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Special Issue on Small Business

COMMUNITY INVESTMENTS

This publication is produced by the Community Development Department of the Federal Reserve Bank of San Francisco. The magazine serves as a forum to discuss issues relevant to community development in the Federal Reserve's 12th District, and to highlight innovative programs and ideas that have the potential to improve the communities in which we work.

CI Notebook

by Jack Richards
Director, Community Development

As we approach community development strategically, it's important to remember the visible role small businesses play in transforming communities. This edition of *Community Investments* examines this role, looking at the challenges and benefits of financing small and micro businesses, especially in low- and moderate-income communities.

Small business lending activity already is an important element of many CRA programs; beyond direct lending, banks have supported intermediaries that provide assistance and funding to micro-businesses. But it appears financing is still severely limited—especially for borrowers needing less than $35,000 in capital—and there is a need to increase intermediary capacity. The Aspen Institute estimates as many as ten million micro-entrepreneurs could benefit from access to technical assistance and financing.

The articles in this issue look at obstacles to providing both small business and micro-enterprise loans and, more importantly, highlight some of the programs and tools government, nonprofit, and financial institutions have implemented that have helped entrepreneurs to maintain and build their businesses.

We hope this issue provides some inspiration to strengthen entrepreneurial capacity and increase the odds for small business success in your communities.

Jack Richards

Inside this Issue

Small Business Development

An Overview

By Naomi Cytron

Small business is "small" in name only. Comprising the vast majority of firms in the United States, small businesses serve as incubators for innovation, promote local and regional economic development, and provide an entry point into the economy for new and displaced workers. Small business ownership can be a means of improving a household's ability to accumulate wealth and assets, and small business development is an important component of comprehensive strategies that aim to stabilize and revitalize distressed communities.

Definitions of what constitutes a small business vary, but the U.S. Small Business Administration (SBA) is the source of the most commonly accepted definition of the term. The SBA classifies businesses by number of employees, annual receipts, and industrial sector to help determine eligibility for governmental resources and programs, including loans and technical assistance. For research and reference purposes, though, "small business" is often simplified to refer to those firms that are independently owned and operated and employ fewer than 500 employees, even though in some sectors the threshold is lower at 100 employees or fewer. Very small businesses refer to those firms with 20 or fewer employees, and microenterprises are those businesses with five or fewer employees.

Under these definitions, the statistics are noteworthy. In 2003, small businesses comprised 99.7 percent of all firms, provided 50.6 percent of employment, and generated half the non-farm output of the U.S. economy. Very small businesses comprised nearly 90 percent of these small firms.[1] While the overall size of the small business sector has not markedly increased over the past decade, it has seen increased participation from women and minority entrepreneurs; between 1997 and 2002, women-owned firms increased by 20 percent to 6.5 million firms, Hispanic-owned firms increased by 31 percent to 1.6 million firms, African-American-owned firms increased by 45 percent to 1.2 million firms, and Asian-owned firms increased by 24 percent to 1.1 million firms.[2]

While these statistics include entrepreneurial activity in high-income, highly-educated sectors of the workforce, including lawyers and consultants, this is heartening news for women and minorities who have been historically marginalized from the mainstream economy. It also bears potential for further expansion of economic opportunity for low-income persons. A recent report by CFED examining the role of small and medium-sized enterprises in reducing poverty points to studies which indicate that small businesses, in comparison to large firms, employ a larger share of persons on public assistance and those with lower education levels.[3] In addition, a study conducted by the Self Employment Learning Project of the Aspen Institute showed that small business ownership can help people move above the poverty line.[4] Small business development is thus an avenue for bolstering the economy and contributing to increased self-sufficiency across the socio-economic spectrum.

The great promise carried by small business development is, however, dampened by the persistence of challenges in establishing and growing small businesses in low- and moderate-income communities in both urban and rural settings. Low-income and minority entrepreneurs often face barriers in accessing capital for starting and maintaining their businesses, and typically need assistance in learning how to efficiently manage and sustain operations. Low- and moderate-income areas also often lack the infrastructure that enables small-business growth; for instance, many disinvested commercial corridors are characterized by vacant storefronts, crumbling facades and a perception of criminal activity, and do not generate the foot traffic or business networks critical for success. Those in rural areas face an additional set of barriers to small business development owing in part to the basic fact of their geographic distance from financial institutions, offices that assist with accessing governmental resources, buyer markets, and community-based organizations that provide targeted training and assistance.

Barriers to Accessing Capital

Small businesses have a variety of credit and capital needs, including startup capital, equity, and working capital. Owners continue to rely on commercial banking institutions as important sources of financing; SBA data shows that small business loans, defined as loans under $1 million, totaled $248 billion in 2003. However, although there was growth in small business loans between 1995 and 2002, loans under $250,000 represented a shrinking share of total bank lending. The total value of loans under $100,000, which typically are sought by early-stage businesses, grew the least of all segments of small business lending.[5] Adding to this, a number of studies point to differentials in lending rates between white and minority-owned firms, as well as between upper-income and lower-income census tracts.[6] These differentials are driven by a variety of factors, including:[7]

- Lack of performance data on loans to minority and lower-income borrowers, leading lenders to perceive them as riskier and beyond their legal risk tolerance;
- In comparison to other borrowers, a tendency of minority and lower-income borrowers to seek smaller-sized loans and require more technical assistance services leading to greater expense for lenders;
- Lack of professional and social networks linking borrowers and financial institutions;
- Limited, or lack of, credit history, collateral, and/or record-keeping required to qualify for conventional financing.

Recent trends within the banking industry, including consolidation, changing patterns of bank branch locations, and increased use of credit scoring in making underwriting decisions are also thought to impact lending patterns. While research is somewhat mixed in determining the exact outcome of these trends–and in particular the impact of increased use of credit scoring, which in some cases has been shown to increase lending activity[8]–they certainly have implications for would-be borrowers' ability to build banking relationships, which is a factor shown by a number of studies to increase availability of credit or lower collateral requirements.[9] And for those with limited or no credit history, a prevalent scenario in immigrant and lower-income communities, the increased use of credit scoring can raise the hurdles for accessing financing.

SBA Programs

Box 1.1

The SBA's largest program is the 7(a) loan program, which provides a guarantee of up to 85 percent of the loan amount, depending on the size of the loan. In fiscal year 2005, the SBA provided nearly $14 billion in guarantees to banks and other loan providers through the 7(a) program, serving over 80,000 small businesses. A number of targeted programs fall within the 7(a) program, including the CommunityExpress program, which pairs 7(a) loans with technical assistance to borrowers in lower-income areas. Started as a pilot program in 1999 in partnership with the National Community Reinvestment Coalition, the majority of the loans made possible through the CommunityExpress program have benefited women and minority entrepreneurs.

The agency's second largest program is its 504 program, which offers long-term financing for fixed-assets such as buildings or equipment. A typical loan package features 40 percent financing through the SBA, 50 percent financing through a private lender, and an investment of 10 percent from the small business itself—though for start-ups a higher equity investment is often required. Most businesses receiving loans through the 504 program must create or retain a job for every $50,000 borrowed. Nearly $5 billion in loans were delivered in FY 2005 through Certified Development Companies, which are nonprofits established to administer 504 loans. Many Certified Development Companies offer and implement other economic development programs in their surrounding communities and regions.

Smaller SBA programs include the Small Business Investment Company (SBIC) program and the MicroLoan program. SBICs are private equity funds that invest in those businesses that meet SBA size and eligibility requirements. Of the nearly 2,300 businesses that received equity investments through SBICs in FY 2005, 23 percent were located in low- and moderate-income areas. The Microloan program is the smallest of the SBA's programs, and has for the past three years been threatened with elimination. The program provides loans of up to $35,000 to eligible start-up businesses through participating Microloan Intermediaries, and integrates technical assistance provision through its PRIME (Program for Investments in Microenterpreneurs) program, which provides grants to community-based organizations to provide training to low-income entrepreneurs.

Through its business "matchmaking" events and HUBZone (Historically Underutilized Business Zone) program, the SBA also helps small businesses owners tap into the contract procurement marketplace, which has historically been difficult for new or emerging businesses to access. Matchmaking events bring together small business owners and procurement representatives from private corporations and federal, state and local governments, and the HUBZone program provides federal contracting preferences to small businesses operating in qualified distressed areas, including Native American reservations. The agency's 8(a) program operates similarly, but targets businesses owned by disadvantaged minorities regardless of geography.

