

Data Network data could be used to develop other products, credit enhancements and liquidity mechanisms for this market. The loans in the Data Network could be securitized. At a later stage, the Data Network could possibly expand to receive EDM loan applications, and based on their credit score, send them out to “bid” among participating banks.

Conceivably, banks could structure their transaction and default costs as a CRA investment by contributing to the Data Network, or issuing a long-term note for the amount of expected losses. These funds, plus foundation contributions, could support the Network’s operations.

Once a pool of sufficient size is collected, the data could be used to create credit-scoring mechanisms reflective of the EDM market. Fair Isaac, the leading developer of credit scoring, is interested in working on this project. A pool must contain at least 1,000 “bad” loans for Fair Isaac to

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Data Network data could be used to develop other products, credit enhancements and liquidity mechanisms for this market.

Securitization and credit-enhancement offer lenders a path to liquidity in order to reduce their risk in issuing credit, and free them to extend additional loans.



While small-business loans, are less easily securitizable, opportunities do exist and could increase the size and scope of EDM lending by mainstream institutions.



A viable securitization in this market requires performance data, a loan pool of sufficient size and homogeneity, and strong credit enhancement to offset the added risk.

consider it a statistically significant sample (assuming a five-to-eight percent delinquency/default rate, this requires a pool of 12,500 to 20,000 loans). Once the 1,000 “bads” have been collected, Fair Isaac could analyze the pool and create a reliable EDM credit-scoring model. By identifying those whose repayment likelihood falls below acceptable levels, the process also identifies the noninvestment grade tranche of a securitization.

MODEL TWO – SECURITIZATION AND CREDIT-ENHANCEMENT

GOAL: Offer lenders a path to liquidity in order to reduce their risk in issuing credit, and free them to extend additional loans.

STRATEGY: Securitization – the pooling and purchase of individual small-business loans from multiple lenders and packaging these loans into a security, or a Collateralized Loan Obligation (CLO), to be sold to a third party – has played a key role in increasing access to capital in the home mortgage, auto loan, and consumer finance markets. While small-business loans, community development finance loans in particular, are less easily securitizable, opportunities do exist and could increase the size and scope of EDM lending by mainstream institutions. Several generic structures and some specific examples appear in this report.

PROCESS: A viable securitization in this market requires several factors:

- Performance data: Model One presents an approach to collecting the necessary data.
- Loan pool of sufficient size and homogeneity (although complete uniformity is not necessary): Pools could be created from several programs targeting LMI and EDM borrowers, including the nonguaranteed portion of SBA 7(a) loans, Capital Access Programs, community development loans backed by state and Federal guarantees, community development credit unions and loan funds.
- Strong credit enhancement to offset the added risk: Several models presented in this report, as well as the reserve funds in loan programs such as the CAPs.

As noted in the report, Capital Access Programs (CAPs) serve EDM borrowers. The mission, size, scope and structure of the CAP program make it an excellent model for LMI-related securitization. Mainstream lenders issue most of the loans, which reach borrowers who would not otherwise have access to capital. CAPs have facilitated over \$1.6 million in loans in over 20 states and cities around the country, demonstrating a pool across which to diversify risk. The size of the state-held reserves continually exceeds the actual loan loss, providing credit enhancement and enabling an investment-grade rating for the security. States manage their own CAPs, but legislation authorizing a National Capital Access Program has been introduced in Congress. The sample CAP securitization structure below is based on the California Capital Access Program (CalCAP), but could be replicated in or pooled with other states.

When a loan is made under CalCAP, the borrower and lending bank each pay two percent into the loss reserve account, and the state adds four percent, for a total reserve of eight percent of the loan amount. Loans can be up to \$2.5 million, with short or long terms, have fixed or variable rates, be secured, and bear any type of amortization schedule. The economics for securitization of these loan products are compelling:

- Verifiable 12-year history of defaults averaging 3.7 percent; 3.5 percent in California
- Bank underwriting and servicing standards
- Lucrative spread of six-to-eight percent for warehouse facility during loan accumulation
- Off-balance sheet, riskless 20 percent profit return to CAP lender on each deal after all expenses
- One-to-three percent high-yield profit margins for investment banker on high-grade bonds
- Lending underwriting standards superior in quality to SBA requirements.

