

# Community Investments Vol. 10, Issue 2 Study Identifies Eight Core Characteristics of Successful Multi-Bank CDCs

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## **Foreword**

Multi-bank community development corporations (CDCs) have evolved tremendously in recent years, and many have become viable, savvy, financing vehicles through which to serve low-and moderate-income communities around the country. The role of these financial intermediaries has remained fairly consistent, but the composition and expectations of their investors has changed significantly. Large financial institutions have become creatures of Wall Street, and are, therefore, reliant upon strategies that create greater cost efficiencies. Small and mid-sized financial institutions have recognized the opportunities inherent in large-bank streamlining, and have staunchly maintained a "high touch" approach to banking.

Community development intermediaries offer benefits to both groups. By assuming the role of subcontractor to their bank investors, multi-bank CDCs can provide the expertise and capacity that small and mid-sized financial institutions cannot often afford. At the same time, these intermediaries can provide large financial institutions an effective way to reach underserved populations through products and services that would be unprofitable if performed internally.

While many multi-bank CDCs are achieving success, others are struggling. The problem may stem from a lack of market discipline found in the other subsets of the financial industry. Are these community development intermediaries immune from the rewards and punishments that guide other businesses? Experience has shown that these organizations have been held to more flexible standards by their investors. An increasingly competitive environment dictates that this flexibility may no longer be acceptable. The next few years will likely be challenging ones for multi-bank CDCs, but the keys to success will be to ride the cutting edge, manage the risks, measure the impact, and "play" according to the rules of the marketplace.

### **Executive Summary**

NationsBank Community Investment Group and Shorebank Advisory Services recently completed a review of multi-bank CDCs involved in small business finance. Multi-bank CDCs are vehicles through which banks can support lending activities in markets they cannot reach efficiently or effectively themselves. Banks provide debt or equity to invest in these entities, which then re-lend the funds to borrowers. Although funneling bank dollars through financial intermediaries can be a successful strategy for reaching "downmarket," the multi-bank CDC model has had difficulty achieving success in terms of generating significant business loan volume or maintaining a strong financial position.

Many CDCs open their doors for business without a comprehensive plan or structure, which directly affects their ability to address market needs, achieve significant impact, become financially stable and attain self-sufficiency. The success of a multi-bank CDC can be significantly hindered in its early years if it is not run in a lean, efficient manner by dedicated and experienced staff. Early success can further be hindered if relationships with bank investors are not maximized. CDCs must draw from the pro-active support of its member banks, particularly in obtaining solid referrals from bank loan officers as well as in-kind support. In-kind support is vital for the

vast majority of CDCs, whose bank investors can provide loaned bank executives, outsourced loan servicing, or donated office space.

CDCs capitalized with equity or low- or zero-interest loans are able to passively earn income from idle funds, often a critical source of revenue in the early stages of CDC operation. In the absence of a portfolio of larger loans or high balances of idle funds from which to earn interest, a CDC will continue to rely upon in-kind support and operating grants. Most CDCs do need considerable subsidies in the early years, but while a low or zero cost of funds is ideal for the CDC, it may not provide enough financial return for prospective banks considering long-term membership.

To reach the markets that banks cannot effectively serve, the CDC must work with "high-touch" customers, which requires a considerable amount of time for underwriting and technical assistance. The interest income from these loans, particularly loans under \$25,000, might be insufficient to cover the total costs associated with the loan. Originating larger loans to earn additional income helps the CDC become self-sufficient, but moves it closer to the customer-base served by its member banks. This paradox illuminates the classic struggle of CDCs: balancing the goals of its organizational mission with the need for financial sustainability.

Multi-bank CDCs struggle, like other types of community development financial institutions (CDFIs), to provide financial services to unserved or underserved communities, while remaining safe, sustainable financial intermediaries. Through the study commissioned by NationsBank, eight standards (and several more sub-standards) were identified that appear to represent the "norm" for successful CDCs. These standards should certainly be considered when establishing or investing in CDCs, but they are not meant to be inflexible rules that CDCs must follow. Rather, the guidelines represent standards to which several viable CDCs conform, and illustrate some of the ways common issues have been addressed.

## **Eight standards for success include:**

- **Management:** with an emphasis on credit experience, early involvement, a dedicated and lean staff, and performance-based compensation.
- **Organizational Structure:** appropriate choice of for-profit versus nonprofit designation, the composition of the loan committee and board of directors, organizational affiliations and accountability.
- **Program Strategies:** a clear mission of the CDC, market discipline, a sizable service area with adequate demand, flexible policies including the role of bank participation, prudent underwriting/eligibility criteria, access to or the provision of technical assistance, and a viable exit strategy for investors.
- **Delivery of Products:** sufficient loan volume, volume per staff, loan size, income per loan in the portfolio, and cost efficiency.
- **Management:** proper management of loan loss reserves, delinquencies, and losses.
- **Capitalization:** and cost appropriate size, structure
- **Subsidy/In-Kind Support:** sufficient amount and appropriate structure of the support
- **Reaching Break-Even:** management surrounding self-sustainability.

CDCs and their member banks need to work together to ensure that their targeted businesses are served, while also developing the CDC into a self-sustaining organization. While many multi-bank CDCs have had difficulty becoming "successful," in terms of significant loan volume or financial condition, several CDCs, as high-lighted in the NationsBank/Shorebank study, have made significant progress in these areas.

For a copy of the multi-bank CDC guidelines, please contact Shorebank Advisory Services at (773) 288-0066 or write to Mary Schultz, NationsBank,

CDFI initiative Manager, 1605 Main Street, Suite 502, Sarasota, Florida 34236.

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### **Shorebank Advisory Services**

Shorebank Advisory Services (SAS) is the advisory and consulting subsidiary of Shorebank Corporation, a bank holding company and one of the leading development finance institutions in the United States. The firm provides short-term and long-term advisory services in development finance, enterprise development and community economic development strategies, bringing practical management and operational experience to each of its engagements. From SAS's major roles in many of Shorebank's expansions to its involvement in strategic planning and design for mainstream and community development financial institutions, the firm has a broad overview of the development finance field, as well as the in-depth knowledge and skills needed for rigorous analysis, report writing and creative design and implementation.