The Federal Reserve Board

Remarks by Governor Laurence H. Meyer

Before the University of Wisconsin-Milwaukee, Urban Studies Programs, Milwaukee, Wisconsin
December 1, 1997

New Approaches to Small Business Development Partnerships

Before I joined the Federal Reserve Board, I spent some quite enjoyable time teaching economics at a university and I must say, I welcome the opportunity to be back on a college campus again. But as reflected by the title of my talk today, I'm not here to present a formal lecture on the intricacies of macroeconomics, monetary policy or interest rates, though I'm certain that some of you would find it quite exciting and hang on to every word. And I'm certainly not here to share with you any insights about political struggles inside the Beltway and the general travails of our nation's capital, Washington, D.C. In fact--quite the opposite. Instead of looking at the world of national policy or macroeconomics, I would like to focus my remarks today on the "micro" level--specifically the world of community development and the roles banks are playing in this growing field.

From time to time, we can all lose sight of how our day-to-day economic life unfolds and how basic economic activities, those that contribute to the long-term economic health and growth of our communities and our nation, play out. Those activities unfold not in Washington, but at the local level, where housing is developed, businesses grow, people save and work, and communities renew themselves.

Community development is uniquely local. It's an effort to reestablish functioning markets in neighborhoods and communities in economic distress. It's also a process used to revitalize these communities through affordable housing development and rehabilitation, commercial revitalization and the creation of jobs for low- and moderate-income persons. And it is necessary in both good times and bad. Even in a growing economy characterized by fast-paced technological change and shifting resources, capital investment strategies in the broader economy may bypass lower-income communities.

For many urban neighborhoods and rural communities, collaborative partnerships that include participation of financial institutions are the hallmark of the community development process. The community development process is designed specifically to increase capital flows to and within lower-income communities.

In discussing community development with you here today, I want to cover roles banks are playing in partnerships to support small business development, especially those partnerships that are part of overall efforts to help revitalize communities.

The Federal Reserve's Multiple Roles

Some of you might be puzzled about why a member of the Federal Reserve Board, an economist selected to serve on the Board because he was considered adept at economic forecasting, would be concerned about community development in low- and moderate-income neighborhoods. The answer is that I come to this subject as a direct result of my responsibilities as a member of the Federal Reserve Board. I learned very early in my tenure on the Board that this is no "ivory tower" operation where economists spend all of their time poring over economic data in isolation from the "real world."

Although many of you are familiar with the Federal Reserve's role as a central bank in conducting monetary policy and ensuring the viability of the payments system, many are less familiar with our role in bank supervision. The Federal Reserve supervises about 1,000 state-chartered banks who are members of the Federal Reserve System and supervises the activities of all bank holding companies. The Federal Reserve conducts regular examinations of these banks and regularly considers all types of applications from banks and bank holding companies wishing to open branches, create new subsidiaries, or acquire other financial institutions.

Many of you also may be unaware that as part of our supervisory responsibilities, the Fed is also quite an important consumer protection agency. In addition to examining banks to ensure that they are operating on a safe and sound basis, we also look at their compliance with consumer laws. Additionally, Congress has given the Fed a quite specific leadership role in writing regulations and policies for a dozen key consumer protection laws. Many of these laws govern the credit relationships of consumers with all types of creditors, from banks to mortgage companies, and from Sears to auto dealers to pawn shops. These laws include, for example, the Truth-in-Lending Act, which requires certain disclosures about loan rates and fees; the Equal Credit Opportunity Act, which prohibits discrimination based on race, color, religion, national origin, sex, age and marital status, in the extension of credit; and laws governing how terms and conditions of consumer leases are to be disclosed. The regulations touch virtually everyone who has a mortgage, credit or debit card, any type of loan or lease, anyone that has a financial relationship with a depository institution.

The result of all this is that on a daily basis, we can be knee deep in issues related to how the banking system works, how to promote and protect fair financial dealings for consumers, and how the finances of consumers and small businesses are related to the broader performance of the economy.

One of the laws we help administer is the Community Reinvestment Act, or CRA for short. Passed in 1977, the CRA reminds financial institutions that they have a continuing obligation to help meet the credit needs of their entire community, including those of low- and moderate-income neighborhoods. These obligations stem from bank charters which say that banks should meet the convenience and needs of the communities they serve. The Federal Reserve, as do other banking agencies, conducts CRA assessments of financial institutions and issues publicly available CRA ratings that reflect our judgement about their CRA performance. We are also required to consider the CRA performance of each financial institution when reviewing its applications for expansion of depository facilities through branching, mergers, or acquisitions.