In order to create a private capital markets link to the CAP program, the State of California passed legislation in 1999 permitting the securitization and sale of CalCAP loans as asset-backed bonds. Additional legislation created by the Milken Institute and others in 2000 opened the door to most classes of small business borrowers and included some finance companies in the lending class. A regional

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CRA credit would be available on 30-to-50 percent of the bonds issued, as further inducement for institutional purchase.



EDM-targeted mezzanine funds bring private management to investments with a public benefit while introducing much needed flexibility to the capital structure of small businesses, and structuring transactions that capture the risks unique to these investments



The Fund could receive investments from investors seeking risk-adjusted market rate and/or double-bottom line returns.

financial institution has structured a deal to securitize these loans in pools of at least \$100 million.

The securitization of this product offers institutional investors a highly attractive investment vehicle. The bond structure accommodates an AAA investment grade rating backed by a 25 percent level of bond protection that is maintained throughout the life of the bond. The bond coupon could be fixed or float with investor call protection and provide approximately 200 basis points of spread to a benchmark U.S. Treasury security. CRA credit would be available on 30 to 50 percent of the bonds issued, as further inducement for institutional purchase.

Under the model, the loans would be real estate or plant and equipment based, with an 80 percent recovery history, 25-year maturity, five years non-refund, 7.75 years average life and float at prime +1. The loans would be 85 to 90 percent LTV and have coverage of 1.2 times. No working capital loans will be securitized. The bonds would float at approximately 30 day Libor +75-80. It is expected that 90 percent of the loans would be rated AAA and the remaining 10 percent rated A.

MODEL THREE: EDM-TARGETED MEZZANINE FUND

GOAL: Bring private management to investments with a public benefit (e.g., job creation, capital access), while introducing much needed flexibility to the capital structure of small businesses, and structuring transactions that capture the risks unique to these investments (e.g., management constraints, debt service capacity).

STRATEGY: Create a privately managed, public purpose equity/mezzanine fund that could target business and project financing in LMI areas and among EDM firms.

PROCESS: With an asset composition of debt and equity instruments, a fund can employ liabilities consisting of both equity and long-term debt to magnify return on contributed capital. The diagram on the following page illustrates a hypothetical mezzanine fund model (Fund). (NOTE: return rates and asset allocation are for illustrative purposes only.) The Fund could receive investments from investors seeking risk-adjusted market rate and/or double-bottom line returns, e.g.:

- Financial institutions and private equity investors

Figure 10
EDM-Targeted Mezzanine Fund Model

Percent of Total	Assets	Liabilities
20%	Equity 25% - 30% Return	A 6%
30%	Mezzanine Debt 18% - 22% Return	BB- 8-9%
50%	Senior Secured Debt 8% Return	Equity 12%
		Insurance
		Government
		Native American Indians
		Foundations
		Banks
		Individuals

- Other banks seeking Community Reinvestment Act (CRA) credit
- Insurance companies
- Foundations interested in mission-related or program-related investing
- Corporations with EDM business strategies
- Socially motivated investors
- Other pension funds
- Government or government-sponsored enterprises
- Native American Tribal Councils

Additional sums could be raised by an investment grade (Single A) issuance at Treasury plus 150 basis point return,

The asset side of the Fund balance sheet could include senior secured debt issued at one interest rate, mezzanine investment yielding a higher rate return, and direct equity yielding the highest return rate.



The Fund’s investors accept different levels of risk, and associated levels of return.



Those that are less risk-tolerant or more double-bottom-line oriented, such as foundations, governments and social investors, subsidize the higher returns demanded by others, such as banks and institutional investors.

and a high yield issuance (BB-) at 600 basis points above Treasury yields. The asset side of the Fund balance sheet could include senior secured debt issued at one interest rate, mezzanine investment yielding a higher rate return, and direct equity yielding the highest return rate. Equity might also be returned in the form of an ongoing “royalty” payment.

The Fund’s investors accept different levels of risk, and associated levels of return. Those that are less risk-tolerant or more double-bottom-line oriented, such as foundations, governments and social investors, subsidize the higher returns demanded by others, such as banks and institutional investors. The Fund could enhance its deal flow and impact by linking with one of the networks described as Model Four and Model Five below.

