Self-Help Development Bank: Economic Development Financing in North Carolina

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Access to credit has long been considered a key component of successful economic development. Government policy and programs have consistently sought innovative financing tools to foster business expansion, job creation, service provision, and income generation. Development banking organizations have been created throughout the United States and Third World, offering alternative financing solutions to make credit more accessible to all segments of society. In North Carolina, the Center for Community Self-Help, Self-Help Ventures Fund and Self-Help Credit Union (collectively known as Self-Help) constitute the nation’s first statewide private-sector development bank.

U.S. development banking organizations grew out of the experience of government and community development corporation business development loan funds. Begun in the 1960s and 1970s, these were generally federally funded community- or region-based loan funds, focusing on job creation and service delivery in economically distressed areas. They usually operated independently of banks or other financial institutions, and often provided low-interest loans to newly created small businesses.

Private development banking in the U.S. began in 1978 with the creation of the South Shore Bank in Chicago. Reflecting the shift in federal policy and programs, development banks differed from earlier loan funds. They were private organizations, received little or no public funding, and involved a central “bank” with several affiliate corporations pursuing related development activities. Today, development banks have several common features. First, a federally-insured depository institution provides a sizable asset base and a broad range of development loans for housing and business development projects. Other non-regulated affiliates provide venture capital, higher-risk debt, technical assistance, advocacy, real estate development, job training, or other services that complement economic development finance. Development lenders differ from conventional banks in three major ways:

- they lend to non-traditional borrowers, economically disadvantaged groups and depressed regions;
- they forge partnerships between the public and private sectors by linking public economic development programs with private lenders and community organizations; and
- they combine financial assistance with technical assistance to further development.

Self-Help’s Development Bank Genesis

The Center for Community Self-Help in Durham, North Carolina began in 1980, in the wake of one of the worst recessions in North Carolina history. Initially, it provided only technical and managerial assistance to struggling employee-owned companies. After four years of trying to raise capital for these projects, it was clear that a source of credit was needed as well. In response, the Self-Help Credit Union and the Self-Help Ventures Fund were created. These two institutions were launched in 1984 with $77 raised at a bake sale and now have combined assets exceeding $36 million. Self-Help has opened small field offices in Charlotte and Asheville and plans to open another in the eastern part of North Carolina in 1992.

The structure of Self-Help’s institutions and services is similar to that of other development banks. The parent corporation for Self-Help is the Center for Community Self-Help, a non-profit corporation that provides technical assistance and advocates for changes in development policy and programs. The Self-Help

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Credit Union is a federally-insured, state-chartered credit union that uses interest-bearing savings accounts (money markets, IRAs and CDs) to build a base for lending. The Credit Union provides a variety of commercial loans and home mortgages to disadvantaged constituencies. The Self-Help Ventures Fund is a non-profit corporation which obtains capital through low-interest loans and grants from foundations, religious organizations and private corporations. The Ventures Fund provides the highest-risk commercial financing at Self-Help and has begun making a few small real estate investments as well.

Self-Help's development strategy is based on the belief that ownership is a key motivation for people to improve their economic position. Self-Help therefore makes loans to disadvantaged communities and individuals to buy homes and build businesses. While many other development groups focus on job creation, Self-Help concentrates on increasing the wealth of individuals and communities. For example, the per capita income of white individuals in the U.S. is roughly twice that of black individuals. However, the measure of wealth (net worth) of white families is ten times greater than the wealth of black families. Lack of wealth can prevent individuals from improving, or even maintaining, their standard of living. Our society places great value on the ownership of property and much of our legal system is based on property rights. The dream of owning a home or small business is widely shared in the U.S. But just as important, Self-Help seeks to address the enormous disparities in the distribution of wealth in our society.

Wealth, or the ownership of personal assets without debt, gives families a financial base for additional economic or educational investment. Families need a certain level of net worth to send their children to college, buy or maintain a home, or start and expand a small business. The principal reason Self-Help expanded into mortgage lending is to counteract the lack of home equity among minority entrepreneurs. Minority businesses are at a disadvantage in raising funds because borrowing against home equity is the primary source of capital for small businesses. The establishment of a business or the purchase of a home provides long-term benefits for individuals and communities. Local ownership of businesses, particularly in rural communities, provides a means for establishing and maintaining a stable economic base. Self-Help uses mortgages and commercial loans to help disadvantaged groups or distressed communities build ownership through debt. As borrowers repay their debt, personal and community wealth increases.

