communities and banking

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FEATURE STORY

The Growing Securitization of Small Business Loans

In 1993, Chairman of the Federal Reserve Board Alan Greenspan noted that "if we could find a way to expedite a secondary market in small business loans, it would be . . . a major contribution to the financial vitality of this country." Since then a growing number of private and nonprofit organizations have been actively pursuing the securitization of small business loans, and in some cases microloans (see pages 6-7.)

Legislative incentives, combined with rapid developments in loan origination and underwriting technology, are paving the way for the creation of marketable debt-like securities backed by commercial loans. The driving force behind the securitization wave is the desire to give lenders access to capital markets, improve their liquidity, and spur more small business lending.

The Record on Securitization of Small Business Loans

Securitization involves the creation of securities backed by a pool of debt instruments, for example, loans or receivables, which produce a stream of payments and have a predictable default rate. The securities are then sold to investors, generating sale proceeds and fees that can be recycled to provide loans to other borrowers. Investors who purchase these asset-backed securities are purchasing a share of the future payments from the underlying debt, for example, a group of auto loans. The practice rose to prominence within financial circles following the introduction of the mortgage-backed security in the late 1970s, a move that led to the creation of an extremely liquid secondary market for home loans in the United States. Soon after, other forms of debt were also being securitized.

Recently, a virtual explosion in securitization has occurred; asset-backed securities grew from approximately $8 billion of investment instruments in 1987 to $140 billion in 1996. The newer asset-backed securities are increasingly risky, offering investors the potential for higher returns while creating added liquidity for capital-constrained lenders. Once confined to mortgages, securitization has also turned auto loans, credit card receivables, student loans, and even phone bills and parking tickets into marketable securities.

Securitization of certain small business loans has been ongoing since the mid 1980s. Commercial real-estate loans and small business loans collateralized with property are already widely securitized by several banks and mortgage companies. In 1985, banks and nonbank finance companies were allowed to pool and sell the *guaranteed* portion of loans originated under the 7(a) and 504 loan programs operated by the U.S. Small Business Administration (SBA). In 1992, nonbank finance companies were allowed to securitize the *unguaranteed* portion of SBA loans, after arguing that their lack of deposits imposed liquidity constraints. Since 1985, qualified lenders (both banks and nonbanks) have securitized over $20 billion of the guaranteed portion of SBA loans; nonbank finance companies have also securitized $1 billion of the unguaranteed portion of SBA debt.

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Small business lenders, including community banks, nonbank finance companies, and economic development agencies, are securitizing their illiquid commercial loans for various reasons. These include the potential to lower loan servicing and capital costs, while simultaneously reducing the riskiness of their loan portfolios. In addition, lenders wish to use sale proceeds to originate more loans to small businesses. For borrowers, the key benefit is increased availability of commercial loans, since lenders will have wider access to the capital markets.

Interest in securitizing commercial loans grew rapidly after the passage of the Riegle Community Development and Regulatory Improvement Act of 1994. The Riegle Act reduces capital requirements for banks that issue securities backed by commercial and economic development loans. It also relaxes investment restrictions on securitized loans. Under the revised Community Reinvestment Act (CRA), a bank or a bank holding company may be entitled to CRA credit for purchasing securities backed by small business loans. The underlying loans must be determined to have primarily a community development purpose and benefit the institution's assessment area or a broader statewide or regional area. In addition, this March the SBA published a rule allowing all banks and other depository institutions to securitize the *unguaranteed* portion of SBA-backed debt. The proposed rules would require that a lender retain a percentage of the loans' value equal to twice its historic loan loss rate.

". . . if we could find a way to expedite a secondary market in small business loans, it would be. . . a major contribution to the financial vitality of this country."
---Alan Greenspan
Chairman of the Federal Reserve

Barriers

Despite these legislative developments, securitization of small business loans is still not a widespread practice. The three main factors that complicate commercial loan securitization efforts are the lack of product standardization, difficulties in risk assessments, and the transaction costs. These factors combine to make small business loan securitization more costly and less attractive in comparison to other initiatives involving mortgages, auto loans, and credit card debt.

First, is the lack of standardization. Greater flexibility in maturity schedules, interest rates, and other underwriting terms have allowed lenders to create loan packages to best suit the particular needs of any small to medium-sized enterprise. The downside of this degree of flexibility is that there are no consistent origination and underwriting standards for most commercial loans, making it very difficult to pool together similar loans and evaluate the risk associated with them. The tendency of small businesses to refinance their debt more often, and the differences in profitability among industries, also muddle attempts to predict cash flows from these loans and to pool them together with other loans.

Second, are the difficulties in assessing the credit quality and risks of these loans. Jim Hammersley, Director of Secondary Market Activities for the Small Business Administration, states that while small business loans are not necessarily riskier than other types of debt, "the quantifiability of risk is lower than for other debt." For example, unlike mortgage loans, many small business loans are not backed by property, the value of which can be easily determined based on market forces. Apart from personal guarantees, there is usually little or no collateral standing behind a small business loan.

In addition, the risk of default in commercial loans depends greatly on the individual borrower, his or her line

BENEFITS FROM SECURITIZING SMALL BUSINESS LOANS

LENDERS
Greater liquidity
Increased velocity of lending
Diversification of credit risk
Reduced regulatory capital and reserve requirements
Improved risk management
Drive towards more standard origination/underwriting criteria

BORROWERS
More loan capital for business start-up or expansion

INVESTORS
Enhanced diversification of portfolios

--adapted from *Bridging the Capital Gap: The Securitization of Small Business Loans,* by Women's World Banking, 1996.

of business, and other local factors. While loan officers have access to this type of information through personal interaction with borrowers, such information is not readily accessible to investment bankers, rating agencies, and potential investors. Poor record-keeping and documentation by lenders and small business owners complicate matters. A lack of long-term performance data on small business loans further prevents securitizers from determining the expected performance of a pool of such loans.

Finally, the transaction costs associated with asset securitization tend to be high, especially for low-volume lenders. The minimum transaction cost of securitizing a loan pool runs from around $500,000 to $1 million, and drops as the size of the loan pool grows. Approximately $50 million to $100 million in loans is the minimum pool size that must be reached before securitization becomes cost-effective. The vast majority of community banks, with assets under $5 billion, may not be able to amass loan portfolios of that size.