MODEL FOUR: FINANCIAL INNOVATIONS LAB & LEARNING CONSORTIUM

GOAL: Address the information challenges involved in linking financial innovation to community development finance, including:

- The ongoing refinement of financial technologies, and their application to ever more areas, information not likely to reach those involved with LMI businesses;
- The lack of contact between mainstream financial professionals and EDM businesses and communities
- The lack of regular, structured learning sessions for those professionals engaged in meshing financial technologies with EDM and LMI financing opportunities.

STRATEGY: Create a formal structure – the Financial Innovations Lab & Learning Consortium (Lab/Consortium) to link those active in the relevant fields to advance innovation, increase learning and provide networks to facilitate increased lending and investment. Community investment lenders at major institutions (e.g., Wells Fargo, Bank of America, Goldman Sachs) note that they rarely have the opportunity to discuss these issues among themselves, much less with the businesses and communities seeking financing.

PROCESS: Institutions, investors, entrepreneurs, community development financing organizations, and policymakers could participate in the Lab/Consortium. Some programs

would be open to all regardless of affiliation or specialty, allowing for cross-fertilization; and some would be reserved for specific subsets, enabling peers to share information. Certain discussions would be confidential to encourage transparency. As it evolved, the Lab/Consortium could collaborate on projects such as the models described above, e.g., data collection, pooling loans for securitization, jointly funded mezzanine funds, etc. The Lab/Consortium could consist of several components, such as:

FINANCIAL INNOVATIONS LABORATORY

Brings together experts in structured finance, community lenders, entrepreneurs, researchers, regulators, etc., to work through specific challenges that limit the flow of capital into EDM communities. Once problems were identified, a small group would build a market-solution by considering the appropriate financial technologies and the relevant adaptations needed for it to work in the LMI market. The solutions would be piloted, most likely by a participating financial institution, and deployed more broadly as applicable. Engaging financial institutions in the pilot design would increase their sense of ownership. Access to a potentially lucrative new product would incentivize them. Engaging both the potential suppliers and users of capital would maximize the likelihood of developing a viable product serving the interests of both parties.

CRA INVESTMENT SYMPOSIA

A regular meeting among those responsible for CRA at financial institutions would enable them to share challenges and solutions. Researchers and innovators would present current data, new models and applications to build the group’s knowledge base, and to generate joint approaches to achieving CRA goals in a market-responsive fashion.

INSTITUTIONAL INVESTOR EDUCATIONAL ACTIVITIES

EDM businesses, and LMI firms in particular, are extremely challenging for large institutional investors. They do not have the regulatory incentive that CRA offers banks. Their interest in the EDM market must derive from the investment proposition. Yet these entities represent the single largest source of capital globally. With the data gaps

A Financial Innovations Laboratory brings together experts in structured finance, community lenders, entrepreneurs, researchers, regulators, etc., to work through specific challenges that limit the flow of capital into EDM communities.



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Researchers and innovators would present current data, new models and applications to build the group’s knowledge base, and to generate joint approaches to achieving CRA goals in a market-responsive fashion.

Lab/Consortium could develop informational tools, products and programs tailored to the needs of institutional investors, and engage them in ongoing learning.



A Bank/Community Lender Exchange (Exchange) would break up the community financing value chain.



A national network would bring these activities to scale and maximize impact.

discussed throughout this report, most investors are at a loss to evaluate the market effectively. The Lab/Consortium could develop informational tools, products and programs tailored to the needs of institutional investors, and engage them in ongoing learning. This would be quite valuable, especially at the public pension funds, which, despite their extensive assets – nearly \$3 trillion – operate lean staffs with little room for niche expertise and in-house education. As noted above, a few funds have taken leadership positions in exploring the EDM arena, but many more will be seeking information.

MODEL FIVE: BANK-CDFI-TECHNICAL ASSISTANCE EXCHANGE

GOAL: Increase information sharing, leverage expertise, reduce risk and match funders and businesses more appropriately, ultimately increasing capital flow to LMI businesses.