Despite recent criticism about inefficiencies—largely related to disaster relief efforts—within the SBA, the agency has been critical in increasing access to capital by decreasing risk to banks and lowering costs to borrowers. In 2005 alone, 105,000 small businesses received $27 billion in 7(a) and 504 loans, creating or retaining an estimated 605,000 jobs. While there are improvements that can be made to both increase the availability of capital to minorities and women and streamline lending procedures, the SBA has been an important partner in fostering the growth of small businesses in underserved communities.

Expanding the Reach of Capital

A number of governmental channels and specialized financial and community-based organizations aim to expand the reach of commercial banking institutions and serve under-bankable small businesses in alternate ways. For one, the SBA provides an important set of products and programs that have been effective in assisting eligible small businesses obtain the financing that they would otherwise not be able to access (See Box 1.1 "SBA Programs"). SBA lending has also been shown to correlate with increases in local employment levels in low-income areas.[10] However, the agency has faced a perennially shrinking budget, and the lion's share of SBA programs is geared toward "larger" small businesses. Its programs designed to assist the smallest of businesses are limited relative to demand and in recent years have been threatened with elimination.

A range of other specialized providers of financing and technical assistance supplement SBA offerings, including the USDA, local governments, microenterprise development organizations (See article "Microbusiness, Macro-impact: Capitalizing on Potential") and Community Development Financial Institutions (CDFIs). Many areas are also served by Community Development Venture Capital funds, which are important providers of equity financing for businesses with high growth-potential in low-income areas (See "Delivering Financial Return and Community Results"). All of these niched organizations provide critical support in building the capacity of small businesses in hard-to-reach communities.

Cascadia Revolving Fund, for example, a nonprofit CDFI based in Seattle, serves entrepreneurs and nonprofits in distressed urban and rural communities in Washington and Oregon. Cascadia makes its small business loans, which range from as little as $1,000 up to $1.3 million, through its revolving loan pool, which is capitalized by financial institutions, individuals, foundations and churches. Over a third of Cascadia's capitalization specifically comes from equity-equivalent investments (EQ2s) made by banks. These are typically large, below-market rate, very long-term investments that allow Cascadia to make larger and longer-term loans–a powerful tool for deepening the impact the organization can have in its region. Cascadia's loan pool structure enables the organization to underwrite loans with more flexible standards than those typically used by commercial banks, thereby extending the reach of capital to borrowers otherwise considered too risky.

Alternative sources of small business financing

Box 1.2

Alternative sources of credit and capital, including credit cards, trade credit, and loans from family and friends, are also used to finance small businesses. Of these, only credit card usage showed an increase between 1993 and 1998.[1] Survey data showed that over 50 percent of firms used personal credit cards to finance business expenses, and that business credit cards have become increasingly available, with 34 percent of firms using such cards.[2] However, the average monthly charges of the businesses that used credit cards (either business or personal) were $600 and the majority reported that they paid their credit card balance in full each month, indicating that credit cards are primarily used as a convenient form of payment rather than as a substitute for more traditional credit.[3]

Access to Capital is Only Part of the Story

Despite having what is typically considered a higher-risk portfolio, Cascadia's 20-year cumulative loan-loss rate as of 2005 in its core loan portfolio was just 2.5 percent. In part, this is because small business owners who receive loans through Cascadia can receive intensive, ongoing technical support for developing and sustaining their businesses. This underscores the point that access to capital is only part of the story. Alberto Alvarado, Director of the Los Angeles District SBA office, emphasized the critical role played by technical assistance provision, saying that, "There is a tremendous and increasing need for technical assistance and mentoring arrangements for emerging entrepreneurs. It is a real challenge to build competency levels and managerial skill sets in people who are, for the first time, thinking like an owner rather than a worker."

Training needs include business plan development, marketing assistance, and help with basic accounting and business management procedures. The SBA offers a variety of capacity-building opportunities through the Service Corps of Retired Executives (SCORE), Women's Business Centers and its Small Business Development Centers (SBDCs). SBDCs, which are often run in partnership with local universities and colleges, have been very effective in boosting entrepreneurial success, leading to job creation, increased sales and tax revenues, and an increased ability to leverage other resources.[11] SBA-sponsored services, however, are typically more able to assist owners of existing businesses who can access conventional financing services. For less sophisticated borrowers who are struggling to keep pace with the changing demands of business ownership, microenterprise programs offer a similar set of training and counseling opportunities, and typically place great emphasis on coupling financial assistance with outreach and mentoring to those small businesses with the greatest training needs (See "Microbusiness, Macro-impact: Capitalizing on Potential").

Small business incubators, which generally integrate access to mentoring and assistance in obtaining financing or contracts with appropriate rental space, flexible leases, shared basic business services and equipment, and technology support services, offer another mechanism to help fledgling businesses thrive. The William M. Factory Small Business Incubator, for example, located in one of Tacoma, Washington's poorest neighborhoods, has been successful in

helping many women, minority and low-income entrepreneurs grow businesses that, in turn, contribute to revitalizing the local economy. The incubator helps foster relationships between incubator tenants, who are mostly in construction-related industries, and public and private sector agencies, which boosts availability of training, financial support and marketing opportunities. Tenants, who sign agreements to first consider unemployed neighborhood residents for job openings, created 300 jobs in 2005. The Factory Incubator won the 2005 Incubator of the Year award from the National Business Incubator Association, and has since inception in 1986 graduated more than 200 companies, 80 percent of which have remained in business or successfully merged with other companies.

Approaches that aim to enhance neighborhood business districts are also important to enabling small business success in low- and moderate-income areas. The Local Initiatives Support Corporation (LISC) is investing resources in neighborhood-level improvements through its Commercial Corridor Revitalization initiatives in many of its program sites nationwide. Bay Area LISC, for example, is active in a number of business districts in low-income and ethnic neighborhoods in Richmond, Oakland and San Francisco, and provides grants and technical assistance for community groups and collaboratives engaging in projects such as streetscape and real estate improvements, creation of marketing materials and promotional events, and safety enhancements. Amy Cohen of Bay Area LISC noted, "The program's strength is its multi-stakeholder involvement. The model engages neighborhood residents, community organizations, city agencies, and local merchants in developing plans that will strengthen neighborhood business districts without placing additional burdens on business owners."

"There is a tremendous and increasing need for technical assistance and mentoring arrangements for emerging entrepreneurs."

Filling Gaps and Building Bridges

There are, then, a range of agencies and organizations whose mission is to help foster success among small business owners who have typically found themselves outside the economic mainstream. However, many programs have difficulty achieving the capacity and efficiency that would allow them to more fully serve individual and community needs.

The CDFI industry, for instance, has been able to support small businesses in a variety of ways and has both demonstrated the viability of markets once viewed as prohibitively risky and created a host of innovative products and services. However, a number of trends, including changes in the financial industry and shifts in federal budget allocations, threaten the sustainability and growth potential of many of these organizations. As such, the industry is in transition and is seeking ways to more efficiently meet the needs of targeted communities.[12]

Financial institutions are vital partners in leveraging resources and filling gaps between ongoing demand and shrinking public support. One boost to the CDFI industry is a recent announcement by Bank of America of a $10 million investment in the Opportunity Finance Network (OFN) specifically earmarked for small business and microenterprise development. OFN works to strengthen CDFIs through financing, capacity building, and policy development (See Box 1.3, "Small Business Initiatives"). Participation by financial institutions in loan pools dedicated to microenterprise development in hard-to-serve areas is also critical for maintaining flexible sources of capital for start-up and expansion of the small businesses located there (See "Building Bridges in LMI Communities" and Box 2.4, "Innovations in Oregon").

While one side of the coin is that financial and community-based organizations struggle to fully meet the needs of emerging entrepreneurs, the flipside is that it can be difficult for business owners to take advantage of the services available to them. Cristy Johnston, a project manager with the Excelsior Neighborhood Commercial Revitalization (ENCoRe) Project in San Francisco, noted that business owners in low-income or minority communities may not know about available financial and technical assistance resources, may have difficulty accessing them due to cultural and language barriers, or may find it overly time-consuming to navigate through what can be a confusing array of disparate and/or distant service providers. As a community liaison, Johnston works to connect business owners with appropriate resources and bridge the cultural gaps that keep them from seeking or receiving needed technical assistance. "The overall goal [of our program] is to help the local community recover economically and begin to grow into a vibrant and thriving commercial district," said Johnston. "ENCoRe is here to strengthen and stabilize the small business community, and ensure that small business operators and their families are able to continue to run their businesses and get the assistance they need to do so."

Financial institutions are vital partners in leveraging resources and filling gaps between ongoing demand and shrinking public support.

Financial institutions can help here, too, in directing would-be borrowers to microlenders and technical assistance providers when they themselves cannot provide direct

Small Business Initiatives

Box 1.3

Two significant announcements were made in the early months of 2006 regarding investments in programs geared toward enhancing small business development in low- and moderate-income communities. In February, CRAFund Advisors launched a $50 million Small Business Initiative, and in April, Bank of America announced a $10 million investment in the Opportunity Finance Network (OFN) to spur small business and microenterprise development.