Techniques

Lenders, investment bankers, nonprofits, and others interested in securitizing small business loans employ a variety of strategies to minimize the costs and overcome some of these information and credit-related obstacles.

Most lenders that engage in commercial loan securitization maintain high levels of loss protection, either through loan loss reserves or by retaining a portion of sold loans. This helps to assure potential investors about repayment and facilitates the sale of commercial loan-backed securities. However, it greatly increases the costs to the originating banks, thus diminishing most of the cost savings associated with securitization. Apart from loss protection, securitizers also seek credit enhancements, often from private foundations, economic development agencies, and public sector initiatives. In particular, the loan guarantees provided by the SBA's various lending programs have been very effective in enhancing the creditworthiness of securitized commercial loans.

In order to overcome the problems of inconsistent underwriting and documentation standards, some secondary market agents specialize in SBA-backed debt, since the agency prescribes certain criteria to its qualified lenders. Others initiate advance commitments that stipulate a specified volume

What About Microloans?

When it comes to securitization, microenterprise loans present an even more difficult set of circumstances than traditional small business loans. First, microlending intermediaries offer a variety of interest rate and maturity structures, third party guarantees, and repayment options tailored to meet the specific credit needs of the distressed communities in which they operate. Compounding this lack of standardization are the small loan amounts: most loans range anywhere from $500 to $15,000. Often little or no collateral is behind these loans, since microlenders usually rely on personal relationships and monitoring to both ensure repayment and evaluate credit risk. Furthermore, the short history of most microlending programs in the United States -- some are only three or four years old -- also does not allow for extensive long-term data collection to aid in risk assessments. Finally, very few microlending organizations have loan portfolios of the size necessary to make securitization cost-effective. These factors make it very difficult to pool similar loans, evaluate the risks involved, and turn microloans into asset-backed securities that are attractive to investors.

Frank Altman, CEO of the Community Reinvestment Fund (CRF), explains that the requisite ongoing technical assistance and small loan amounts make securitizing microenterprise loans much more complicated. "If you underwrite loans that small, you have to underwrite the lender. You need a portfolio big enough to have critical mass, and a high level of comfort with the lenders and how they make and monitor their loans."

Policy debates concerning the expansion of microlending services have often focused on the need to securitize these loans. The purpose is to allow the mostly nonprofit microlending intermediaries to obtain more loan capital and wean themselves from dependence on bank loans, private donations, and dwindling federal grant money. Strategies include the pooling of the often riskier microloans with other conventional commercial loans, thereby spreading risks and facilitating conversion into marketable debt instruments. Efforts are also under way to develop more standardized origination practices.

Larger microlending organizations are beginning to pool and package their loans, usually selling them in private placements. ACCION

of loans to be originated following specific origination and documentation guidelines. Minneapolis-based Community Reinvestment Fund (CRF), which operates a secondary market for community development loans, often uses advance commitment arrangements when purchasing loans. As CEO Frank Altman explains, "CRF negotiates a lending protocol with them [community development lenders] in advance. If loans meet or exceed standards, we buy them as they are made."

To deal with issues of scale and to diminish risk, securitizing agents engage in overcollaterization. Overcollaterization involves the pooling of many loans, sometimes from different originating sources, to increase the collateral value behind the security. By raising the collateral value above the face value of the debt, the issuer reduces the overall risk of the newly created asset-backed security. Through pooling, a lender can sell a larger number of commercial loans from its portfolio -- even those that are potentially riskier.

Usually the securitizing agent issues bonds or short-term commercial paper backed by the pooled loans. The securities are often sold as "A piece"/ "B piece" structured debt instruments. This process involves the division of the debt into senior ("A piece") and subordinate ("B piece") tranches; the A piece is often attractive to institutional investors, while the more risky B piece, either retained by the lender or purchased by less risk-averse investors, absorbs most of the credit risk from the commercial loans. In many cases, the securities are sold through a private placement, which offers certain tax advantages to potential investors.

Developments in the Field

To date, most of the small business loans that have been securitized are either real-estate-based or are originated under the SBA's lending programs. Currently, there is significant interest in developing mechanisms to further securitize non-real-estate and non-SBA-backed commercial loans. One potential solution is to create a securitization intermediary. Although the Riegle Act does not include provisions for it, there has been some discussion about creating a government-sponsored enterprise (GSE) that would purchase small business loans from banks and package them into marketable securities, much as Fannie Mae and Freddie Mac do with mortgages. The creation of a GSE specifically for small business debt might also aid in standardizing origination and underwriting criteria and in the collection of long-term performance data for use in risk assessments.

Despite the absence of such a public intermediary, several promising developments are facilitating more widespread securitization of small business loans. In particular, technological advances are facilitating more securitization activity. The prevalence of credit scoring in the commercial lending industry has accelerated the application process, while also giving lenders a standard benchmark against which to measure an applicant's credit risk. "Credit scoring with known profiling capability can [also] be used by investors," notes the SBA's Jim Hammersley. Credit scores might be used to help aggregate commercial loans and pool them based on broadly defined risk categories.

Non-real-estate commercial and economic development loans are also being securitized, often by individual banks and nonprofit intermediaries. One of the most well-established is the Community Reinvestment Fund (CRF), which provides liquidity to nonprofit and state-run economic development lenders. Since 1988, the CRF has purchased 869 loans totaling more than $57.1 million and issued over $45.7 million in bonds and certificates of participation to investors. The CRF has various products to deal with the variety of underwriting criteria employed by its clients, and it has recently begun to securitize microenterprise loans.

Investment banking firms are also beginning to offer securitization services to small business lenders. Van Kasper & Company of San Francisco recently launched its own Small Business Loan Securitization Program, which will target

International, the Somerville, Massachusetts-based global microcredit organization, has begun to securitize elements of its loan portfolio. In June of 1997, ACCION New York sold 64 microloans worth $272,500 in a private placement with the CRF--the first time that microenterprise loans were packaged and sold in this manner. The CRF has also begun to work with the Montana Department of Commerce, entering an advanced commitment agreement to purchase $500,000 of loans made by five small microlending organizations in that state.

The Senior Director of ACCION's U.S. Division, Livingston Parsons III, explained that the organization used the sale proceeds to retire several bank obligations, thereby improving liquidity. Mr. Parsons also stated that future securitization will depend on ACCION's ability to obtain grants and other bank loans. "There's only so much you can get from foundations and banks," he said. In addition, Mr. Parsons predicts that increased securitization of microloans will become more attractive to microlenders as banks seek more investment opportunities. "Banks will get CRA credit and find a true investment opportunity--not just having loans to ACCION on their books."