STRATEGY: Within the LMI small business finance world, firms seek funding, banks seek deals, community lenders and investors seek deals and funding, and each could provide value to the others. However, most often, there is little crossover. With bank consolidation, territories are expanding and banks are reaching into unfamiliar communities. A Bank/Community Lender Exchange (Exchange) would break up the community financing value chain. There are excellent examples of Bank-CDFI partnerships, several of which are described in this report. There are also new models of Bank-Technical Assistance partnerships, the most extensive of which is CommunityExpress. A national network would bring these activities to scale and maximize impact.

PROCESS: An Exchange could include several functions, such as:

- Banks that could not fund applicants due to credit quality could refer them directly to CDFIs or other community-based lenders in the appropriate location. While this is often done on a local basis, it is more difficult for national institutions. Additionally, local banks have only the local CDFI to tap. Given the number and diversity of community finance organizations, pooling the information could enable more appropriate referrals. Incentives for participation and referrals could be provided to launch the effort.

- Banks or CDFIs or other community lenders could tie loan acceptance to the entrepreneur receiving technical assistance (as CommunityExpress bank participants now do). The Exchange could include a national pool, and use a system such as CARAT's TACP to certify approval. Ensuring quality technical assistance as part of the loan package would mitigate lender risk.
- Once an applicant is referred to a CDFI, the CDFI could track the entrepreneur's progress and direct him to the bank when he is creditworthy. Without networks, the borrower's relationship to the mainstream sector might be lost, and the bank might lose a potential customer.
- Members could go directly to the Exchange to obtain interest in a deal, sources for deals, suggestions for or E-Bay-like ratings of service providers (e.g., technical assistance, CDFIs or Banks, other vendors), products and services, co-investors, etc. The comprehensiveness of the system would provide a valuable directory, and its transparency would support reliability, both of which are likely to expand financing activity.

With a sufficient membership size, the Exchange could develop data collection processes (as in Model One), securitize loan pools (as in Model Two), invest in common funds (as in Model Three), or extend on-line learning programs (as in Model Four).

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APPENDIX I:

RESEARCH METHODOLOGY

The following methodology was employed in researching this report:

- **Literature Review:** An examination of relevant research regarding the history and current trends in financial innovations, the financial services industry, and small business and community development finance.
- **Data analysis:** An analysis of data sources such as Federal Reserve Flow of Funds, U.S. Economic Census data, Dun and Bradstreet data on women- and minority-owned companies, SBA/Federal Reserve Survey of Small Business Finance, data on minority and women targeted private equity data, thrift financial reports, bank call reports, and credit union data.
- **Interviews:** Interviews of those who borrow, lend, and invest on a regular basis, EDM entrepreneurs, researchers, and regulators. The interviews typically lasted one to three hours, and in some cases, group interviews were conducted (see Appendix II for a full list of interviewees).
- **Roundtables:** A series of roundtables were held in Los Angeles, New York, and Washington DC with representatives of depository institutions, nonbank lenders, community development financial institutions, financial and business trade associations, academic and policy research organizations, governmental and regulatory bodies, investment banking firms, private equity and venture capital firms, institutional investors, minority entrepreneurs, minority business leaders and community experts. The roundtables were held to test the viability and scalability of innovations.

Based on the described research conducted for this study, the Milken Institute determined those innovations that would most likely to be successfully implemented and brought to significant scale.

APPENDIX II:

INTERVIEWEES AND WORKING GROUP PARTICIPANTS

Cecil Adams	Chief Operating Officer	Founders National Bank
Rebecca Adamson	President	First Nations Development Institute
Henry Alford	President & CEO	National Black Chamber of Commerce
Avis R. Allen	Vice President	National Community Reinvestment Coalition
Frank Altman	President	Community Reinvestment Fund
A. Bernard Anderson	Managing Principal	Andercorp International Inc.
Brian Argrett	President & CEO	Fulcrum Capital Management
Shawn D. Baldwin	President & CEO	Capital Management Group Advisors
Michael J. Banner	President & CEO	Los Angeles Local Development Corp.
Michael Barr	Dep. Asst. Sec., Community Development	US Department of Treasury
Marva Smith Battlebey	Executive Director	Vermont Slauson Economic Dev. Corp.
Shari Berenbach	Executive Director	Calvert Community Investments
David Berge	President	Underdog Ventures LLC
Nitin Bhatt	Executive Director	USC Business Expansion Network
Betsy Biemann	Assistant Director, Working Communities	The Rockefeller Foundation
Joseph Blair	Exec. Vice President, Capital Markets	Advest Inc.
Francisco L. Borges	President & Managing Partner	Landmark Partners Inc.
Sandy Bourne	President	Pasadena Enterprise Center
Rodger Boyd	Program Manager	Community Dev't Financial Institutions
Jeffrey Brenner	Man. Director, Community Ventures Team	NCB Development Corporation
Julia Brown	District Community Affairs Officer	Comptroller of the Currency
Rodger Brown	President	Bright Horizons Family Solutions
Patricia Brownell	Executive Director	National Credit Union Foundation
Ambassador John Bryant	Founder, Chairman & CEO	Operation Hope Inc.
Beth Bubis	Vice President, Community Relations	Bank One
Kathryn Bushkin	President	AOL/Time Warner Foundation
Douglas J. Bystry	President & CEO	Clearinghouse CDFI

Phyllis Caldwell	Sr. VP, Comm. Development/ Private Equity	Bank of America
Roger Campos	Executive Director	Minority Business Roundtable
Shaw Canale	Executive Director	Cascadia Revolving Fund
Len Canty	Chairman	National Monetary Fund
James H. Carr	Senior Vice President	Fannie Mae Foundation
Joy Chen	Board Commissioner, Housing Authority	City of Los Angeles
Elyse Cherry	President	Boston Community Capital Venture Fund
Kurt Chilcott	President & CEO	CDC Small Business Finance Corporation
Chingyin Chu	VP, Small Administrative Business	Cathay Bank
William H. Chu	President & CEO	Los Angeles Community Development Bank
Della Clark	President	West Philadelphia Enterprise Center
Todd Cohen	President	CRA Fund Advisors
Linda Cole	VP, Community Development Manager	Cal FED Banking
Christopher Conley	President	Nonprofit Capital, LLC
Margot Copeland	President & CEO	Greater Cleveland Minority Business Roundtable
Mary Cosgrove	Director, Ctr. for Comm. Dev. Enterprise	Citigroup
Jamir R. Couch	Vice President	M.R. Beal & Company
Courtland Cox	Former Director / Minority Bus. Dev. Agcy	US Department of Congress
Gregory Craig	Chief Executive Officer	Cook Inlet Energy Supply
Lemuel L. Daniels	First Vice President, Investments	Salomon Smith Barney Inc.
Stephen Davey	First Vice President	Valley National Bank
Steven Davidson	Senior Financial Economist	America's Community Bankers
Don J. DeBolt	President	International Franchise Association
Christina Brooks DelDonna	Principal	Allied Capital SBLC Corporation
Gilbert E. DeLorme	Attorney	Greenstein DeLorne & Luchs PC
Real Desrochers	Director, Alternative Investments	CalSTRS
Bob Devereux	Public Affairs Specialist	State Farm Insurance
Andy Ditton	Director, CCDE	Citigroup
Catherine E. Dolan	Senior Vice President	First Union Bank
Amy L. Domini	Managing Principal	Domini Social Investments
Annie Donovan	Managing Director	National Cooperative Bank
Penelope Douglas	President	Silicon Valley Community Ventures