CRAFund Advisors, a fixed-income money manager based in Florida, is developing their Small Business Initiative with the Community Reinvestment Fund, a Minnesota-based nonprofit that operates a secondary market for economic development loans. The Initiative earmarks funds that will be used to purchase SBA 7(a) loans, USDA loans, and municipal bonds for economic development and enterprise growth, all of which finance the start-up and continuation of small businesses in low- to moderate-income and minority and communities. During the press release event, Alyssa Greenspan, Director and Portfolio Manager of CRAFund Advisors, noted, "Our new Small Business Initiative will appeal to individuals, corporations, public pensions, government entities, banks and institutions that are seeking a competitively performing investment that generates the capital needed for small business development and economic growth in minority, rural, and other emerging communities."

Bank of America's investment in the Opportunity Finance Network was made though the bank's Program Related Investments division. OFN will use the capital to provide loans and investments to CDFIs in its national network. In turn, CDFIs will lend to, and make investments in, small enterprises that are not otherwise able to access the financing necessary for growth and expansion. Distribution of financing will first be within California, and will expand later to other markets. One of the first products of this investment was a $2.5 million loan made by OFN to Clearinghouse CDFI, based in Lake Forest, CA. Doug Bystry, Clearinghouse CDFI President and CEO, said, "This loan will make a major impact in addressing unmet credit needs throughout California. Every loan we make benefits the community in a measurable way. Opportunity Finance Network's backing will sharply accelerate our small business lending in California."

financing (See Box 1.4, "Making Connections"). Alvarado also encouraged those financial institutions not already working with local SBA offices to establish relationships with them as a means to connect entrepreneurs to resources and build the capacity of community organizations serving marginalized communities. "This work is very much about building direct relationships," he said, "and it is so important to really raise awareness of opportunities."

Financial institutions can also help build entrepreneurial readiness and develop banking relationships through financial education, culturally-appropriate outreach measures and asset building strategies such as Individual Development Account (IDA) programs. IDAs, through a match incentive, help low-income people save for specific asset-building purposes such as capitalizing a small business (See Community Investments, Vol. 17, No. 2 for more information on IDAs and asset building). EARN, a San Francisco-based organization that helps low-wage workers amass savings through IDA programs, reported that as of the first quarter of 2006, a third of their savers were working towards investing in microenterprises. Success stories include savers who used IDA funds to purchase inventory and equipment for new catering, graphic design, and clothing businesses that allow their owners to support their families and reduce reliance on public support.

Building Knowledge, Building Relationships

As is true for many strategies aimed at bolstering wealth and stabilizing low- and moderate-income communities, within the field of small business development there is a need for continued research, innovation and outreach. A number of questions remain, including how to build efficiencies without sacrificing the ground-level relationships necessary for building the capacity of small and unsophisticated businesses, how to further the recognition of the market potential of businesses in lower-income areas and thereby increase targeted investments, and how to more effectively measure the performance of programs that aim to link entrepreneurship with poverty reduction. Also at issue are ways to strengthen small business success in rural and remote areas, where economic development strategies that center on local entrepreneurship are increasingly being promoted and implemented (See "The Corner Store: Investing in a Sense of Place"). Continued partnership building and collaboration among financial institutions, government, private and nonprofit stakeholders, though, can help to improve service delivery and enhance the entrepreneurial climate. Overall, coordinating support across what is a continuum of need can strengthen the viability of small business development as a part of a comprehensive strategy to revitalize communities and build household wealth. CI

Making Connections

Box 1.4

When entrepreneurs are turned down for small business loans by a mainstream financial institution, they may encounter difficulties in finding out where to turn for further assistance. The iCapital Assistance Network, launched in September 2005, is a national, web-based business loan referral network and loan packaging service designed to serve as a pipeline to refer small business loan declines to certified CDFIs and SBA Microlenders. This no-cost service, available online at www.icanloan.com, is intended to assist emerging entrepreneurs access capital and technical assistance, and to help these clients eventually become eligible for traditional bank loans and products. Participation in this network can help banks further their community development goals and is a way to help the microloan industry build scale and efficiency.

Bank of America is one of the institutions piloting the iCAN project and has incorporated standardized language about the referral network into their small business loan declination letters issued throughout their 30-state footprint. Through iCAN's website, clients can access contact information for alternate lenders in their area and use an online loan-packaging tutorial feature, which is a step-by-step guide to assembling a loan package. The service was developed by the Self-Employment Loan Fund, Inc (SELF), an SBA Microloan Intermediary and CDFI located in Phoenix, AZ. To find out more about how to become a member of iCAN's referral network, please contact Caroline Newsom, Executive Director of SELF, at (602) 340-8834 or carolinenewsom@selfloanfund.org.

Other directories of microlenders and technical assistance providers are available online through the Association for Enterprise Opportunity, a national member-based association dedicated to microenterprise development, and through the Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD), a research, policy, and grant-making project of the Aspen Institute in Washington D.C.:

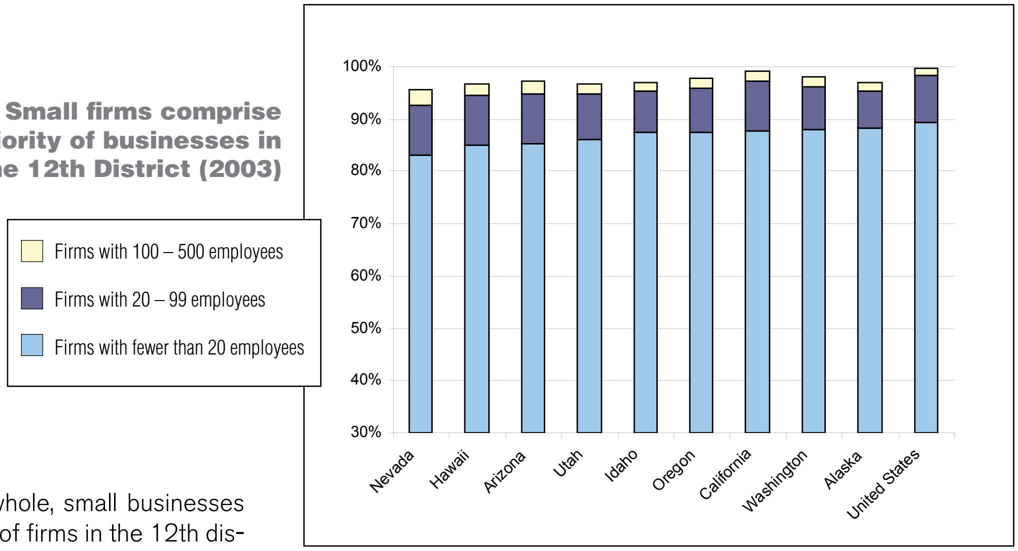
www.microenterpriseworks.org/nearyou/bystate.asp

www.fieldus.org/Publications/Directory.asp

Small Business in the 12th District

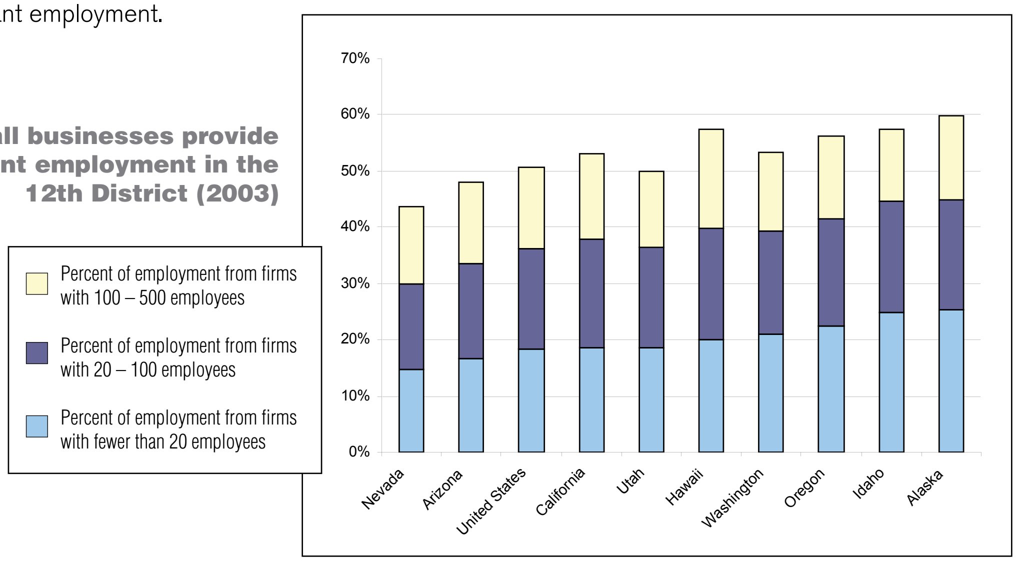
Box 1.5

Small firms comprise majority of businesses in the 12th District (2003)



As in the U.S. as a whole, small businesses make up the majority of firms in the 12th district, and in most 12th District states, smaller firms provide significant employment.