The ACCION sale was a pilot program for the CRF. The CRF's Mr. Altman expects that in the future his organization and others will be able to create a secondary market security backed entirely by microenterprise loans. While demand for securitizing services from other microlenders has been high following the ACCION deal, Mr. Altman explains that regulatory prohibitions on the sale of loans made under the SBA Microloan Demonstration Program may keep other large microlenders from accessing the secondary market in the near future.

ACCION recently received a grant from the Ford Foundation to help create a vehicle for broader microloan securitization in the United States, a project that is currently in the development stage. ACCION's Mr. Parsons noted that such an intermediary would help "bring a lot of standardization and familiarization to the industry."

community development agencies that routinely lend to small businesses. Van Kasper's Senior Vice President, James A. Laurie, states that "There's a lot of interest out there and [a sense that] the private sector can play a role in assisting communities with their lending programs and providing them with a source of liquidity."

Certain developers of underwriting technology have also begun to pool loans made using their own credit scoring and/or loan origination software. Portland, Oregon-based CFI Enterprises, in conjunction with TIS Financial Services, Inc., recently launched LORI MAE (Loan Origination Management and Exchange), which will purchase and securitize commercial loans originated by community banks using CFI's software. LORI MAE's Chief Operating Officer, Tom Sidley, explains that trends in the banking industry, such as the "commoditization" of small business lending, are facilitating large-scale securitization of this type of debt. "The way bankers do business enables the market to securitize without a GSE [such as Fannie Mae or Freddie Mac] behind it." LORI MAE intends to create short-term commercial paper backed by small business loans worth $75 million to $100 million by year end.

The Future

Recently investor acceptance of securities backed by small business loans has been growing. The CRF's Frank Altman remarked that because of increasing demand from investors, "the CRF can pick and choose among bidders." In addition, banks, eager to comply with the CRA, are finding that investment in such securities allows them to participate in community development activity without having to bear increased loan servicing costs.

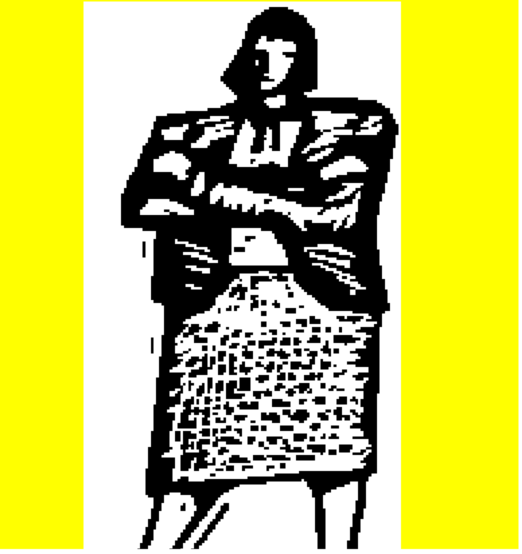
Of course more work needs to be done. In particular, Mr. Altman believes that "the challenge is to increase the velocity of loan purchase activity." Mr. Altman also believes that there has been enough of a trend with these instruments to begin to obtain credit ratings from national rating agencies on the senior pieces-- a move that would allow for more public issues of these securities by the CRF and other intermediaries. As of this writing, the SBA is receiving comments on its proposal to allow for securitization of unguaranteed portions of SBA loans. No doubt, as regulatory incentives and technological developments increase, so too will the securitization of small business loans and, it is hoped, small business development itself.

--by Luxman Nathan
Federal Reserve Bank of Boston

PRODUCTIVE PARTNERSHIPS

The Venture Center: Venture Capital for Women-Owned Businesses

The Center for Women & Enterprise (CWE) saw an opportunity. According to both the U.S. Small Business Administration and the National Foundation of Women Business Owners, by the year 2000 more than 40 percent of all U.S. companies will be women-owned. While most of these firms are small, there is a rising number of women-owned and managed firms with 100 or more employees in various industries. Despite the rapid growth of women-owned business in the United States, these firms received about 1.5 percent of the $4 billion invested by venture capital firms last year.



In the fall of 1998, CWE and Fleet Bank will launch the opening of the CWE Venture Center. The Venture Center is an innovative and much needed resource in the state of Massachusetts. One of the greatest unmet needs for women entrepreneurs is access to equity capital. The CWE Venture Center will endeavor to fill this gap.

The CWE

The Center for Women & Enterprise (CWE) is a nonprofit educational organization established in October 1995. Since that time, CWE has served over 1,000 entrepreneurs from more than 100 cities and towns in Eastern Massachusetts. The organization's mission is to empower women to become economically self-sufficient and prosperous through entrepreneurship. As part of this mission, CWE is helping to establish a more fair and efficient capital marketplace for women-owned businesses, by offering a continuum of programs and services for women at all stages of business development. What makes CWE's approach unique is the belief that a full-service, comprehensive, integrated educational program can work for the many women and the few men they serve.

BankBoston is CWE's founding corporate sponsor. The bank has played and will continue to play a critical role at CWE. It provided the initial seed money and has a three-year commitment to CWE. BankBoston's commitment goes beyond financial support, including the continued hosting of networking and business development events. These events include Turbo Day -- a workshop designed to help women "boost" their businesses or start-up ventures. In addition, three members of the bank's executive staff are involved at the board level. Both Gail Long and Terry Cavanaugh sit on CWE's board of directors and Gail Snowden sits on the organization's advisory board.

The Venture Center

The CWE Venture Center is intended to assist women owners of fast-growing businesses in accessing growth capital. The Venture Center will act as a one-stop capital shop where women can explore their equity financing options. Specifically, it will provide an on-line resource clearinghouse, as well as workshops, mentoring, and networking opportunities.

Andrea Silbert, Executive Director of CWE, explains that "oftentimes venture capitalists, angel investors and women entrepreneurs operate in parallel worlds." Venture capital firms prefer large multi-million dollar deals that provide fast turnaround with high rates of return for their investors. Angel investors, on the other hand, have more independence and flexibility. They tend to have longer time horizons than venture capitalists and represent a far larger source of equity capital. It is estimated that angels invest $20 billion in 30,000 businesses annually. The goal of the Venture Center will be to connect these worlds by identifying venture capitalists, establishing both relationships and access to capital for women entrepreneurs. CWE will also work to directly expand the pool of capital available to women-led firms by reaching out to successful women.

