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A 'Systemic Shift' in Small Business Lending

As banks cut back on lending directly to small businesses, CDFIs are expanding their role and tapping recently formed bank holding companies for capital

By John Tozzi

Lesia Bates Moss knows opportunity when she sees it. Shortly after she became president of Seedco Financial, a New York-based nonprofit lender with balance-sheet assets of $55 million, in March 2009, she sought new sources of capital to expand Seedco's lending to small businesses in low-income neighborhoods. Among Moss's top prospects were mammoth financial institutions like Goldman Sachs (GS) that had converted to bank holding companies in late 2008 to access federal aid. These bailout recipients would now face federal ratings under the Community Reinvestment Act on how well they serve disadvantaged neighborhoods—and Moss thought Seedco Financial could help.

Community Development Financial Institutions like Seedco are generally nonprofits that finance small businesses, housing, and other development in poor areas. They have long tapped a mix of federal funding, philanthropic grants, and investments from commercial banks to fund their work. Although CDFIs typically lend to clients that banks consider too risky, their loans have held up well in the recession, in part because they come with lots of hand-holding for borrowers. With banks still reducing their direct lending to small businesses, policymakers and bankers alike expect CDFIs to play a growing role in financing small businesses in the recovery.

"As we speak, several of the nation's largest banks are developing CDFI partnerships to provide small business credit," says Mark Pinsky, CEO of Opportunity Finance Network, a Philadelphia-based alliance of CDFIs. "I know of at least two significant deals that could launch in the coming weeks if all goes well." Commercial banks have long been among the biggest funders of CDFIs: JPMorgan Chase (JPM) has invested $1.2 billion in the last five years; Bank of America (BAC) has a $1 billion CDFI portfolio; and Wells Fargo (WFC) has $400 million in CDFI loans and investments. Now add Goldman Sachs to that list.

GOLDMAN'S SMALL BIZ PROGRAM

At a conference early last summer, Seedco's Moss met Alicia Glen, a managing director at Goldman's Urban Investment Group, a decade-old $1 billion division that invests in inner-city businesses and real estate. That started a conversation that led to Goldman making a $20 million loan to Seedco to fund small businesses in New York City's low-income neighborhoods. It's part of a $500 million national program to aid small businesses Goldman announced in November. The initiative includes $250 million in loans and $50 million in grants to CDFIs over five years, as well as $200 million for education and mentoring for business owners. "We're not a retail bank," Glen says, noting that Goldman has no plans to underwrite small business loans directly. "But there's a whole set of intermediaries that do exactly that."

Investments in CDFIs, along with direct community development lending, help banks comply with the Community Reinvestment Act, the 1977 law designed to encourage depository institutions to serve disadvantaged areas. A new cohort of financial institutions that converted to bank holding companies to access government bailouts during the financial crisis is now subject to the law, including Goldman, Morgan Stanley (MS), American Express (AXP), CIT Group (CIT), and GMAC. Goldman, for its part, says the program goes well beyond its plan to meet CRA requirements, which only apply to the firm in New York, New Jersey, and Utah, where its bank division has offices.

Goldman's announcement, which coincided with an apology from CEO Lloyd Blankfein for the firm's role in the financial crisis, was described as a PR move by critics to quell anger over bankers' billions in compensation. But the allocation is real money for CDFIs: Goldman's loans and grants equal 1% of the combined $30 billion in assets of the roughly 900 CDFIs certified by the Treasury Dept.

FEDERAL SUPPORT

As CDFIs unlock new sources of private capital, the federal government has also increased its support. Congress allocated $247 million in 2010 for the Treasury fund that supports community lenders, by far the largest annual sum in the program's 15-year history. The CDFI Fund also benefited from $100 million in stimulus money last year, which the agency fully disbursed by Sept. 1.

New money can't come soon enough. CDFIs nearly doubled their demand for Treasury funds last year, seeking $467 million. "The demand continues to rise even as our funding increases," says Donna Gambrell, director of the Treasury's CDFI Fund. In a December survey of CDFIs by Opportunity Finance Network, 48% of respondents said they were capital-constrained during the third quarter. OFN's Pinsky says his members see more demand each quarter from borrowers that would previously go to banks for financing. "These are generally businesses that we would have in the past not looked at, only because we thought the banks or others could do the deals," he says.

While banks may no longer want to loan directly to these borrowers, many consider CDFIs a low-risk way to reach them. "As an industry it has a very low historic loss rate," says Megan Teare, vice-president for CDFI lending programs at Wells Fargo. "They have the ability to provide a lot of technical assistance to their borrowers, which typically a bank cannot do. That often makes a difference if small businesses are viable or not." And small businesses that start out with this kind of assistance may later become attractive customers for mainstream banks. "They are always looking to see how they can graduate their borrowers to become bank borrowers," says Dan Letendre, senior vice-president for CDFI lending and investing at Bank of America.

CDFI INDUSTRY AVOIDED WORST OF CRISIS

CDFIs have not been immune from the downturn. The OFN survey indicated 9.3% of loans were more than 30 days past due in the third quarter. But that compares favorably with some commercial banks. Bank of America, whose small business portfolio former CEO Kenneth Lewis famously called "a damn disaster," has a loss allowance equal to 15% of its small business portfolio, CFO Joe Price said on a call with analysts Oct.16.

The CDFI industry has avoided the worst fallout from the financial crisis. "We have not seen certainly the deterioration that we were fearful we would see," says Gambrell, the Treasury fund director. "[CDFIs] have been doing the work that they have done for many, many years. They know how to do it very, very well."

Mainstream banks that have watched their own balance sheets implode are taking notice. A group of senior officials in several banks' community development departments met in October at a conference of the Opportunity Finance Network to form a nascent CDFI Investors Roundtable to discuss the risks and opportunities in CDFI lending. At the table were Bank of America and Merrill Lynch, Citigroup (C), Deutsche Bank (DB), Goldman Sachs, JPMorgan Chase, Wells Fargo and Wachovia, Opportunity Finance Network, and several foundations, according to two people who attended the meeting.

Moss sees a growing role for lenders like Seedco to partner with such institutions to channel money to businesses that will create jobs in neighborhoods where they are needed most. "What is occurring now is really a systemic shift in the whole financial markets," she says, as banks reduce their risk and their capacity to lend directly to small businesses. "It really supports the case for CDFIs and other alternative lending sources to play a much more critical role to fill that gap."

Tozzi covers small business for BusinessWeek.com.