Small businesses provide significant employment in the 12th District (2003)



Although Nevada and Arizona lag slightly behind other 12th district states in small business measures, entrepreneurial activity that results in self-employment, captured by the Census as data on "nonemployers," is on the rise in both states. Census data showed that, nationwide, Nevada and Arizona led growth in nonemployer businesses between 2002 and 2003, with 11.4 and 9.4 percent growth, respectively. Idaho and Utah also saw higher than average self-employment activity in this period. Four of the five counties leading growth nationwide in self-employment between 2002-2003 were in the 12th district.

Source: US Census

12th District Counties Lead Growth in Self-Employment

	Number of Non-employer Firms: 2002	Number of Non-employer Firms: 2003	Percent Change
United States	17,646,062	18,649,114	5.7%
Top five counties			
1. Clark, NV	84,219	95,923	13.9%
2. Riverside, CA	97,800	109,583	12.0%
3. Gwinnett, GA	49,113	54,784	11.5%
4. Maricopa, AZ	181,059	199,254	10.0%
5. San Bernardino, CA	91,578	99,952	9.1%

Microbusiness, Macro-impact

Capitalizing on Potential

By Valerie Plummer, Executive Director, Oregon Microenterprise Network (OMEN)

Jenny Richardson was a sculptor in New York City who came down with a chronic illness after the 9/11 attacks. In and out of hospitals and bankrupt, she made her way to Portland, OR. With the help of a $7,000 Mercy Corps Northwest loan, she opened Jennie Greene Floral Designs in a trendy Portland neighborhood. "I had an idea, but I wasn't eligible for a (bank) loan," says Richardson, who is meeting her loan payments as agreed. This Mother's Day – one of the biggest holidays for flower merchants – Jenny celebrated her business's one-year anniversary. She's learned many lessons during her first year, and is hopeful that her second year in business will be one with strong sales and many opportunities for bringing her artistic flower designs to the wider community.

Roots and Evolution of an Industry

In America, the fruits of prosperity are shared unevenly. According to recent statistics quoted by the Aspen Institute, approximately 37 million people in the U.S. live in poverty, and those at the bottom 60 percent in terms of income own less than five percent of the nation's wealth, while wages for the working poor have remained relatively stagnant. In addition, an estimated 22 million people are "unbanked," making saving money and building assets a struggle.[1] Policy makers and practitioners have struggled with how to address these trends and how to mitigate their negative impact on people's financial well-being. Microenterprise and self-employment have emerged as important strategies in the effort to improve the economic well-being of low-income families.

A microenterprise is generally defined as a business with five or fewer employees with capitalization needs under $35,000. Typically, these microenterprises run into difficulties accessing conventional financing due to being economically disadvantaged or not meeting lending criteria. The microenterprise industry that exists in the U.S. today – an industry of over 500 programs serving up to a quarter million people per year – has roots in the international microcredit movement. In the 1970s and earlier, the Grameen Bank in Bangladesh began to provide very small loans ($10-$50) to women to purchase such things as materials for weaving and livestock for food production, which could then be used to generate income for their families. These loans were highly successful in developing countries due to the lack of access to capital in local villages, and the positive peer pressure that resulted from "peer lending" models in which borrowers were accountable to fellow entrepreneurs in their tight-knit communities.

During the 1980s and 1990s, organizations in both the U.S. and abroad experimented with a variety of program and service models that built on this idea of sparking economic self-sufficiency though the provision of microloans. The resulting microenterprise field now encompasses a wide range of organizations, from women's economic development organizations that see microenterprise as a response to the limited employment options for women, to community development corporations that view microenterprise as a complement to community revitalization strategies, to

A Drop in the Bucket: Reaching Scale

Box 2.1

An estimated 10 million microentrepreneurs could benefit from the financing and business development services that microenterprise programs provide, according to a recent study published by the Aspen Institute.[1] Given that some entrepreneurs may not want or need services, and that there are other providers in the marketplace, it is unreasonable to assume that programs should be serving this entire market. However, even if one were to estimate that the field should achieve market penetration of 10 to 20 percent – or one to two million entrepreneurs – the field is currently only reaching between 7.5 and 17 percent of even that share, according to the study's authors. This mismatch between the estimated size of the potential market and the current scale is due to several factors, including the scarcity of funding necessary to expand services, and the geographically-focused or target market-focused nature of programs for whom "scaling up" is not of major concern.

community action agencies which have identified self-employment as an option for people with limited opportunities in the labor force. And while the industry is still young and many organizations are small, it is estimated that as of the end of 2002, $98.5 million was outstanding in microenterprise loans, which represent loans made to nearly 14,000 microentrepreneurs.[2] Many more clients, an estimated 150,000-170,000 in 2000, receive assistance in the form of training and technical assistance, (See Box 2.1, "A Drop in the Bucket").

Products and Services Provided by Microenterprise Development Organizations

Business management training, counseling, business plan development and microloans are essential to help many microenterprises start, expand and prosper. While microenterprise development programs differ in their organizational missions, target populations and program designs, a majority of practitioners help entrepreneurs assess and develop: 1) business readiness and feasibility of business concept; 2) personal readiness; and 3) entrepreneurial skills. Services typically include assistance in identifying the business target market and competition, developing a pricing strategy and sales technique, and guidance that addresses a broad range of practical business issues facing small business owners.

Services may be provided by stand-alone microenterprise development organizations (MDOs), or microenterprise programs within community development corporations (CDCs), Community Development Financial Institutions (CDFIs), or Small Business Development Centers (SBDCs). These service providers all reach different segments of the entrepreneur "market," but do need to effectively work together to bring an entrepreneur from the early concept and start-up phase through the stabilization and growth phase of his or her business.

Microenterprise development programs generally focus on underserved populations who have had difficulty accessing business development services or credit through traditional institutions. At the national level, microenterprise program clients are predominately women (60 percent), low- or moderate-income (60 percent), and ethnic or racial minorities (50 percent). A significant proportion come from very low-income situations, with about 30 percent falling at or below the poverty line, and 11 percent receiving welfare assistance.[3]

Historically, many of these potential entrepreneurs have had loan applications rejected for a variety of reasons, including inadequate equity, lack of a credit (or poor credit) history, failing to meet the bank's underwriting guidelines, as well as racial or gender discrimination. One of the biggest barriers is the loan size–often it is too small to be of interest to a mainstream bank. Regarding the challenge of accessing conventional sources of capital, one aspiring business owner remarked, "You know, a lot of good ideas die in the parking lot of banks." She said, "I knew I was a good baker. I knew I could open a bakery. I knew I could employ people. But I didn't have the collateral, and the amount of money that I wanted was below the lending limit of the bank."

Microenterprise programs aim toward working around some of these barriers to accessing capital, all the while emphasizing training and technical assistance. And while small business ownership is not for everyone–personal commitment and internal motivation are essential for self-employment–developing and running a business can be beneficial for a portion of would-be entrepreneurs. Microenterprise may be a particularly strong option for those living in areas where wage jobs are very scarce, for those with disabilities for whom regular wage employment is a challenge, and for those who may be able to best meet their child-care needs by working from home. Examples from rural Oregon include a married couple who worked in a plant nursery for several years before opening their own specialty nursery, a single mom who opened her own home-based child care facility, and an entrepreneur with a disability who developed and created a blanket designed specially for those in wheelchairs.

Macro-impact

Box 2.2

Microenterprise development can generate benefits on both individual and community levels. Self-employment allows people in low wage jobs to supplement their income at a lesser cost than public assistance[1] and it offers a variety of groups the flexibility to balance work and family. In rural areas, self-employment has become a central means for many to cope with structural unemployment caused by mill and plant closings. And in urban areas where corporate downsizing and a lack of living-wage employment opportunities in distressed neighborhoods have affected communities, microenterprise programs are often able to reach entrepreneurs with increased efficiency and breadth of services. Communities with successful microenterprises can benefit not only from increased availability of new jobs, but also from increased local availability of a diversity of goods and services and a reduction in business loan delinquency and default. This can generate improved commercial districts with vibrant retail stores and restaurants, increased tax revenues, and reduced public assistance costs.