The Venture Center's lead corporate sponsor is Fleet Bank. Fleet Bank's innovative initiative with CWE should prove to be the beginning of a successful and long-lasting partnership. Pat Hanratty, Fleet's Executive Vice President, will be joining the board of directors at CWE. The bank will host events such as panel discussions, networking workshops, one-on-one consulting and business plan reviews. In their roles as board members, Fleet's representatives will provide advice to CWE in designing the programs and services for the Venture Center. They will also provide CWE clients access to financial and human resources from the venture capital and private investor arena.

Leveling the Playing Field

The Venture Center and other initiatives like it across the country, are responding to the increased demand for venture capital, both from female entrepreneurs and the growing number of female investors in the market. In fact, there are now several women-owned venture capital funds operating nationally. For example, the $25 million Women's Growth Capital Fund has become one of the largest venture capital funds in the United States investing exclusively in women-owned and managed businesses. The fund had 30 initial investors acquiring units between $50,000 and $500,000. Seventy percent of the investors in the fund are women. The SBA recently declared the Women's Growth Capital Fund the first women-owned, women-focused SBIC in the country.

This fund and others are breaking new ground in the traditionally male-focused world of venture capital. According to Patty Abramson, co-founder and Managing Director of the Women's Growth Capital Fund, "women have just in recent years begun to look at venture capital as a way of growing their businesses. Historically, women-owned businesses have been below the radar screen of venture capitalists due to the size of their companies. Typically, the types of businesses owned by women were in the retail and service industry and had a smaller need for capital." Today, women are more technologically astute and more likely to either own or manage larger companies in the software and health care industries with ever-increasing asset levels.

Michael Cronin, Managing Partner of Weston Presidio Capital and co-chair of CWE's advisory committee, believes that increasing women's access to venture capital is an evolutionary process. He points out that the general

Did You Know?

• Women-owned businesses contribute more that $2.38 trillion annually in revenues to the U.S. economy.

• The latest U.S. Census data indicate that women owned 6.4 million businesses in 1992. Current calculations indicate that women now own almost 8 million firms, including C corps.

• Women entrepreneurs are taking their firms into the global marketplace at the same rate as all U.S. business owners. As of 1992, 13 percent of women-owned firms were involved in international trade.

• From 1987 to 1992, employment in women-owned firms with 100 or more workers increased by 158 percent -- more than double the rate for all U.S. firms of similar size during that same period.

• Women-owned businesses are more likely to remain in business than the average American enterprise. Nearly 3/4 of women-owned firms in business in 1991 were still in business 3 years later, compared to 2/3 of all U.S. firms.

• Women are increasingly starting businesses or managing enterprises in traditionally male-dominated fields such as construction, wholesale trade, transportation, communications, agriculture, and manufacturing. A recent study by the National Foundation of Women Business Owners indicates that in particular, firms owned and operated by minority women are rapidly growing in these non-traditional fields.

• The 10 states with the fastest growth in women-owned firms as measured by number, employment, and sales are: California, Florida, Georgia, Illinois, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Texas.

--- ***adapted from information provided by the U.S. Small Business Administration & The National Foundation of Women Business Owners (NFWBO)***

public, including venture capitalists, must realize that women have just entered the work force over the last few decades and as a result women have gained a tremendous amount of experience and knowledge of the business world. Mr. Cronin also stated that at Weston Presidio Capital, "if you have a great idea or business plan, gender does not matter." He adds that he sees a trend in husband and wife teams, with more and more husbands and wives becoming business owners.

In response to these changing circumstances, the overall demand for venture capital targeted to women-owned businesses is rising. CWE,

INFORMATION EXCHANGE:

To Their Credit: Women-Owned Businesses, a production of the Boston, Chicago, and San Francisco Federal Reserve Banks, is available on video. *To Their Credit* highlights some of the difficulties that women business-owners face in applying for and receiving credit. Studies show that one out of every four workers is employed by a company that is either owned or managed by women. Yet, many female entrepreneurs have a hard time obtaining credit for start-up or even expansion of existing, profitable enterprises. *To Their Credit* outlines techniques and strategies that women business-owners can use to maximize their chances for loan approval. These tips include developing business plans, standardizing accounting procedures, shopping among banks for better terms, and developing strong management teams. Above all, the video stresses the need for women entrepreneurs to create and maintain relationships with their bankers, allowing the bankers to understand their firm's short and long-term credit needs in advance. For more information on how to obtain a copy of this video, please contact the Federal Reserve Bank of Boston at (617) 973-3459.

through its partnerships with BankBoston and Fleet, is aiming to help women entrepreneurs in New England gain access to much needed equity capital. As women-owned businesses grow and continue to expand both locally and globally, they will become more and more attractive to both traditional venture capitalists and angel investors. Initiatives such as the Venture Center should accelerate this trend.

-- by Arneese Brown
Federal Reserve Bank of Boston

The Business Consortium Fund: Working Capital for MBEs

For Minority Business Enterprises (MBEs), quick access to reasonably priced short-term working capital can mean the difference between growth and stagnation. MBEs, like many small to medium-size businesses, often struggle to meet their short-term financial obligations. New business activity, that arises in the form of contracts or large purchase orders can further exacerbate the strained cash positions of MBEs. Oftentimes MBEs cannot fully realize opportunities to increase market share because they simply do not have ready access to affordable working capital.