Self-Help's constituency reflects North Carolina's unique economic needs. It provides loans to small businesses owned by minorities and women; to businesses located in depressed rural areas; and to cooperative, employee-owned and non-profit enterprises that provide a wider base of ownership within their communities. In addition, low- and moderate-income families can obtain mortgages to purchase homes. In 1991, Self-Help will provide over $10 million in development financing.

**Balancing Development Objectives and Financial Viability**

Self-Help and other development lenders work to expand the limits of lending risk without going bankrupt. Self-Help faces unusually high costs compared with conventional banks because it makes loans to marginal businesses with inexperienced management and to home buyers with poor credit histories and less cash for down payments or repairs. Unlike conventional lenders, Self-Help faces costs associated with the development and possible failure of new programs. Self-Help has devised a corporate financial/marketing strategy that recognizes the inherent costs and constraints of development banking. It uses three approaches to offset the higher costs of making risky loans.

**External Subsidy.** Self-Help seeks continuous, reliable sources of subsidy to support new program development, technical assistance and advocacy. Subsidies take the form of direct grants and donations for operations and loan loss reserves, low-cost loan capital (i.e., funds borrowed by Self-Help at low interest and then lent to borrowers) which supports higher risk loans, and the provision of pro bono services by outside organizations. Self-Help also uses grants and donations for a surrogate "endowment" which is never put at risk. Earnings from this endowment support additional costs associated with development lending, and to a limited extent, replace direct grants.

**Lending in Market Gaps.** Self-Help pursues markets that conventional lenders perceive as unprofitable. Its development targets are chosen primarily on the assumption that there are market gaps in certain commercial and mortgage markets that can be served without assuming enormously high costs. For example, Self-Help targets cooperative, non-profit, minority and women-owned firms as potentially profitable but underserved markets. Further, Self-Help's NC HOME affordable mortgage uses an innovative structure (a more flexible, low down payment mortgage sold to Fannie Mae) to serve low-income first-time home buyers who would otherwise not receive financing.

Although economic development literature frequently advocates this approach, in practice Self-Help has found that such niches are not always as profitable or extensive as expected. For example, an apparent market gap in rural commercial lending often reflects a lack of local markets and business management talent in these areas. Marketing and distribution costs are often higher because businesses are dispersed, and the cost of identifying lending opportunities is higher for lenders. New credit gaps arise constantly as industries change in response to shifts in technology and international ex-
change rates. Local markets change as a result of governmental policies, demographic changes and industry developments.

Market Displacement. Self-Help has also explored making lower-risk, profitable loans in certain commercial or mortgage markets that would usually be made, in whole or in part, by conventional lenders. By combining these conventional-risk loans with higher-risk development loans, the overall portfolio is less costly to manage.

There are two approaches to market displacement lending. One is for development banks to originate conventional, non-development loans. This method making loans that maximize return and minimize risk without consideration of development targets. For example, South Shore Bank in Chicago has used this approach to establish a foothold in conventional hospital leasing and in the financing of McDonalds' franchises. Self-Help has not used this approach, partly because of geographic limitations, and partly because of its success using other approaches.

The method most often used at Self-Help is to participate fully in loans where a development lender would typically take only a subordinate position. In development banking, commercial loan packages are usually split into a fully secured senior loan taken by a conventional lender and an unsecured subordinate loan taken by a development lender. At Self-Help, the entire loan package originates in-house, with the Self-Help Credit Union handling the less risky portion and the Self-Help Ventures Fund taking on the subordinate, more risky, piece. Coordination between the two sister institutions reduces overall risk. Securing each loan with all business assets allows for more flexibility in foreclosure and reduces loan losses.

Interest Rates, Risk and Cost of Capital

In addition to a corporate strategy for sustainability, Self-Help has made several strategic choices concerning loan pricing and the degree of risk Self-Help can manage.