In many states, those involved in community economic development have recognized that a homegrown, collaborative approach can be more successful than the old economic paradigm of searching for big manufacturing plants or employers that will bring in hundreds of new jobs. Coupling microenterprise development services with other workforce development, community revitalization and economic literacy initiatives is a way to amplify program effectiveness and a means to contribute to improved local economic development.

The Outcomes of Microenterprises in the U.S

Jenny Richardson's floral design shop in Portland, OR was made possible through a microloan from Mercy Corps Northwest.

One critique of microenterprise is that small business is also risky business, and that very few businesses see their first anniversary, let alone thrive for the long-term and create a stable source of income for the business owner and/or others. But with the proper technical assistance, microbusinesses can do very well. Survival rates of microbusinesses compare favorably to the general population of small businesses. A study conducted by the Self Employment Learning Project (SELP) of the Aspen Institute showed 49 percent of micro businesses surviving after five years, with average revenues increasing 27 percent and profits doubling in that period. Nearly three-fourths of the microentrepreneurs increased their household income over five years, and more than half – 53% – of poor entrepreneurs moved over the poverty line.[4] Compared with working one (or several) jobs at minimum wage, microenterprise appears to be a viable strategy that can complement other options available to the working poor who are striving toward economic self-sufficiency.

Program and service costs of microenterprise development are in line with those of other job creation strategies designed to help low-income individuals improve their incomes. In addition, there are multiplier effects that stem from self-employment strategies. While many microentrepreneurs will

Effective Practices in Action

Box 2.3

Testing Microenterprise as an Income-Generation Strategy in Portland

In 2004, Portland's Bureau of Housing and Economic Development (BHCD) launched the Economic Opportunity Initiative, which currently invests in 30 citywide projects that work with very low-income Portlanders. All Initiative projects share a common goal to raise individual participant's incomes and assets by a minimum of 25 percent within three years.

At one year after project launch, the following results have been reported:

- Thirty small projects based on best practices serve 994 low-income people;
- Nine Microenterprise Development projects currently serve 256 very small businesses;
- Twenty-one workforce projects are linked to employers and provide training, internships, employment and retention for 738 low-income residents;
- After one year, existing businesses are achieving a 50.4% increase in revenue. The average annual revenue increase for existing businesses ($18,738) far exceeds the cost of the program ($8,000 per participant over three years, with the majority spent in the first year);
- The Initiative is leveraging new health care, legal services and technology support for participants.

not grow their businesses to employ more than themselves, the average microenterprise creates 1.5 jobs per business.[5] And an analysis of the U.S. microenterprise industry prepared for the International Labor Organization (ILO) estimates that return on investment in microenterprise development ranges from $2.06 to $2.72 for every dollar invested.[6]

Engaging Financial Institutions

The financial support of the microenterprise development field is complex. It receives public funding from various departments of the federal government – including the SBA, Treasury Department (through the CDFI Fund), Department of Labor, HUD (through the Community Development Block Grant, or CDBG, Program), USDA and the Department of Health and Human Services – and a variety of departments within state and local governments, as well as private funding from foundations and corporations.

In addition, banks play a pivotal role in microenterprise development, though most, due to fixed transaction costs that make small loans of $500 to $35,000 unprofitable, have not found it financially feasible to provide direct financing to many of the customers of microenterprise development organizations. Instead, banks have generally welcomed opportunities to partner with programs that assume part of the cost of serving microenterprise clients (See Box 2.4, "Innovations in Oregon").

This solution has been effective because microenterprise practitioners act as intermediaries between entrepreneurs and mainstream banks. The arrangements banks have made with microenterprise development programs range from grants (usually $5,000 to $50,000), forgivable loans, and low-interest loans and lines of credit (i.e. the organization receives a loan from the bank to capitalize a loan fund, which the organization then uses to lend to entrepreneurs), to actually making loans to program clients. In the latter case, banks may either take the full risk or the microenterprise organization may assume part of the risk by providing partial loan guarantees, or by making an agreement that a specific percentage of the total loan portfolio will be covered by a loan-loss reserve fund. The Community Reinvestment Act (CRA) has provided major incentives (as well as the threat of sanctions) for bank participation in serving the low-income clientele who are reached by microenterprise development programs.

Other benefits can stream from successful partnerships between financial institutions and microenterprise programs. The training and technical assistance that microenterprise practitioners provide can be a form of risk reduction, and clients build positive repayment histories and greater financial skills. After a microloan is repaid, entrepreneurs can be referred to financial institutions for larger business loans. In addition, communities targeted by microenterprise intermediaries are often in geographies that are outside a bank's "footprint" or in areas where alternative, and often predatory, financial service providers are prevalent. By partnering with microenterprise intermediaries, mainstream financial institutions have the potential to reach new customers and target products and services in new ways.

Increasing Opportunity, Realizing Potential

Owning a business has always been part of the "American Dream," and microenterprise is a critical option for a portion of the working poor. Microenterprise should be

Innovations in Oregon

Box 2.4

Banks Supporting Capital Access for Microenterprise

The Oregon Microenterprise Network (OMEN) is launching a statewide revolving loan fund that will provide capital access to Oregon communities that do not have loan programs for microenterprise. Many community development organizations in Oregon, especially in rural areas, provide considerable guidance, skill development, and technical assistance for start-up and emerging microenterprises but are limited by lack of access to financing for their clients. By partnering with these local practitioners, OMEN will be able to provide loans to those entrepreneurs unable to access conventional sources of financing.

The statewide loan fund will provide first-time loans up to $10,000 and growth loans up to $25,000 for those that successfully pay their original loans. The fund will be centrally administered by OMEN which will be in continuing communication with the local partners to ensure their client's success. The local partner will be required to provide technical assistance to the borrower throughout the life of the loan. OMEN will employ an experienced loan officer and administrator to provide the essential expertise.

OMEN is partnering with several Oregon financial institutions to provide the necessary funds and grants—approximately $500,000 in total—to support administration of the fund. Funds will come in the form of equity-equivalent (EQ2) investments. In addition to meeting their CRA goals, participating banks see the benefit of public awareness of their community involvement and the potential of future banking customers. As entrepreneurs pay off their loans through the Oregon statewide loan fund, they will in turn become stronger candidates for larger loans as their businesses prosper.

integrated into mainstream employment systems so that self-employment can become a more widely feasible option to help people exit poverty and contribute to their local economies. Achieving this goal will require commitment from legislative bodies, government agencies, funders, and microenterprise programs, all of which will need to collaborate to make major changes in policies, program designs, operating procedures, and outcome tracking and documentation. (See Box 2.5, "Strengthening the Industry"). Such integration should, in the long term, result in stable, mainstream funding for microenterprise development services. As funders and practitioners together build a culture focused on accountability, program performance and return on investment, the field can realize the potential presented by microenterprise development as a viable means to further open wealth and ownership opportunities to individuals and communities long excluded from the mainstream economy.

What is OMEN?

Oregon Microenterprise Network (OMEN) is a statewide network of approximately 45 microenterprise programs and supports providing business training, technical assistance, microloans and other services to low-income and disadvantaged entrepreneurs. OMEN's mission is to increase opportunities for low-income entrepreneurs and communities by building the capacity of Oregon's microenterprise organizations. OMEN accomplishes this through: 1) Providing access to funding for microenterprise programs, 2) Advocacy efforts on a federal, state and local level, 3) Access to capacity-building services through the OMEN Asset Building VISTA Corps, 4) Training and technical assistance for microenterprise service providers, and 5) Facilitation of community efforts that support microenterprise development. Visit us at www.oregon-microbiz.org.

Strengthening the Industry

Box 2.5

Aside from traditional financial support and grantmaking, there are three important ways for funders and financial institutions to help increase the strength of the microenterprise industry:

1. Get to know your local microenterprise development practitioner

A national listing can be found online at www.fieldus.org/Publications/Directory.asp. There are many ways for banks to partner at the neighborhood/branch level, as well as at the state and national level, beyond simply providing funding to practitioners. Also, get to know your state's SMA, or State Microenterprise Association. The majority of states have an SMA, whose sole purpose is to increase the capacity and performance of the microenterprise practitioners. A directory of SMAs can be found at AEO's website, www.microenterpriseworks.org.