The New England Minority Purchasing Council

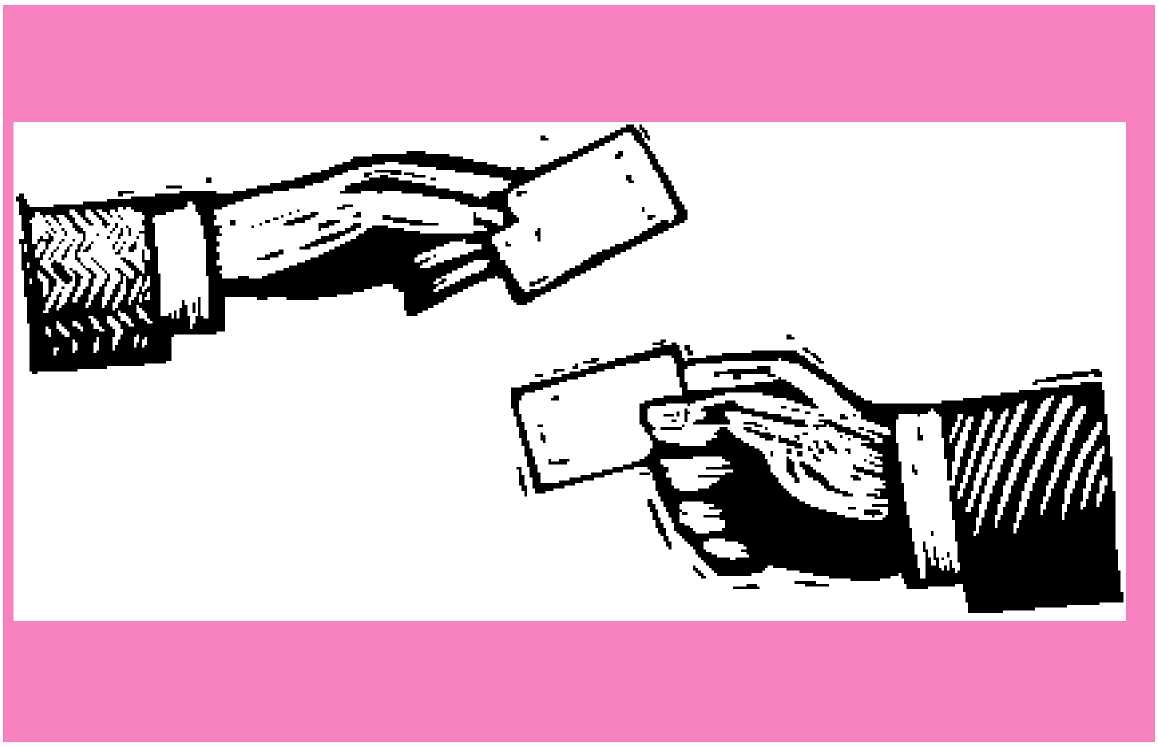
The New England Minority Purchasing Council (NEMPC) is a non-profit organization established to enhance the development, expansion, and success of minority-owned businesses. The NEMPC certifies MBEs as viable businesses, provides MBEs with management training techniques, and puts MBEs in contact with purchasing agents at large regional and national companies. The NEMPC makes this interaction possible by informing its Corporate Members (large regional and national companies) of the availability of minority-produced goods and services, assisting them in establishing effective MBE purchasing programs, and encouraging their commitment to utilize MBEs as suppliers. Additionally, the NEMPC can help MBEs realize business expansion opportunities by helping them gain access to reasonably priced short-term working capital through the Business Consortium Fund.

The Business Consortium Fund

The Business Consortium Fund Inc. (BCF) is a minority business development company of the National Minority Supplier Development Council (NMSDC). The BCF provides short-term contract financing to certified ethnic minority businesses across America through a network of local participating banks and Regional Minority Purchasing councils like the NEMPC. The BCF is funded through several sources including corporations, state governments, and foundations.

The BCF offers straight and revolving lines of credit and direct loans, with financing arrangements that fit the payment terms of the MBE’s contract or purchase order. To qualify for a BCF loan, minority business enterprises have to be certified by the regional minority purchasing council and have a contract or purchase order with a company that is a Corporate Member of the National Minority Supplier Development Council or with an affiliate Regional Council. The maximum loan amount is $500,000, with a maximum guarantee of up to $250,000.

BCF loans are administered by



Certified Bank Lenders (CBL). To become a certified lender, banks must submit a written request to the BCF and provide a copy of their annual report, proof of FDIC coverage, and specimen signatures of bank officers responsible for approving the loans. Once this process is complete, the CBL's role is to perform the credit analysis and due diligence necessary to approve loans. The CBL can then lend up to 25 percent of the total value of the loan and charge as much as 130 percent of prime on its participation. The BCF lends at prime rate for the remaining 75 percent of the loan value.

It's clear that MBEs seeking short-term working capital can benefit by utilizing BCF funding, due to both greater access to capital and lower borrowing costs. The favorable interest rate extended through the BCF funding source is of significant assistance to MBEs. This is corroborated by a survey (conducted by the O.N.E Corporation) that suggests minority businesses often have to seek higher interest rate, nontraditional forms of financing. The study, *Business In The Black Does Not Equal Green*, states that the average rate of interest paid on a fixed rate loan from an alternative funding source was 28 percent higher than interest paid on traditional fixed rate bank products.

The Results

Over the past ten years, $123 million has been lent nationally through the BCF and participating CBLs. The BCF has lent $92 million directly, with participating banks lending the remaining $31 million. The default rate over this same time period has hovered at 4.5 percent. In addition, some 534 minority business enterprises have received loans and 5,271 jobs have been created as a result of BCF lending.

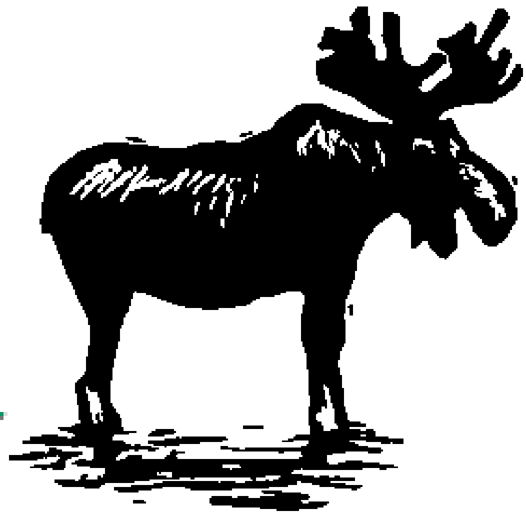
Mrs. Carrie Jones, President of Sparkle Cleaning Associates, a commercial janitorial cleaning service company in Framingham, Massachusetts, received BCF financing in 1993 for operations capital. At the time, Mrs. Jones was unable to obtain debt or equity financing from either traditional or nontraditional sources. She looked to the BCF as her lender of last resort and received assistance. The BCF loan she obtained helped her complete her contract. Now Ms. Jones has a revolving line of credit with a local bank, but she vividly remembers the days when her access to capital was not so good. Mrs. Jones thinks that MBEs should understand that "BCF financing is not free money," and that the loan approval is still based on the creditworthiness of the applicant.