Lucy Drafton	CRA Program Analyst	District of Columbia Government
Jane Drake	Chief Operating Officer	Women's Equity Mutual Fund
Ed Dugger	President	UNC Partners Inc.
Brenda Ross Dulan	VP, Corporate Community Development	Wells Fargo
William Dunkelberg	Chief Economist	Nat'l Federation of Independent Business
Denise Fairchild	Executive Director	Community Development Technologies Center
Robert H. Forsythe	Senior Vice President	CNL Finance Inc.
Michael S. Frankel	Managing Director	Southern California Community Ventures
Michelle Garcia	Director, Operations & Investor Outreach	Emerging Venture Network
Richard Gentilucci	Senior Vice President, Real Estate	Shamrock Holdings
Donna Gilding	Chief Investment Officer	Progress Investment Management
Garrett Gin	VP, Community Development Manager	Merrill Lynch
Bob Gnaizda	General Counsel & Policy Director	The Greenlining Institute
Michael Golden	Vice President	Shared Equity Strategies
Darius Goore	Legislative Aide	Senator Jon. S. Corzine
Andrew W. Gordon	President	Arizona MultiBank Community Dev. Corp.
Bernell K. Grier	Senior VP & Director	Fleet Community Banking Group
Gloria Guerrero	President	Rural Development & Finance Corporation
Michael Gunning	Senior Legislative Advocate	Personal Insurance Federation of California
Sharon G. Hadary	Executive Director	Center for Women's Business Research
Richard Hartnack	Vice President	Union Bank of California
Penne Hasson	CRA Officer	Mellon First Business Bank
Richard Hayes	Senior Principal Investment Officer	CalPERS
Shelly Herman	Senior Managing Director	Shorebank Advisory Services
Victor Hoskins	Vice President, Strategic Alliances	Urban America
Thomas P. Hourican	President & CEO	Hourican & Associates
Susan Howard	Community Affairs Officer	Office of the Comptroller of the Currency
Giles Hunt	Advisor	Business Loan Marketing Association
Peter F. Hurst	Chairman & CEO	The Community's Bank
Rick Jackson	Vice President, Business Development	Actrade Financial Technologies
Carlton Jenkins	Partner	Yucaipa Corporate Initiatives Fund

Erik C. Johnson	Director	Community Lending Group
Ron Johnson	Associate Director, Corporate Ratings	Standard & Poor's
Maurice Jones	Acting Director	CDFI Fund
Micardo Jones	Director	Enron Investment Partners
Mary F. Kaiser	President	Cal Community Reinvestment Corp.
Mary Grace Karonis	CRA Manager	Cathay Bank
Gale K. Kaufman	Senior VP, Finance	New York City Investment Fund
Michael J. Kelley	President	Intrust USA
Clifton Kellogg	President	CityFirst
Donald Kincey	Vice President	Comerica Bank, California
Lynn Sheri King	Director, Legislative Affairs	National Community Reinvestment Coalition
Michael Klausner	Professor of Law	Stanford Law School
Kay Koplovitz	Principal	Koplovitz & Company
Deborah J. La Franchi	President & CEO	Genesis LA Economic Growth Corporation
James P. Laffargue	Vice President	Union Bank of California
Henry Lanier	Managing Director	Lehman Brothers
Jim Laurie	Consultant	Legg Mason
Daniel Letendre	VP, Community Development Group	J.P. Morgan Chase & Company
Andrea Levere	Vice President	Corporation for Enterprise Development
Judd Levy	President	Community Development Trust
Reta J. Lewis	VP, Counselor to the President & CEO	US Chamber of Commerce
Haddon Libby	Vice President	Bank of America Corporation
Dan Liebsohn	Consultant	Community Development Finance
John Logue	Director	Ohio Employees Ownership Center
Nigel L. Long	President	Dilworth Companies Inc.
Sandra Long	Deputy Secretary	Maryland Dept. of Business & Econ. Dev.
R.D. Lottie	President & CEO	Pacific Coast Regional Small Business Dev. Corp.
Joe Lumarda	Executive Vice President	California Community Foundation
Doug Martin	Government Affairs	Fireman's Fund Insurance Company
Victor L. Maruri	Managing Partner	Hispania Capital Partners, LLC
John May	Managing Partner	New Vantage Partners
Jim Mayer	Executive Director	Little Hoover Commission
George McDaniel	President & CEO	Community Bank of the Bay
Reuben McDaniel	President & CEO	Jackson Securities, Inc.