2. Invest in building the capacity of microenterprise practitioners to measure and improve performance

To understand the impact of their work and track outcomes, practitioners need to know who they serve (demographics like gender, race and income), how many clients they serve and with what services (training, consulting, microloans), at what rate of success (completed business plans, increased business revenues), and at what cost. Indicators may include data such as business survival rates, changes in business revenue and household income, rates of job creation, changes in public expenditures such as reduction in TANF payments and food stamps, as well as non-economic indicators. These may include personal empowerment due to increased self-esteem and newly developed financial management skills, and community impacts such as increased community involvement and increased creation of mutual support networks among entrepreneurs. The Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD) recommends that "donors can invest in management information systems and other capacities that help their grantees measure and improve performance, and recognize that these investments are required on an ongoing basis. They also can support the further development and expansion of national systems and tools for measuring performance, and capacity-building resources designed to help more institutions come into compliance with national standards."[1]

3. Reward performance through grant-making

FIELD recommends that "donors should expect grantees to participate in industry-wide efforts to measure and improve performance. Funders also should make explicit that grantees must maintain the discipline of working toward higher scale, effectiveness, efficiency and cost recovery as they work to achieve good business and client outcomes. This will involve requiring grantees to report on critical performance measures, as well as structuring grant awards to support and reward progress toward achieving greater internal efficiency and effectiveness, increasing the scale of operations, and producing better outcomes."[2]

The Corner Store

Investing in a "Sense of Place"

By Carolina Reid

When Aregawi first came to the United States in 1993, he quickly realized he was a long way from his hometown of Addis Ababa. Arriving to San Francisco's dense fog and chilly night sky in the middle of summer, the first shock was the weather. The second was the paucity of living wage jobs available to him, despite his engineering degree from Ethiopia. "[The ministry that helped us come to the U.S.] provided us with housing and living assistance, but the job counselors kept pointing me towards jobs in janitorial services or the food industry. I kept thinking that cleaning toilets would not make me a better life. I wanted to start my own business. It was my dream. It's how you become rich in America."

Aregawi followed his dream, and today he owns two businesses, an airport limo service and a small Ethiopian grocery store on a "tough street" in the Bay Area. The businesses help him to support his family, but he is still a long way from striking it rich; indeed, the family relies on his wife's earnings as a nanny to make ends meet, and they offset the cost of housing by living with other members of his family. The romantic vision of entrepreneurship is long gone. "My limo service does well. I now have three cars and two people working with me to help take calls at busy times. But it's not an easy work. Most of the time I'm working late at night or early in the morning, and always on weekends. I can't turn off the phone; every call we have to take or we might not make it [financially]."

The store has been a particularly difficult business to sustain. The monthly rental costs eat away at most of the sales receipts, and it has been a challenge to retain employees. Aregawi hires members of the local Ethiopian community and generally draws his employees from a vast social network of family and friends, but he can't pay salaries that match the cost of living in the Bay Area. Aregawi talks frankly about needing to sell the place unless business picks up soon. "The business is important for our community–so that we can maintain some of the cultural aspects of our country through our meals and holidays–but I don't know if I can keep waiting to see if business will improve. It might be easier for us if we sold it."

Aregawi isn't your typical entrepreneurial "success story," but his story may reflect a more truthful depiction of the difficulties of starting and sustaining a small business. While the idea of entrepreneurship is beguiling–particularly when contrasted with the daily nine-to-five grind so acerbically portrayed in Dilbert cartoons–running a small business is not an easy job. The hours are long, the upfront capital needs are high, and the risks that the owner has misjudged market demand or the costs of operation are very real. In addition, most research on entrepreneurship shows that the majority of low-income entrepreneurs realize only modest financial returns from their businesses.[1] While the microenterprise field has demonstrated success in helping to alleviate poverty–particularly when entrepreneurs have access to strong training and technical assistance–the financial returns to entrepreneurship are not overwhelmingly strong. A recent study by the Aspen Institute, for example, found that while some businesses did very well, overall the median revenue for businesses was relatively low at $20,000. Forty-three percent of the full-time business owners surveyed in the study reported drawing less income from their business than what they would have earned in full-time minimum wage work.[2]

Yet there's another dimension to microenterprise that is at least as important as helping to advance financial self-sufficiency. As I walk down the "tough street" of Aregawi's shop, it's hard not to notice the positive changes in the neighborhood, even though these impacts may not be reflected on his balance sheet. When Aregawi opened his store three years ago, his was the only shop on a block filled with abandoned buildings and graffiti sprayed walls. Trash collected in doorways and the paint on metal safety grills was chipped and faded. Today, there are visible signs of revitalization; an Ethiopian restaurant has opened nearby, as has a bakery. Two of the residential buildings on the block are undergoing renovation, and the storekeepers have developed a local partnership to keep the street clear of trash and to plant seasonal flowers in the once-barren dirt patches on the sidewalk.

By filling a once vacant storefront, bringing in goods and services, and creating a couple of jobs, Aregawi's shop has become a community asset that is supporting the broader process of neighborhood revitalization. As Mihailo Temali, Executive Director of the Neighborhood Development Center in Minneapolis and author of *The Community Economic Development Handbook,* argues, microenterprises are important "pivot points" in a community, in that they are small investments that can catalyze much greater change.[3] Lisa Servon, Senior Research Fellow at the New America Foundation, has similarly emphasized that microenterprise can serve a dual role by not only promoting the social welfare of individual households, but also by fostering community economic development. As such, microenterprise development is both a "people–based" and "place–based" strategy. Evaluating the merits of microenterprise development programs on income improvement alone likely underestimates the impact that small businesses have in improving the well-being of low-income households and communities.[4]

The idea that microenterprise can serve as the basis for economic growth and revitalization is gaining traction in the field. In particular, it is emerging as a viable economic development strategy in rural communities and on tribal reservations.[5] Arguably, in a dense urban center, workforce development and assistance in securing a living wage job may be a safer choice for helping a family move out of poverty. But in many rural communities, jobs are scant. Economic anchors like local banks and "Main Street" businesses have disappeared, and the consolidation of farms has led to a loss of local employment opportunities in agriculture. As a result, families who do not wish to leave these communities are increasingly relying on self-employment and microenterprise as a way to supplement their incomes.[6] These small businesses are "assets" in the same way that Aragawi's shop is an asset to the low-income neighborhood in the city.

Partners for Prosperity, a nonprofit organization serving sixteen counties in Eastern Idaho and the Fort Hall Indian Reservation, has made entrepreneurship a linchpin of its community development strategy. The organization embarked upon an ambitious effort to understand the challenges facing poor rural areas, visiting local places and asking residents what they felt it would take to reduce poverty in their communities. Rather than asking "what's missing?," Partners for Prosperity focused their questions on "what's already here that we can help to support and grow?" What they found was a wide variety of cottage industries that were helping families make ends meet and serving as an important cultural anchor for residents. Jessica Sotelo, the Executive Director of the organization, noted, "The residents we spoke with articulated the important cultural identity that goes along with living in a rural community, a 'sense of place' that residents felt it was very valuable to maintain."

As a result of this planning process, Partners for Prosperity has focused its rural economic development strategy on entrepreneurship rather than on attracting, for instance, a new ethanol factory or manufacturing plant. Helping existing informal enterprises grow and reach new markets–for example, by helping them to connect to a global market through e-commerce, by providing access to capital, or by building a network to new distribution channels–can deliver benefits not only to the business owner, but also to the surrounding community. "It's incredibly empowering to watch a small Latino bakery tap into a statewide market through a partnership with a grocery chain," says Sotelo. "Not only do they increase their own income, but they create jobs locally. We're helping cottage industries to become viable businesses, drawing on local strengths and interests. Rather than feeling trapped by the whims of big businesses, the feeling is 'I get to stay here and do what I love to do, and make a living at it.'" Sotelo points out that this type of strategy is an effective use of public funding because it builds on assets that already exist. "The business is already happening, and the families have been innovative in using their savings or EITC refund to finance it. What we do is leverage a small amount of dollars, for education or training, to help them have a greater impact in the community."

"We're helping cottage industries to become viable businesses, drawing on local strengths and interests."

While the work in Idaho is just getting off the ground, evidence from the Lakota Fund in South Dakota shows that microenterprise can help to improve economic indicators in rural communities and on tribal lands. The Lakota Fund was one of the first attempts to promote microenterprise as a community development strategy in the United States, targeted largely at residents of the Pine Ridge Reservation. Over the past twenty years, the Lakota Fund has invested over $3 million in reservation entrepreneurs, mostly in small loans ranging from $1,000 to $75,000. These loans have helped to catalyze economic development on the reservation. While poverty and unemployment remain high, income growth in the surrounding county has been double that of South Dakota since 1985, and its 80 percent growth in employment was the second fastest of all the counties in the state.[7]

Like most entrepreneurs, Aregawi still is happy with his decision to go into business for himself. As he read an early draft of this article, he laughed and noted, "Did I make it sound so hard?," not realizing I would focus so much on the financial difficulties of running a business. He's also particularly interested in the argument that entrepreneurship can help low-income and rural areas maintain their cultural and historical integrity. "Sense of place. That's what my shop provides, and why I keep the business even if it's not making money. You walk in and it smells like Ethiopia. It's my place." In the end, it seems that entrepreneurship is as much about building individual and community identity as it is about building wealth, and finding ways help to sustain those business owners who are following their dreams is part and parcel of generating vibrancy in areas left behind.