Mr. Mark Cutting, President of C&D Electronics, a military and commercial electronics component distributor in Springfield, Massachusetts, also recalls difficult experiences during his attempts to obtain traditional sources of debt and equity financing. Much like Mrs. Jones, Mr. Cutting has recently been able to access traditional sources of financing, and he currently has a line of credit with a local bank. However, things weren't always so easy. " The Business Consortium financing worked out great; [it] was very timely, and it was critical to my ability to expand and fulfill my contract obligations."

The Challenge Ahead

As part of celebrating the BCF's tenth-year anniversary, the organization has gone through a strategic planning exercise to revamp and enhance the program. One of the main challenges identified was the need to improve communications with regional councils, minority vendors, and banks in general. John Tear, vice president of operations, at the BCF, stated that he and others from the organization will begin visiting regional councils and banks around the nation to better communicate the mission of the BCF. This is a simple but worthwhile mission that will lead to more business, more jobs, and economic growth and development in communities that need it the most. In short, this will be a mission to "support minority businesses with the needed capital to perform on corporate contracts or purchase orders."

--By Marques Benton
Federal Reserve Bank of Boston



AROUND NEW ENGLAND

Microenterprise in Maine: Training Curriculum Development

This past Spring, the Federal Reserve Bank of Boston co-sponsored a microenterprise lending seminar with Maine's microenterprise lending association, MicroNet. The program was held in Bangor, Maine, and was the culmination of a year-long partnership between the two organizations to develop a comprehensive and affordable training seminar for microlending practitioners.

The project began over a year ago, when the Federal Reserve realized that a significant number of community organizations were beginning to shift their traditional focus from the creation of affordable housing units to economic development issues. In part the change was due to a shift in the community development industry's view that sustainable communities need jobs as well as housing. But it was also a response to changes in the economy. The growth of the service sector and low-wage, part-time employment has compelled some of the working poor to try to make ends meet by starting small home-based businesses. Defense cutbacks, along with corporate downsizing, and mergers, have led many skilled workers also to consider the new challenge of starting their own companies.

Many municipalities and community development organizations, hoping to meet the credit and technical assistance needs of these new entrepreneurs, in turn started community development loan funds and took on a new challenge, with little or no training. While these loan funds lend relatively small sums, they have taken on a job that even experienced bankers consider to be an impractical, if not impossible task -- lending to start-up companies -- which includes small business loan underwriting, the applications and due diligence process, and loan monitoring and collection. On the nonfinancial side, microentrepreneurs often need basic education in businesses management, writing business plans, and developing and marketing products.

TYPES & SIZES OF MICROENTERPRISE VENTURES

Type	Ownership	Owner Income	Employees (5 or less)	Typical Capital Needs	Capital Uses	Size/Growth in Business Equity
A **Micro-enterprise**	Sole propri-etor, rarely a corporation or partner-ship	Supplemental	Owner part-time and perhaps part-time seasonal (often family)	$3,000 or less	Inventory Marketing Fixed assets	Little or no growth. Usually limited to start-up, fixed assets and some invento-ry, seldom retained earn-ings (often cash-based businesses)
B **Very small business**	Sole propri-etor. some-times a cor-poration or partnership	Living wage	Owner full-time and usually other part-time (often family)	$1,000 to $10,000	Inventory Marketing Fixed assets Operating capital	Some growth in fixed assets and inventory, sometimes retained earnings
C **Small business**	Sole propri-etor, some-times a cor-poration or partnership	Living wage,some profits distrib-uted to owner	Owner full-time and other full-time	$5,000 to $25,000	Inventory Marketing Fixed assets Operating capital	Some growth in fixed assets and inventory, usually retained earnings
D **Growth business**	Usually a corporation or partner-ship	Living wage for owners plus profits for distribution to partners or investors	Owner full-time and other full-time	Start-up capital to $25,000, plus capital growth	Product dev. Marketing Inventory Fixed assets	Significant growth in cash, inventory, fixed assets and retained earnings.

--adapted from Northeast Enterprise Fund, Inc.'s *Minnesota Microenterprise Study*, December 1994.

It became clear that meeting these challenges required a significant lending and training capacity that many community loan funds lacked. In an attempt to build this capacity among microloan funds around New England, the Fed partnered with MicroNet to develop a training curriculum and two-day seminar for microlending practitioners.

Content

The curriculum and seminar cover many facets of microlending. The program defines for practitioners the various types and sizes of microenterprise ventures. The differences between more traditional enterprises and the non-traditional enterprises serviced by microloan funds, including differences in ownership structures, numbers of employees, and capital needs and uses, are also discussed.

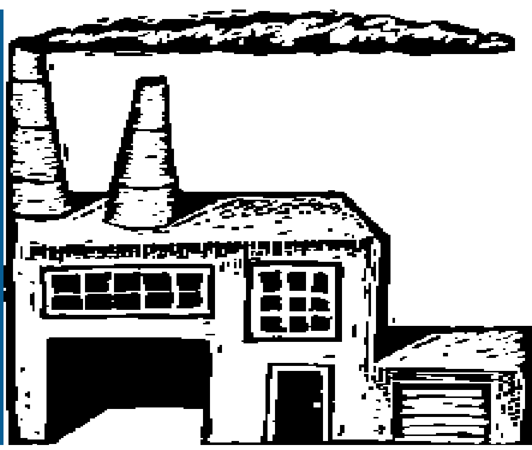
The curriculum covers issues of adult learning and approaches to providing technical assistance to small business entrepreneurs. The program discusses key points such as the importance of guiding clients to solving their own problems and making their own decisions.

Among the more perplexing issues for community loan funds is the use of due diligence procedures by traditional lenders, and how such procedures can be adequately tailored for assessing microenterprise borrowers. The curriculum's due diligence checklist helps microlenders define the appropriate level of information needed to assess each borrower, and it also helps entrepreneurs better understand their businesses by including them in the information-gathering process. Other issues covered by the course include loan packaging, loan monitoring, and post-loan technical assistance.

The May seminar represented an important step in the Federal Reserve's effort to increase the technical capacity of public and nonprofit microloan funds to finance and advise their entrepreneur clients. But much of the expertise that made the program and curriculum possible was the work of MicroNet members such as Ellen Golden of Coastal Enterprises, Inc., Al Maroney of Sanford Institution for Savings, and Eloise Vitelli of Maine Centers for Women, Work and Community. They and their organizations' experience in working with microentrepreneurs helped to develop the program's focus on good lending practices as well as on the specific needs of microenterprises -- particularly start-ups.