Dan Meiri	Executive Vice President	Bank Leumi
Fred Mendez	Community Investment Specialist	Federal Bank of San Francisco
Ray Mendoza	Vice President	(CEDLI) Calif. Economic Dev. Lending Initiative
Steve Mercil	President & CEO	MINCorp, Minnesota Investment Network Corp
Nell Merlino	Co-Founder & President	Count-Me-In for Women's Econ. Independence
Clara Miller	President	Nonprofit Finance Fund
Saunders Miller	Senior Policy Advisor, Investment Division	US Small Business Administration
Amy Millman	President	Springboard Enterprises
Karen A. Mocker	External Affairs Officer	CDFI Fund
Betsy Mongrain	Senior Vice President & COO	Neighborhood National Bank
Bill Boler	Vice President	Business for Social Responsibility
Laurence C. Morse	Partner	Fairview Capital Partners, Inc.
Kirsten S. Moy	Dir, Community Development Innovation	The Aspen Institute
Thomas Nagel	President	Urban Development Resource Corp.
Eric Natwig	President	New West Partners, Inc.
John Eric Nelson	Director, Corp. Partnership Program	Nat'l Congress for Community Economic Dev.
Dominic Ng	Chairman, President & CEO	East West Bank
James Nixon	Chair, Board of Directors	Sustainable Systems Inc.
Jack Northrup	Consultant	New England Market Research
Jeremy Nowak	President & CEO	The Reinvestment Fund
Ken Oliver	Senior Vice President	Development Credit Fund, Inc.
Karen A. O'Mansky	Director, Community Facilities Fund	Self-Help
Nina Orville	Vice President	New York Community Investment Co.
Erik R. Pages	Policy Director	National Commission on Entrepreneurship
Michael A. Pfeifer	Senior Manager	Fair, Isaac & Company, Inc.
Penny K. Pickett	Business Director	Telecommunications Development Fund
Mark Pinsky	Executive Director	National Community Capital Association
Jean Pogge	Sr. VP, National Accounts Group	Shorebank
Marcel R. Portmann	Vice President, Emerging Markets	International Franchise Association
Ed Powers	Senior Vice President	Bank of America
Michele Prichard	Director, Special Projects	Liberty Hill Foundation
Roy O. Priest	President & CEO	Nat'l Congress for Community Econ. Dev.

Mike A. Provencio	Senior Vice President & CRA Manager	City National Bank
Paul L. Pryde Jr.	President & Managing Director	Capital Access Group
Luther M. Ragin Jr.	Vice President, Social Investing	FB Heron Foundation
Gregory Ratliff	Director, Economic Opportunity	John D. & Catherine T. MacArthur Fnd.
Charles Raymond	President	Citigroup Foundation
Tarrus Richardson	Managing Director	ICV Capital Partners, LLC
Lisa Richter	Fund Advisor	National Community Investment Fund
Janice Cook Roberts	Senior Vice President	New York City Investment Fund
Richard Roberts	Managing Director	Goldman Sachs & Company
Steven Rogers	Professor	Kellogg School of Mngt/Northwestern Univ.
Forecee Hogan Rowles	President & CEO	Community Financial Resource Center
Julia Rubin	Ph.D. Candidate	Harvard University/Harvard Business School
Jun Sakumoto	Vice President	Jackson Securities
Ruth M. Salzman	Senior Vice President	JP Morgan Chase & Company
William Sayles	Managing Director	The Center for Credit Union Innovation LLC
Adria Graham Scott	Community Investment Advisor	Federal Reserve Bank of San Francisco
Jack Shakely	President & CEO	California Community Foundation
Daniel Sheehy	President & CEO	Impact Community Capital
Brenda Shockley	President	Community Build Inc.
Robert Shoffner	Citibusiness Regional Manager	Citigroup
Andrea Silbert	CEO	Center for Women & Enterprise
D. Wayne Silby	Chairman	Calvert Foundation
Terry Simonette	President & CEO	NCB Development Corporation
G. Winston Smith	Supplier Diversity Director	AT&T Corporation
Shelly Smith	President	L.A. City Employee Retirement Services
Gail Snowden	Executive Vice President	FleetBank Boston NA
Howard Sommer	President	New York Community Investment Company
Marianne Spraggins	CEO	ALIC Investment Advisors
Michael Springer	Office of Economic Policy	US Department of Treasury
Reginald T. Stanley	Senior Vice President	Calvert Foundation
Gregory M. Stanton	Director	Capital Markets Access Program
Joseph Stark	Senior Managing Director	Bear Stearns
Anne Stausboll	Chief of Staff & General Counsel	State of California
Kathy Stearns	Director, Financial Services	National Community Capital Assoc.