Using CRA-Qualified Community Development Activities to Reach More Small Businesses

By John Olson

Not all small businesses are candidates for conventional financing from financial institutions. The business may be too small, too new, or the business owner may require additional technical assistance to be ready for financing. While these businesses may fall outside the financial institution's lending guidelines, financing for these businesses is a critical credit need in many communities. Under the CRA, financial institutions are rewarded for community development activities that help these businesses get the financing or education they need.

For small institutions, these lending-related community development activities are evaluated only at the institution's discretion. For intermediate small institutions, these activities are evaluated under the Intermediate Small Bank Community Development Test. For large institutions, these activities will be evaluated under one of the three tests – Lending, Service, or Investment Tests – depending on the nature of the activity. Regardless of how the activity is evaluated, supporting small businesses through qualified community development programs and products can be an important part of a comprehensive response to a critical community credit need.

. . . supporting small businesses through qualified community development programs and products can be an important part of a comprehensive response to a critical community credit need.

Partner With a Community Based Lender

One key way for a financial institution to expand its reach to small businesses is to partner with a CDFI or other community-based lender that has a focus on small business lending. A range of activities can be considered under the CRA. Providing a line of credit or other lending facility to such an organization can be considered under the Lending Test. Possible community development services include serving on the organization's board of directors, providing technical assistance to the organization, or sitting on a loan review committee. Making an equity investment (including equity equivalent, or EQ2, investments) in, or making a qualified contribution to, a small business CDFI can be considered under the Investment Test.

Partner With a Technical Assistance Provider

One of the most important ways an unbankable or near bankable business can get ready for bank financing – perhaps the most important way – is to take advantage of the educational and training resources provided by small business technical assistance organizations. These services may be offered by a nonprofit, an SBDC, or a community college, and include everything from assistance with business plan preparation to business incubation services. A range of community development possibilities exist for these community partners as well. Providing a facilities loan for a business incubator can be considered under the lending test. Community development service options include serving on a board or providing technical assistance to the organization or to the organization's clients. A qualifying contribution to one of these organizations would be considered under the Investment Test.

The Exam

CRA examiners don't expect that the bank or thrift they are examining will be able to respond to every community credit need on its own. Examiners will, however, be looking for ways that the institution has used its community development partners to address these needs. The successful CRA officer will demonstrate that: 1) the bank understands the small business needs in the assessment area, how those needs are being met, and whether there are any unmet needs; 2) the bank has used its own products and resources to respond to these needs within the bounds of safety and soundness; and 3) the bank has partnered with community-based organizations and other entities that can help the bank expand its reach to the small businesses in its community. CI

Building Bridges in Low- and Moderate-Income Communities

By Stanley Tom, Valley Small Business Development Corporation

Operating a small business in today's dynamic marketplace is a difficult venture, and in low- and moderate-income communities, the challenges multiply. Often, pockets of business are isolated, the storefronts are a bit worn, and municipal infrastructure is dilapidated. Small business owners in these communities, many of whom are first-time entrepreneurs and new Americans, often need financing from outside sources to help them grow their businesses.

Collaborations between financial institutions, financial intermediaries, and other service providers . . . can result in effective methods of increasing access to education as well as to financial tools.

To qualify for commercial capital, however, financial institutions require high credit scores, strong net worth, adequate cash flow and sufficient collateral. Unfortunately, for those small business owners who do not fit the traditional profile served by financial institutions, these requirements act as barriers. In the face of these barriers, small business owners may seek or impulsively accept credit card offerings and solicitations from payday or cash advance offices. Depending upon how the small business owner manages these alternative financial resources, they can help or can become a burden.

An important community development trend has been the creation of safer alternative sources of capital through loan pools designed for start-ups and small businesses. These loan pools, which are typically managed by nonprofit lenders or governmental agencies and offer flexible underwriting standards, bridge the short-term needs of small businesses until they can qualify with traditional lenders. The pools are capitalized by CRA-eligible investments from financial institutions, government funds, grants and internally generated funds. Some of the most flexible loan funds are created through Community Development Block Grants (CDBG), U.S. Department of Agriculture Rural Business and Enterprise Grants (RBEG), and foundation grants. Targeted to borrowers in specific geographies or income-brackets, the funds offer attractive features for borrowers, such as longer terms, low or no loan fees, and below or comparable commercial market rate interest. To qualify for these loan funds, small business owners must prepare and gather a loan package. At a minimum the loan package must answer the following questions: does the small business owner have the ability to repay the loan and does the small business owner have the strength of character, as demonstrated by a credit report, to repay the loan.

Small business owners may need assistance not only in assembling information for a loan package, but also in generally boosting their financial literacy skills so that they can eventually qualify for financing from mainstream institutions. Collaborations between financial institutions, financial intermediaries, and other service providers, such as educational institutions, chambers of commerce, community organizations and government agencies, can result in effective methods of increasing access to education as well as to financial tools. These institutions can partner to provide topic-specific workshops and training, one-on-one counseling, trouble-shooting and operational review for small businesses, all of which can help owners learn how to improve operating margins and increase revenue. Participating financial institutions benefit by both learning the special needs of the small business community and receiving valuable input on how to improve their financial services to these potential customers.

The networks created through these collaborations improve the capacity of the service providers working with small business owners and help owners access the financing and information they need if they are to grow their businesses. They also create forums for exploring and exchanging ideas that benefit all participating parties. Ultimately, these partnerships build the bridges that will help small businesses in low- and moderate-income communities succeed. CI

Building Bridges

Box 5.1

Supporting Hispanic Entrepreneurs in the Central Valley

Helping an entrepreneur access the resources to grow his or her business is no simple task. For immigrant entrepreneurs, many of whom have little or no prior experience using U.S. financial institutions, the hurdles are more daunting. But Wells Fargo Bank, the Fresno Area Hispanic Chamber of Commerce, and the Valley Small Business Development Corporation (VSBDC) have partnered to expand delivery of services and credit to Hispanic entrepreneurs in the Central Valley.

VSBDC, which administers 15 loan and loan guarantee programs directed to small businesses in nine counties in the Central Valley, was working in 2003 with Hmong farmers in the area. One of their loan officers was able to conduct outreach, and thereby extend loans, to the Hmong community, but the organization did not have the capacity to do the same kind of culturally and linguistically appropriate outreach for Hispanic entrepreneurs. The Fresno Area Hispanic Chamber of Commerce, on the other hand, had built trust and developed strong relationships within the Hispanic small business community, but did not have the capacity to extend loans to those having trouble accessing the capital needed to start or grow their businesses.

With the help of Wells Fargo Bank, an innovative partnership was developed between the two groups as a way to make the most of each organization's assets. Wells Fargo provided an initial $250,000 equity-equivalent (EQ2) investment to VSBDC for a revolving loan pool, which was to be administered by the Hispanic Chamber of Commerce. On its own, the Chamber could not qualify for the capital needed for a loan program, but with VSBDC acting as the intermediary, the Chamber is now able serve as the "face" in extending microloans to the Hispanic community. The Chamber, which does a great deal of outreach to Spanish-speaking business owners and can accept loan applications in Spanish, established a loan committee of community "peers" who make determinations on loans held by VSBDC.

The program has taken off—indeed, the initial pool of capital was disbursed within the first 30 days of the program's existence. Since then, Wells Fargo has invested an additional $500,000 in the program and the Chamber has consequently seen hundreds of clients and made 35 loans; out of these, only one has defaulted. This is in large part due to the Chamber staff's ability to provide continual follow-up with clients, which has generated a high level of accountability among borrowers. "Clients come to the Chamber and share their personal stories, and we are able to build relationships with them," said Dora Rivera, Executive Director of the Fresno Area Hispanic Chamber of Commerce. "We have the flexibility to help clients get through hardships…and we can provide the hand-holding and encouragement to make sure that clients meet their obligations." Another important feature of the Chamber's program is that they have established a loan-loss reserve fund to protect VSBDC from delinquencies and losses.

"We have the flexibility to help clients get through hardships…and we can provide the hand-holding and encouragement to make sure that clients meet their obligations."