The Federal Reserve Bank of Boston and MicroNet plan to hold similar training seminars in the Fall in other New England states. Copies of the curriculum will be provided to all program participants. For more information about the microenterprise lending seminars, contact Paul Williams at (617)973-3227.

-- by Paul Williams
Federal Reserve Bank of Boston



CONSUMER FOCUS

Regulation M: Improved Protections for Consumer Leasing

As of January 1, 1998, auto leasing companies (lessors) are required by law to provide their customers with more meaningful information about lease transactions. This is the result of the Federal Reserve Board's (Board) recent amendments to Regulation M. Regulation M implements the Consumer Leasing Act, which is a disclosure law requiring lessors to provide particular information to consumers prior to the consummation of a leasing contract.

The changes to the law are largely in response to the exploding popularity of auto leasing. Auto leasing increased fivefold over the past ten years and doubled over the past five years. Approximately one third of all new cars delivered in 1997 were leased. Some consumers have found leasing attractive because down payments and monthly payments may be lower than payments in a purchase transaction. In a lease transaction, the consumer pays only for use of the vehicle for a certain period of time rather than paying for the vehicle itself. Others have traded the benefits of purchasing (for example, equity in the car, unlimited mileage, no early termination or excess wear and use charges) for the luxury of driving a more expensive car that might otherwise be unaffordable.

Whatever the reason, the increasing popularity of leasing has been accompanied by increasing consumer complaints and problems. The Board's amendments to Regulation M are intended to respond to these consumer issues. The most significant feature of the amended Regulation M is the segregation of all critical disclosure information in a uniform format. Under the old version of the regulation, lessors were required to provide certain disclosures to consumers, but these terms were scattered throughout the lease documents. Leasing contracts can be lengthy and complex, and key information is often overlooked. To rectify this problem, Regulation M now requires that lessors provide the most important information separately from all other leasing information. The segregated disclosures must be given to consumers before consummation of the lease on a form substantially similar to the model provided in Regulation M (see page 21).

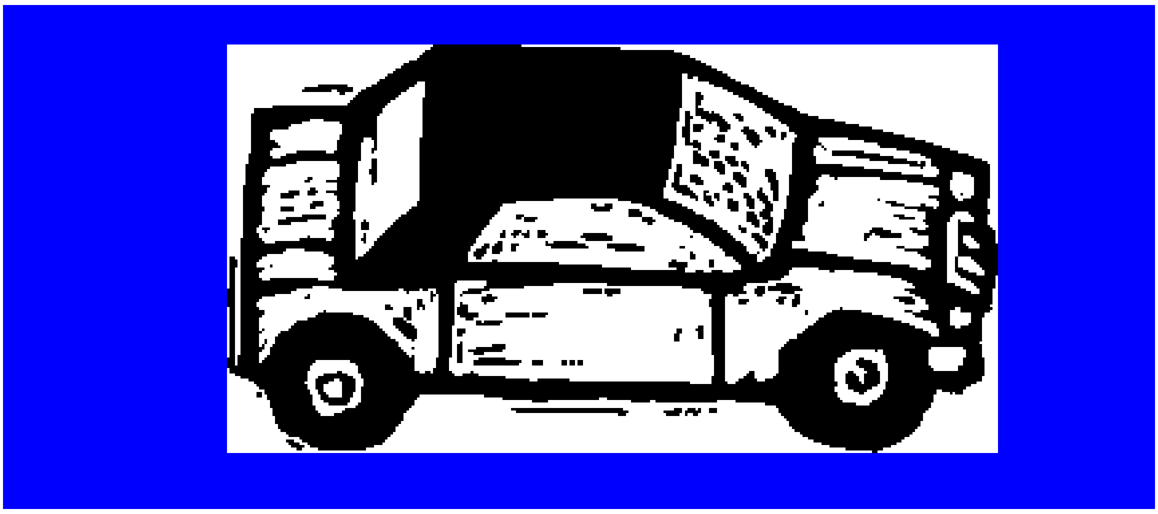
The segregated disclosure form is meant to help the consumer focus on and understand key terms in the lease and improve the consumer's ability to comparison shop for financing alternatives and negotiate terms. It provides a clear picture of payments required at the beginning, during, and at the end of the lease.

Payments at Beginning of the Lease

The new amendments now require lessors to itemize the amount due at lease signing and how that amount will be paid. In the past, it was often unclear to consumers whether and how down payments and trade-in were credited to a lease. Now, consumers need only review the segregated disclosure form to be sure that proper credit is given for down payments, trade-in, and rebates.

Payments During the Lease

The segregated disclosures also make it easier for consumers to understand how monthly payments are determined. The amended regulation now requires lessors not only to provide the dollar amount of the monthly payments in the segregated disclosures, but also to provide a mathematical progression demonstrating just how the lessor calculated the dollar amount. A consumer can check the progression to ensure that the lessor based the monthly payments on the negotiated price of the car and not the sticker price. The progression begins with the agreed-upon value of the vehicle, which is part of the gross capitalized cost, and shows deductions for trade-in, rebates, cash paid, and the residual value of the car and additions for rent charges and applicable taxes.



Payments at End of the Lease

The new segregated disclosure form must include strong narrative warnings about the possibility of incurring early termination charges and excess automobile wear and use charges. The regulation also requires lessors to inform consumers of any mileage limits and excess mileage charges. In the past, when consumers returned their cars, they were often surprised by these charges that ranged from hundreds to thousands of dollars. The new warnings for early termination and excess wear and use are notices only: the actual guidelines or standards are listed elsewhere in the lease documents. The segregated disclosure form must, however, include the actual mileage limit and the cost per mile in excess of the limit.

The segregated disclosure form must also inform the consumer of the option to purchase the vehicle at the end of the lease. The lessor is required to disclose the purchase price and any purchase option fee.

Other Disclosures

Other important segregated disclosures include total payments (total dollar amount the consumer will have paid by the end of the lease) and other charges. The total payment amount does not include the purchase price, the purchase option fee, or refundable amounts. "Other charges" may include a disposition fee, which covers the lessor's cost of selling the vehicle if the consumer chooses not to exercise a purchase option.

Note that Regulation M requires lessors to provide consumers with other disclosures which do not appear on the segregated disclosure form. For this reason, there is a required statement on the segregated disclosure form encouraging consumers to review their lease documents for other important disclosures. It is important that consumers review all documents before signing the lease contract.