Michael Stegman	Director, Ctr. For Community Capitalism	Kenan Institute
Beatrice Olvera Stotzer	President	New Economics for Women
Michael Swack	Prof & Dir, Community Econ. Dev. Program	New Hampshire College
Scott Syphax	President & CEO	Nehemiah Corporation
Richard N. Tambor	Sr. Vice President & CCO	American Express Small Business Services
Wilson Tang	Regional Vice President	Cathay Bancorp Inc.
Charles Tansey	Senior Policy Advisor	Neighborhood Reinvestment Corp.
Blair Taylor	President	Inner City Development Corp.
John Taylor	President & CEO	National Community Reinvestment Coalition
Selma Taylor	Executive Director	California Resources & Training - CARAT
Kerwin Tesdell	President	Community Dev. Venture Capital Alliance
Stanley Tucker	President	Meridian Management Group Inc.
Paul Turner	Project Manager	Southern California Edison
Lauren Tyler	Managing Member	Quetzal/Chase Chase Partners LLC
Fidel Vargas	Vice President	Reliant Equity Investors
George Vradenburg	Sr. VP, Global & Strategic Policy	America Online
Larry Waddell	Managing Director	Sustainable Jobs Fund LP
Orson W. Watson	Vice President, Research & Strategy	Initiative for a Competitive City
Phillip J. Weber	SVP, American Communities Fund	Fannie Mae Foundation
John Weiser	Partner	Brody, Weiser & Burns
Robert Weissbourd	Senior Advisor, Urban Logic	RW Ventures
Anita Cooke Wells	Chief, Office of Financial Access	MBDA, US Department of Commerce
Lynn Reilly Whiteside	President & CEO	Social Compact
Mark Whitlock	Executive Director	FAME Renaissance
Alma Williams	VP, Community Development Officer	California Commerce Bank
Ruth Lopez Williams	President	Latin Business Association
George Williamson	President	(CEDLI) Calif. Economic Dev. Lending Initiative
Mark W. Willis	Executive Vice President	JP Morgan Chase & Company
Lee E. Winslett	VP, Community Lending	Wells Fargo
Brenda Wright	Sr. VP, Regional Manager, Comm. Dev.	Wells Fargo
Jim Yacenda	VP & CIO, Community Investments	Federal Home Loan Bank of San Francisco

Nancy Ylvisaker

President

Merrill Lynch CDC

Erika Y. Young

CRA Manager

District of Columbia Government

Jeffrey Zinsmeyer

President

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ABOUT THE AUTHORS

GLENN YAGO is Director of Capital Studies at the Milken Institute. He specializes in financial innovations, financial institutions, capital markets, and environmental finance. Yago is creator of the Milken Institute Capital Access Index, an annual survey that measures access to capital for entrepreneurs across countries and initiated establishment of the Center for Emerging Domestic Markets at the Milken Institute. He is the author of five books including *Restructuring Regulation and Financial Institutions*, and the forthcoming *Beyond Junk Bonds*, and is series editor for the Milken Institute Series on Financial Innovation and Economic Growth, published by Kluwer Academic Publishers. Yago received his Ph.D. from the University of Wisconsin, Madison.

BETSY ZEIDMAN heads the Center for Emerging Domestic Markets at the Milken Institute. Zeidman oversees the Center's resource network, research and publications, roundtables and conferences, advisory services and financial innovations lab. She is a frequent speaker on issues of emerging domestic markets and double-bottom-line investments. She also works with the Institute on issues of strategic philanthropy and environmental finance. She remains principal of Zeidman & Associates, a strategic management advisory firm specializing in issues of social responsibility and financial performance. Zeidman earned her MBA at the Yale School of Management.

BILL SCHMIDT was a Research Analyst at the Milken Institute focusing on research, analysis and application of data and information to emerging domestic markets and Latin American economies. Schmidt earned his MBA at the University of California, Los Angeles.



MILKEN INSTITUTE

1250 Fourth Street • Santa Monica, California 90401
Phone (310) 570-4600 • Fax (310) 570-4601 • E-mail info@milkeninstitute.org
www.milkeninstitute.org