One of the ways banks meet their CRA obligations is through a variety of working partnerships that facilitate community development lending and investment. These are public- private partnerships that involve the participation of community-based development groups, local and state agencies, financial intermediaries, including banks and thrifts, and other private sector groups, from insurance companies to utilities to foundations.

As part of my other duties as a member of the Board of Directors of the Neighborhood Reinvestment Corporation, I have had the pleasure of visiting with a number of community development organizations throughout the country and have toured dozens of their projects. These projects are vastly different, ranging from multifamily rental housing that includes comprehensive social services on site, to row-house rehabilitation, to development of new neighborhood shopping centers. But they all have one common denominator: They are the product of public-private partnerships that brought together representatives of government, nonprofit groups, business, banking and others, to develop solutions to community problems that could not be addressed by any one of these groups working alone.

Evolution of Community Development

Public policy now reflects this partnership approach, based on tailored programs that help meet the needs of localities and neighborhoods. This was not always the case. The huge federal urban renewal programs of the 1960s gave way to equally huge federal housing programs of the 70s and 80s. The money came from Washington, along with direction from Washington. Local government agencies and community organizations were reduced to chasing federal dollars that were used to subsidize projects that often were ill-advised because they were conceived to meet federal policies and requirements.

Current forms of community development activity had their origins in efforts to meet the needs for affordable housing and revitalize housing in lower-income areas. What began in neighborhoods and communities across the country with a few community-based groups working with banks, foundations, and local government agencies to rehabilitate housing has blossomed into a vibrant community development industry. Today, there are over 2,500 community-based development corporations that have produced thousands of units of affordable housing. These nonprofit community development corporations, called CDCs, serve as developers and rehabbers, provide housing and mortgage counseling assistance, operate their own revolving loan funds, and arrange financing with others. New state and local government loan programs are responding to the need for neighborhood based revitalization.

Additionally, there is a new set of increasingly effective intermediaries that have greatly influenced the direction and output of the affordable housing industry. These range from new-age affordable housing builders, such as Habitat for Humanity, to national intermediaries that help local groups to plan, develop and finance affordable housing projects, such as the Local Initiatives Support Corporation, the Enterprise Foundation and the Neighborhood Reinvestment Corporation.

On the financing side, lenders, government agencies and community organizations have created a wide variety of special loan products. Institutions, often with help from their community partners, have pioneered new approaches to looking at appraisals, debt-to-income ratios and the employment and credit histories of borrowers. Additionally, bankers have helped create new intermediaries, including multi-bank lending consortia, community development corporations, equity pools, and revolving loan funds to help finance affordable housing. The interest of financial institutions and the secondary market agencies has made some of the private mortgage insurance companies more willing to participate in the affordable housing market. Low down payment/low closing cost loans have helped families become home owners who never would have dreamed it possible.

Over the years, more direct and sophisticated mechanisms involving public-private financing arrangements, joint ventures, use of special tax incentives, and other techniques have become the *modus operandi* of the community development process.

The results have been impressive. The home ownership rate reached an all time high of 66 percent in the third quarter. Underlying this number is the fact that record numbers of minority and female-headed households have been participants in the new home ownership boom, especially in predominantly minority areas where strong community development organizations have been active. Overall, minorities have accounted for almost a third of new home owners in the last few years. Clearly part of the increase in home ownership is a direct result of the activities of the community development industry to supply affordable housing, develop special financing and counseling programs that make it possible for low- and moderate-income households to enter the home ownership market. Home Mortgage Disclosure Act data confirm that the number of home loans made by private lenders in lower-income neighborhoods and communities has increased at a dramatic rate over the last five years. In addition, much of the increase can be attributed to households who previously were excluded from the home ownership market.

Need for Economic Development

While the results in helping stimulate the market for affordable housing and home ownership in lower-income areas and markets have been in many respects remarkable, it has become clear over the years, that housing is not enough. It is not enough to revitalize distressed communities. It is not enough in many cases to reinvigorate neighborhood life. And it is usually not enough to create the kind of economic value that helps sustain revitalization efforts in ways that continue to benefit low- and moderate-income residents. While housing rehabilitation and new housing development may be necessary in successful community development, it is hardly sufficient.

There has been growing recognition that to sustain revitalization efforts, community developers must address the capital and income gaps in lower-income areas. What is needed, in addition to affordable housing, is economic development. By that I mean business development, especially small business development, job creation, and commercial revitalization that makes neighborhoods more convenient and attractive places to live, work, and shop.

I do not want to suggest that this is an abrupt change in direction for the community development industry, because it really is a change that evolved over the last 25 years. Some community-based economic development has been around for a long time, and in a number of larger cities, quite sophisticated economic development partnerships have been successful over a number of years. For example, over 20 years ago in Chicago there were over a dozen nonprofit CDCs specializing in neighborhood economic development.