Federal Consumer Leasing Act Disclosures

Date________________ Lessor (s) ____________________________ Lessee(s)__________________________

Amount Due At Lease Signing Or Delivery	Monthly Payments	Other Charges (not part of your monthly payment)	Total of Payments (The amount you will have paid by the end of the lease)
(Itemized below)* $____________________	Your first monthly payment of $________ is due on ________________, followed by ________payment of $________due on the ________of each month. The total of your monthly payment is $____________.	Disposition fee (if you do not purchase the vehicle) $__________ ____________________ ___________ Total $___________	$______________

***Itemization of Amount Due at Lease Signing or Delivery**

Amount Due at Lease Signing or Delivery:		How the Amount Due at Lease Signing or Delivery will be paid:	
Capitalized cost reduction	$_______________	Net trade-in allowance	$ _______________
First monthly payment	_______________	Rebates and noncash credits	_______________
Refundable security deposit	_______________	Amount to be paid in cash	_______________
Title fees	_______________	_____________________	_______________
Registration fees	_______________		
_______________	_______________		
Total	$_______________	Total	$_______________

Your monthly payment is determined as shown below:

Gross capitalized cost. The agreed upon value of the vehicle ($_______________) and any items you pay over the lease term (such as service contracts, insurance, and any outstanding prior credit or lease balance).. $ _______________

If you want an itemization of this amount, please check this box. ☐

Capitalized cost reduction. The amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost.. - _______________

Adjusted capitalized cost. The amount used in calculating your base monthly payment .... = _______________

Residual value. The value of the vehicle at the end of the lease used in calculating your base monthly payment......... - _______________

Depreciation and any amortized amounts. The amount charged for the vehicle's decline in value Through normal use and for other items paid over the lease term.. = _______________

Rent charge. The amount charged in addition to the depreciation and any amoritzed amounts .... + _______________

Total of base monthly payments. The depreciation and any amoritzed amounts plus the rent charge.................. = _______________

Lease term. The number of months in your lease.. ÷ _______________

Base monthly payment .... = _______________

Monthly sales/use tax.. + _______________

_______________ .... + _______________

Total monthly payment .... =$ _______________

Early Termination. You may have to pay a substantial charge if you end this lease early. <u>The charge may be up to several Thousand dollars</u>. The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater This charge is likely to be.

Excessive wear and Use. You may be charged for excessive wear based on our standards for normal use [and for mileage in excess of of ___________ miles per year at the rate of ________ per mile].

Purchase Option at End of Lease Term. [You have an option to purchase the vehicle at the end of the lease term for $___________ [and a purchase option fee of $_______________].] [You do not have an option to purchase the vehicle at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance Responsibilities, warranties, late and default charges, insurance and any security interest. If applicable.

Educational Efforts

In addition to these and other amendments to Regulation M, the Board has taken further steps to help consumers better understand the intricacies of leasing. Given the complex nature of auto leases, the Board determined that it was necessary to educate consumers about the existing protections. Together with state and federal consumer education and protection agencies, not-for-profit consumer groups, and industry trade associations, the Board organized a national educational program. One of the results of this campaign was a brochure entitled, *Keys to Vehicle Leasing- A Consumer Guide*. To help consumers better understand the vocabulary used in auto leasing, the coalition also compiled a leasing language glossary. These and other educational materials pertaining to auto leasing may be obtained from the Federal Reserve Bank of Boston, Public & Community Affairs at (617) 973-3097. They are also available on the following web-site: http://www.bos.frb.fed.us/pubs/leasing

--by Carol Lewis
Federal Reserve Bank of Boston

The Community Affairs Staff, Federal Reserve Bank of Boston

Left to right: Ricardo Borgos (College Intern), Paul Williams (Supervisor), Cindy Reardon (Manager), Richard Walker (A.V.P. & Community Affairs Officer), Luxman Nathan (Editor & Community Affairs Specialist), Arneese Brown (Community Affairs Specialist), Lesly Jean-Paul (Community Affairs Specialist).

Pictured above is the Community Affairs Staff which works to promote the understanding and use of public and private community and economic development resources through this and other publications.

Communities and Banking seeks to further the practice of community and economic development by exploring effective ways for lenders to work with public, private, and nonprofit sector organizations toward proactive compliance with the Community Reinvestment Act.

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TOOLS TO USE

CRA Compliance Software

The key to CRA compliance is managing and maintaining information about loans and borrowers. Two computer software products are available that can assist you in meeting your CRA requirements by providing you with tools for better analysis and presentation of lending data.

The CRA Data Entry Software System

The most up-to-date version of the CRA Data Entry Software System by the Federal Reserve System has been available since November 1997. A new version will be released later this year. It was designed to help bankers automate the filing of CRA data on a per loan basis. This user-friendly software not only should assist bankers in preparing for CRA examinations, but should also help streamline the entire examination and monitoring process.

The software allows you to record information on small business, small farm, community development, third-party, and consumer loans at the time of origination. The software also allows for more standardization of CRA-related data and allows users to print out several different types of reports for improved product and market analysis.

Finally, the software also includes editing and reporting features to help lenders verify, complete, and analyze data.

The CRA 1996 Aggregate & Disclosure Software System

This CD-ROM, offered by the Federal Financial Institutions Examination Council (FFIEC) and the Board of Governors of the Federal Reserve System, contains comprehensive information on small business, small farm, consumer, and community development lending throughout the United States as of 1996 (the most recent year available). The software allows the user to obtain information on bank originations and purchases, aggregated by MSA (Metropolitan Statistical Area).

The software can be used to prepare reports about lending in certain MSAs as well as about the lending activity within specific neighborhoods. It can also be used to determine if an institution’s lending activity demonstrates that it serves the credit needs of the communities where it does business.

This information is highly useful for community development groups that seek to better understand the bank lending activity in their areas. It is also important for banks, which can gauge their lending performance against those of other lenders and thereby improve CRA compliance activities.

The CRA Data Entry Software System is available free of charge, and the CRA Aggregate & Disclosure Software System is available for a fee of $10. Both software packages can be obtained from the Board of Governors of the Federal Reserve System, 20th & C Streets, N.W., Mail Stop 502, Washington, D.C. 20551. Assistance with these software programs can be obtained by calling the CRA Assistance Line at (202) 872-7584 or by sending e-mail to crahelp@frb.org