This partnership has been beneficial for all those involved. The Chamber has become a "one-stop-shop" providing loans, technical assistance and outreach to clients, and has been able to attract other funding necessary to operate its programs. Its future plans include opening a business incubator facility in the city of Fresno. In addition to learning how to better manage business finances, borrowers are able to get the training and mentorship they need to become comfortable with mainstream banking institutions, and VSBDC is able to reach a market they were otherwise not able to adequately access. For its part, Wells Fargo is able to meet CRA requirements in an innovative way and sees opportunities for creating new bank customers and cross-selling other products. Tim Rios, Vice President of Wells Fargo's Community Development Group, said, "It's not a cinch to start these programs and it has taken the support of many institutions, but the Chamber has become a mini-powerhouse… CRA stories just don't get any better than this."

Delivering Financial Return and Community Results

Pacific Community Ventures

By Beth Sirull and Todd Schafer, Pacific Community Ventures

Pacific Community Ventures (PCV), the West Coast's first Community Development Investment Capital organization, brings the tools of venture capital – both financial and non-financial – to bear to stimulate business development in California's low- and moderate-income (LMI) communities. In making investments, PCV seeks competitive financial returns as well as measurable "social returns." Since 1999, while achieving market rates of return for investors, financed companies have employed over 1,500 residents of California's LMI communities, paying an average wage more than 20 percent greater than the surrounding area's living wage ordinance, and providing health care, vacation, sick leave, training benefits and wealth-building opportunities.

Small Business and the Financial Marketplace in Distressed Communities

The financial marketplace in LMI communities is characterized by a lack of available equity capital and a lack of access to the business networks that provide opportunities for strategic support and professional development.

A lack of available equity capital. Most of the businesses in which PCV invests are located in geographic areas, or participate in industries, that are overlooked by institutional equity investors. While California received approximately 20 percent of the $585 billion in venture capital investments made globally between 2000 and 2005, over 60 percent of this investment was concentrated in 35 zip code geographies, primarily in Silicon Valley and other economically well-developed areas. In addition, the majority of venture capital investments made nationally between 2000 and 2005 were investments in technology-related companies, not businesses that generally employ lower-income workers.[1]

A lack of strategic support and networking opportunities for emerging entrepreneurs. In addition to lacking access to capital, PCV's target businesses also lack access to business networks through which they could gain valuable, board-level strategic advice. These advisory networks often come through the same institutional investors that traditionally have not invested in PCV's target industries and geographies, or through alumni or other networks prominent in the "mainstream" business community.

PCV's Model: Investing Capital, Deploying Expertise and Extending Networks

There are two primary ways by which PCV invests in promising businesses in California's LMI communities: by deploying capital and by providing advisory services.

Investing Capital. PCV is the managing member of two private equity funds through which it makes investments in high potential companies located in, or near, and hiring from, LMI communities. PCV makes investments in traditional industries including food distribution and services, value-added manufacturing, and consumer and business services, where the organization has expertise and robust deal-flow. PCV commits $1-$2 million to businesses with at least $5 million in revenue, a clear path towards profitable growth, a strong management team and independent governance. To date, PCV's investment funds have deployed over $11 million in nine active companies. As of year-end 2005, PCV's first fund had a competitive implied net IRR compared to other 2000 vintage funds. PCV's second fund had an implied net IRR that put it in the top quartile of 2002 vintage funds.

At the same time, PCV's financed companies paid a weighted average wage of $13.18 per hour, considerably above the living wage ordinances in surrounding areas. All of PCV's financed companies offered health benefits to low-income employees, compared to just 67 percent of all companies in California. Two-thirds of portfolio companies offer retirement plans and all of those make contributions to those plans. Through PCV's Individual Development Account (IDA) program, which provides financial literacy training and matched savings, 48 employees at three portfolio companies are saving for retirement, education or a home purchase.

Leading financial institutions, including Wells Fargo Bank, Citibank and the California Public Employees Retirement System (CalPERS) have committed capital to PCV's funds as have regional and community banks such as Silicon Valley Bank and Greater Bay Bank. Foundations including the Rockefeller Foundation have also invested. Through these investments, banks can earn CRA credit, bolster community involvement, earn a competitive financial return and build an additional loan pipeline source.

Deploying Expertise and Extending Networks. Most private equity investors provide governance and management assistance to the businesses in which they invest. PCV goes further through its Business Advisory Service, providing nonfinancial resources including mentoring, strategic advice and access to business networks to our financed companies, and providing these services, free of charge, to other small businesses – outside of our financed portfolio – located in California's LMI communities.

PCV's Business Advisory Service links experienced business professionals with the management teams of qualifying businesses. Each volunteer advisor works one-on-one with the advised company over a 6-12 month period. Over 25 percent of advising projects address sales/marketing issues, 21 percent strategic planning/business development, 18 percent operations/manufacturing, 15 percent financial planning and the remainder address new product development and fundraising preparation issues. In a recent survey, over three-quarters of advised management teams indicated that their advising relationship had resulted in a tangible impact on their business.

In addition, through CEO Forums–leadership and management workshops lead by top business school professors–and Business Roundtables–where one advised company presents an issue it is facing and receives practical input from a diverse group of executives–participating entrepreneurs develop their management abilities, learn new frameworks for addressing business challenges, and have the opportunity to network with their peers.

From its inception in 1999, through year-end 2005, PCV's Business Advisory Service has provided intensive support to nearly 90 growth-stage companies. In addition to contributing to the business climate in LMI communities, these efforts prepare the pipeline for future equity investment, enhancing next generation "deal flow" for capital providers, all while providing significant benefits to residents of LMI areas. At year-end 2005, PCV's advised businesses employed 470 residents of LMI communities. Nearly two-thirds of advised companies provide health insurance to their low-income employees while over three-quarters provide paid vacation and offer skills training on an ongoing basis.

Market Need, Market Opportunity

America's underserved communities present an enormous opportunity for investors who seek both financial and social return. Through its two-pronged model that provides management and capacity-building resources in addition to capital, PCV has shown that investors can integrate private equity investments in businesses in these communities into their portfolios, earning CRA credit while producing competitive returns, building new sources of loan volume, and yielding significant community benefits.

To learn more about PCV, please visit

www.pacificcommunityventures.org and/or www.pcvfund.com.

PCV is currently raising its next Investment Fund. For more information, please email *info@pcvmail.org.*

Case Studies

PCV Promotes Economic Development by Supporting Growing Businesses in Underserved Areas

Equity Investment

PCV first invested in Timbuk2 Designs, a bicycle messenger bag manufacturer in an LMI neighborhood of San Francisco, in 2000. Two years later, PCV led the company's recapitalization necessary for long-term success. Along the way, the company expanded its product lines and distribution with the addition of over 30 new items – from computer carrying cases to luggage to daypacks. Over the life of PCV's investment, Timbuk2 grew its San Francisco workforce while increasing both wages and benefits for its front-line workers. Over the same period, Timbuk2's revenue grew more than four times.

With Timbuk2's sale from the portfolio in 2005, PCV's investment funds realized a substantial return multiple. In addition, the sale triggered an equity-based Wealth Sharing Mechanism – negotiated by PCV at the time of investment – that produced cash payouts of up to 2 times annual salary (more than $1 million total) for the 40 factory and warehouse employees of the company.

The Business Advisory Service

ValueFinders, a real estate appraisal firm founded in 1999, has several employees from LMI neighborhoods in Compton and Los Angeles. The company joined PCV's Business Advising program in March 2005 and was matched with advisor Brian Garrett, a Principal at Santa Monica's Palomar Ventures. The project – to assist in launching an online technology solution for mortgage brokers, appraisers, and their clients – made good use of Brian's expertise in infrastructure software and business development for technology start-ups. The newly launched www.appraiserConnect.com is paying tangible dividends, with increased company revenues and new jobs for LMI residents.

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Delivering Financial Return and Community Results: Pacific Community Ventures

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Supplier Diversity Symposium

August 3, 2006
Federal Reserve Bank of San Francisco

Do your company's vendors reflect the diverse population that surrounds us? Does your company's process for identifying new suppliers allow small, minority, women, disadvantaged and disabled veteran businesses the opportunity to participate? Diversifying your supplier pool is an effective and affirmative strategy for promoting economic development, supporting the communities where you do business, and expanding opportunities for your company.

Please join community development officers from financial institutions, corporate managers and industry specialists for a symposium about the process and value of creating a supplier diversity program. Attend to gain a detailed understanding about all aspects of creating a supplier diversity program or improving your current program. Please contact Lena Robinson by phone: (415) 974-2717 or via email: lena.robinson@sf.frb.org to be added to the mailing list for this event.

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The second issue of the *Community Development Investment Review,* focusing on the securitization of community development investment loans and the possibility of developing a vibrant secondary market for such loans, will be hitting the stands this summer. Please visit the Center for Community Development Investments website at www.frbsf.org/cdinvestments to access the *Review* online and to subscribe to the mailing list.

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