But there is a much greater emphasis on the economic development side of community revitalization now. One reflection of this new emphasis is that in many communities around the country, community development groups that may have started out as essentially housing organizations, are moving resources into economic development activities.

Most successful programs are taking a comprehensive approach that includes planning, job training, commercial real estate development, entrepreneurship training, and a wide variety of small business assistance.

Small Business Financing in the Community Development Milieu
Although discussion of any one of these activities could take our entire day, I want to focus my remaining remarks on the financial side of economic development, particularly on how banks are participating in small business development and neighborhood-scale commercial development. Just as bank financing has been critical in helping fuel affordable housing partnerships, bank participation, on both the debt and equity sides of the equation, is equally important in economic development.

In general, the growth and diversity of the small business market have not been lost on bankers, in both small and large institutions. Across the country, many large institutions that previously had left the small business market to their community bank brethren, have been quite busy developing a wide array of products and services specific to small business needs. Sweep accounts, tailored investment programs, affinity business credit cards, smaller revolving credit lines, term loans and improved lock-box services are just some of the business services being offered in the new, more competitive small business financial services marketplace. The world of small business financing has gotten a lot bigger, as well as access to loans, and even the regional and national capital markets continue to grow for many small businesses.

Commercial banks are by far the most important supplier of credit and financial services to the small business market. The Federal Reserve's National Survey of Small Business Finances found that 84 percent of small and medium sized businesses identified a commercial bank as their primary source of financial services, though 20 percent also had financial relationships with nondepository institutions. Importantly, the survey also suggested that the use of nonbank sources of financial services increases with firm size. Very small businesses rarely use nondepository sources, but for firms with over 50 employees, about 40 percent said they used at least one nondepository source.

In the community development context, I believe these findings are quite important, because they suggest that the types of businesses that would be represented in community development areas, primarily very small and young firms, are generally those that would be most dependent on banks for financing. On the other hand, banks traditionally have had myriad problems in lending to such businesses.

The small business market is quite diverse and the term "small business" can mean quite different things to different bankers. Most banks tend to focus on mature, growing businesses--those with more than $5 or $10 million in sales. Other bankers typically refer to the small business market as the "middle" market, perhaps including firms with $25 to $50 million or more in sales, that are still dependent on bank loans because they are not quite large enough to float their own debt securities in the national capital market.

Usually, that is not the small business market on which community developers focus. And generally, with the exception of supermarket or drug store chains, those are not the types of businesses you would usually find or attract in smaller commercial strip shopping centers in urban neighborhoods or even rural areas.

Bank Approaches To Key Issues
Nonetheless, I think the community development industry has helped reshape bank perceptions of the small business market by perfecting new tools and techniques that enable banks to support financing for a broad range of small businesses--from small manufacturers

to very small, and even start-up firms--and to facilitate neighborhood commercial revitalization. Many of these tools and techniques are quite similar to those used in the affordable housing arena and are designed to address key issues that make it difficult for banks to lend to very small firms.

One of the primary difficulties, of course, is credit risk. Very small and start-up businesses generally lack the operating history and often have inadequate record keeping. They typically lack equity that can be valued or collateral that gives lenders the confidence they will be repaid if problems arise. The failure rate of small, newer firms is high and recoveries of principal are rarely achieved.

A second major set of difficulties involve the typically high transaction costs associated with making small loans, especially those under $25,000. If banks price to compensate for these costs, they risk making the financing unaffordable for the small firm. Additionally, many of these firms do not have traditional business plans, pro formas, and need far more advice and technical assistance than other small businesses.

A third difficulty, typical of all types of community development loans, is lack of liquidity, especially for term loans. Very small loans to new untested businesses, or longer term but small commercial mortgages, cannot be sold to investors; lenders must keep these in their portfolios, preventing loan funds from being replenished by limiting the amount of lending that can be done.

By adopting new financing tools and partnership approaches, many banks are learning to overcome these difficulties and increase their support for small business development.

Specialized Lending Units
A number of banks now have separate small business lending units that specialize in making longer-term loans, including loans that utilize federal and state loan guarantees. Guaranteed loans from the SBA, the rural development arm of USDA, and state economic development agencies, for example, continue to help banks make longer-term loans needed for new facilities, equipment and permanent working capital that often make small business expansion possible. These loans can be sold to investors and the proceeds used to make additional loans as a result of the government guarantee. Thus, the use of loan guarantees not only helps banks manage credit risks, but it also helps them leverage their capital to sustain and expand lending to small businesses.

In addition, by specializing in particular types of loans, bankers can develop efficient systems that help minimize the normally high transaction costs for smaller commercial loans.