Pricing. Self-Help has established a policy of increasing the access to credit to disadvantaged borrowers, instead of lowering the cost of credit. Both options involve high cost to the lender. On one hand, increasing access to credit increases risk, resulting in higher loan losses (or default rates) and loan servicing costs. On the other hand, reducing the cost of credit (i.e. lowering interest rates) gives a lender less income to cover costs. Most development lenders must choose between these two options; it is rarely possible to subsidize both risk and interest rates. Self-Help believes that development lenders, particularly those that focus on commercial lending, will be more effective if they improve access to credit. The problem facing most commercial enterprises is not having credit available at any interest rate. Decreasing interest rates does not help firms that are considered a credit risk by conventional standards, if a lender is not willing to broaden its underwriting criteria. The cost of capital does not significantly affect the

Dick Gilbert and friend at the Stone Soup Restaurant in Asheville, N.C., another Self-Help Ventures Fund project.
profits of most commercial borrowers. For example, a 50 percent reduction in interest rates generally only makes a 1-2 percent difference in a business’ net margin, yet halves revenue to the lender. Therefore, lowering the cost of credit is an ineffective application of subsidies because it makes only a marginal difference to a firm. A more effective strategy is to subsidize risk to reach firms that are not served by conventional lenders. (The one exception to this principle is in low-income housing, where borrowers are enormously sensitive to interest rates. In this case, interest subsidy is essential to reaching low-income families.)

Many of the publicly-funded enterprise loan programs of the 1960s and 1970s focused on both reducing interest rates and increasing access to loans. Many of these programs were unable to manage the loan losses associated with this strategy, despite a relatively unlimited supply of federal subsidy. Today’s development lenders must use more sophisticated management techniques to insure that they can make loans without bankrupting their organizations.

Risk. Self-Help manages a portfolio of home mortgage and commercial loans that would typically be considered poor or marginal credit risks by the underwriting standards of conventional banks. Yet it continues to operate on a profitable basis, and maintains acceptable delinquency and loan loss figures. Self-Help has been able to adapt its staff and finances to manage a degree of risk that conventional banks avoid. Development banking expands the management principles of conventional banking to include the selected use of technical assistance, greater attention to loan collections, and careful management of the loan underwriting process.

Self-Help offers technical assistance to companies with specific weaknesses that they can address with additional information or training in simple management procedures. In many cases, technical assistance is provided to companies that have not accurately determined the financing they need to achieve viability. Self-Help sometimes counsels existing customers to take advantage of new market opportunities or to address difficulties that affect company performance. Self-Help either provides technical assistance directly or refers clients to other sources (government business assistance programs and private consultants). However, Self-Help is careful not to replace a client’s in-house management with outside assistance and advice.

Recognizing that many of its lending programs involve high delinquency rates, Self-Help emphasizes its loan collection efforts. Delinquency, and therefore higher loss rates, is a particular threat in home mortgage programs, where borrowers often have marginal credit histories or unstable income. By remaining in close contact with borrowers to remind them of their payment schedule, good payment patterns are established early. This small initial effort saves considerable time and money later. Self-Help has received high marks on its collection procedures from Fannie Mae (the largest secondary market mortgage institution), and has kept an otherwise difficult mortgage portfolio within acceptable delinquency levels.

Self-Help’s underwriting process seeks to expand the definition of a “bankable” loan, but also has its own limit of acceptable risk. It is crucial to choose the appropriate criteria for the approval of a particular loan so that interest revenues and loan losses are maintained at predictable levels while insuring that development objectives are also met. In the absence of research or practice on the particular underwriting problems facing development banks, Self-Help has had to learn from its own successes and failures.

Self-Help’s approval process borrows heavily from conventional banking, but adds several distinct features of its own. First, underwriting criteria are more flexible, allowing Self-Help’s loan officers to seek out strengths in one area of a borrower’s application to compensate for weaknesses in another. For example, a commercial borrower may not have enough collateral to fully secure a loan, but another factor, such as unusually strong profits, a partial guarantee, or a large and profitable contract, may compensate for the lack of collateral. Self-Help offers several types of mortgages, each of which is designed to compensate for conventional weaknesses such as low down payments, less stable personal incomes, or problems in credit histories.

In contrast to conventional banking practice, Self-Help identifies weaknesses in a loan application, and to the extent possible, helps the applicant to address them. Loan officers often suggest a variety of ways in which borrowers can improve their applications. Self-Help actively seeks the assistance of government business and mortgage loan programs to reduce risks. It has packaged its loans with Community Development Block Grants, Small Business Administration guarantees and debentures, local government revolving loan funds, and Farmers Home Administration Business and Industry programs.

Direct lending plays only a limited role in solving economic problems. Certainly Self-Help, by lending $10 million a year, or even $100 million a year, will not eliminate poverty in minority families. Self-Help sees itself as a laboratory for economic opportunity, testing new development concepts, strategies and programs, casting aside those that don’t work and refining the ones that do. By setting an example for change in public economic development programs and private banking, Self-Help can advocate for larger institutional changes with greater significance in the fight for economic opportunity and justice.