Consortium Lending Corporations and Loan Pools
A growing number of multi-bank loan consortia are helping banks share risks and costs associated with small business finance. These loan consortia may also be called community reinvestment corporations or simply "loan pools." Although many are organized primarily by banks, they often have nonbank participants such as insurance companies, utilities, other business corporations, religious institutions and others. Loan consortia can be organized as nonprofit or for-profit corporations, and while some operate on a statewide basis, most focus on particular local areas. Statewide multi-lender consortium organizations in Massachusetts, Indiana, California, Washington State and West Virginia, among many others, reflect the

growing interest in this approach.

But consortia can also be particularly useful for smaller banks at the local level. Here in Milwaukee, the Lincoln Fund is a multi-bank loan pool that provides a variety of types of financing for businesses located in the Lincoln Avenue neighborhood of the city. By providing loans as small as $5,000, the fund helps stabilize and preserve the economic viability of the neighborhood. Two smaller commercial banks--a savings bank and the Wisconsin Community Capital Corporation--are participants.

Community Development Investments
Small and minority businesses are often undercapitalized and need additional equity as well as debt financing. Under both federal and state laws that govern the activities and powers of financial institutions, banks and bank holding companies can be granted permission by their primary regulators to make equity investments in small businesses under certain conditions. Typically, one or more banks or bank holding companies form a community development corporation, limited liability company, or invest in a limited partnership or equity pool, which in turn makes debt and equity investments in small businesses that are in low- and moderate-income areas. To use this equity investment authority, the bank must certify that the majority of the jobs and services provided by the assisted business must benefit low- and moderate-income persons. Most bank CDCs focused on small business also provide specialized loans and technical assistance.

One example is the Birmingham (Alabama) CDC, created through a partnership of city government and local financial institutions as a multi-bank community development corporation, that provides start-up and expansion loans for small minority-owned businesses in the inner-city. Loans are funded from a $2.5 million pool created by the banks. Under the program, the maximum loan amount of $150,000 is available for a variety of loan types: start-up, term financing for equipment, gap financing, and credit enhancement for new bank financing. A unique attribute of this approach is that the City of Birmingham guarantees 50-75 percent of all loans using part of its allocation of federal Community Development Block Grant funds.

Support for Nonprofit Small Business Finance Organizations
Another fruitful technique used by banks is support of other lenders who are more adept in providing the specialized financing needed by very small firms. Banks have assisted a wide variety of nonprofit small business finance organizations by providing them loans, investments and contributions. For example, banks support the activities of SBA Certified Development Companies which are nonprofit corporations specializing in small business finance. They are "certified" by the SBA to issue SBA guaranteed long-term debentures that are used to help fund small businesses. A typical financial package includes a combination from at least three sources: 50 percent of the package must be funded by a private financial institution; 40 percent is funded by issuance of an SBA guaranteed debenture; and 10 percent from business owner equity or other private funds that may be from foundation grants or corporate contributions. Usually, the certified development company provides technical assistance to the small businesses and develops the financing package.

Banks also can provide loans and contributions to support small business revolving loan funds operated by community-based nonprofit organizations. The advantage here is that the community organization often provides technical assistance and training for the entrepreneur, handles loan servicing, and absorbs other transaction costs that would make small loans unprofitable if the bank made them directly.

Community-Based Micro-Enterprise Loan Funds
Micro-enterprise loan funds represent a growing part of the small business lending supported by financial institutions. Community developers recognize that micro-enterprises--very small businesses initially created by self-employed individuals--can help bolster the economies of distressed areas and neighborhoods. Community-based nonprofit organizations and state and local governments throughout the country have created a wide variety of loan funds to help micro-enterprises get started or expand. These funds provide very small loans--ranging from $1,000 to $25,000--to individuals and families starting businesses. The typical micro-enterprise fund also provides intensive training and technical assistance to the new entrepreneurs.

A recent survey by the Aspen Institute looked at 328 micro-enterprise programs throughout the country. The average number of loans per program was 29 and the average loan size was just over $9,200. Of the micro-entrepreneurs supported by these micro funds, 62 percent were from a minority, ethnic or racial group, and 78 percent were women.

Banks support micro-enterprise funds in a variety of ways: They provide loans, investments and contributions to help capitalize the funds; they serve on the funds' board or loan review committee; and they may help review loans, business plans and activities of micro-entrepreneurs.

Conclusion
This is just a small slice of the diverse ways in which banks and other financial institutions are supporting small business development. What is quite important is that in every case, these examples all reflect the new public-private partnership approach to rebuilding communities. Although they may utilize resources from government programs or national community development intermediaries, they are uniquely local; each partnership is planned and executed by local participants. While banks cannot provide small business financing without profitable compensation, they clearly have demonstrated that there are tools and techniques that can be used to mitigate risk, limit costs, and increase liquidity when participating in economic development.

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