PARTNER CONTENT

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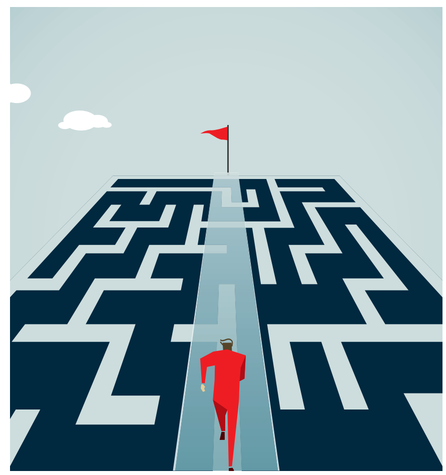
Creating New Pathways to Capital

by Robin Brulé & Alvin Warren Summer 2019

Inequity continues to plague the lending industry, but a microlending program in New Mexico has created a solution that is providing underserved communities the capital they need.



Despite many honest attempts to address inequity in the lending industry, the barriers to accessing capital for business owners in low-income and marginalized communities persist.

Entrepreneurs from underresourced communities often lack the credit scores or collateral to secure the capital they need. Those who are "unbanked" (particularly members of low-income and immigrant communities, as well as communities of color) often distrust and are unfamiliar with the formal financial system. Low-income and marginalized business owners often turn to informal lenders in their neighborhood who offer high-interest, small-dollar loans (under $10,000), many of which come with costs and terms that trap borrowers in a cycle of debt.

Lack of access to capital not only prevents business growth but also perpetuates cycles of intergenerational poverty and racial inequity that affect families and communities at all levels. To address these problems, equitable, culturally adept lending needs to become the norm, not the exception. By building partnerships between financial institutions and community organizations, we can transform who gets access to capital and how, and thereby accelerate progress toward a more equitable future. We know this from a proven track record of success in New Mexico.

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Redefining Creditworthiness

The Land of Enchantment is a diverse state: The majority are people of color; it is home to 23 Native American pueblos, tribes, and nations. Its private sector economy is based largely on owner-operated small businesses. In this context, community development financial institutions (CDFIs) and alternative lenders have been formulating solutions aimed at expanding access to affordable capital.

According to a 2017 report in the *Santa Fe New Mexican*, payday lenders in the state outnumber fast-food restaurants, and the small-dollar loans they offer come at an extremely high cost. New Mexico regulation and licensing officials have found that interest rates on title loans from such lenders average 238 percent and can even surpass 450 percent. Business owners who borrow from them are often scarred by the experience.

To create an alternative financial system in New Mexico that supports underserved communities, Nusenda Credit Union is working with the W.K. Kellogg Foundation; the Albuquerque Community Foundation; the McCune Charitable Foundation; and local, community-based organizations through City Alive, a collective-impact initiative focused on entrepreneurship. The relationship- based, community-circle microlending program, called Co-op Capital, transcends the formulas typically used for eligibility.

With Co-op Capital, the decision of whether someone should receive a loan shifts from the lending institution to partner organizations—such as nonprofits, community groups, and educational institutions. This approach widens the pathway to capital because underwriting does not have to rely on the usual "5 Cs of Credit": character, capacity, capital, collateral, and conditions. Organizations have discretion over their lending criteria and application, and entrepreneurs have more access to business resources.

Traditional lending practices, which focus on assets and credit histories, exclude many low-income people and people of color. Research published in the *Journal of Consumer Research* in 2014 looked at minority versus nonminority treatment for business loans. The study found that even though the entrepreneurs wore the same clothes, asked for identical loans to expand identical businesses, and had nearly identical backgrounds, loan seekers who were people of color were given less information on loan terms, were asked more questions about personal finances, and were offered less application assistance by loan officers.

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Co-op Capital targets these proven biases by asking two questions: Would trust between an organization and a "high risk" borrower make it possible to overcome the persistent barriers that keep many business owners of color or of limited means from accessing the capital they need to be successful and grow? And would flexible criteria for creditworthiness and terms be sustainable for the lender?

The program, which has been active for seven years, has loaned more than $675,000 in low-interest capital to more than 370 borrowers. The interest rate has averaged around 5 percent, and loan amounts range from $400 to as much as $27,000—averaging a little more than $1,800 each. These loans have a default rate of only 1 percent; by contrast, the industry average is 2 percent.

In addition to increasing access to capital, this approach builds creditworthiness and addresses a large population of unbanked and underbanked individuals. As loan payments are made, the "bankability" of low-income individuals is demonstrated and positive credit is reported. Individuals who utilize Co-op Capital become members of Nusenda Credit Union, which provides them with a financial home—often for the first time in their lives.

Conscious Criteria

People who are unbanked or underbanked need guidance, but so do financial institutions that ignore underserved communities. Financial literacy and cultural competency are almost always siloed—with the former housed in credit unions, banks, and other financial institutions, and the latter housed in community organizations. Co-op Capital makes equitable, culturally adept lending possible by bringing community organizations directly into the process.

Partners in the Co-op Capital program—whether a nonprofit, community organization, or educational institution—set their own guidelines. Partners begin their assessment first by evaluating the loan requests of prospective borrowers and determining their eligibility. Then the partner determines the appropriate size of loan based on the borrower's needs and likelihood of successful repayment. Nusenda provides loan origination and IT support, and convenes peer-to-peer cohorts to share best practices for successful repayment. Nusenda charges a 5 percent annual percentage rate (APR) interest. The partner provides Nusenda with 10 percent collateral to secure the loans. Loan payments must begin within nine days, and repayment terms range from 12 to 180 months.

The Co-op Capital program applies three basic criteria to ensure success:

1. Outreach and screening community organizations for fit. Peer-to-peer lending is complex. When lending to borrowers who are considered by traditional lenders to be too risky, it becomes even more crucial to find community organizations that value the program's transformational—not just transactional—potential for their communities. When community organizations champion the financial stability of their communities; are willing to take calculated risks; and demonstrate deep, long-term relationships with potential borrowers, their loans are more likely to be paid in full and on time.

Communications research on environmental issues has shown that tapping into people's desire to have a positive impact on future generations can prompt them to act in the near-term.

2. Building financial literacy and an effective lending process. After preliminary screening, Nusenda supports the community organization in building a custom application and review process. Together the credit union and community organization design a review board responsible for approving loans. The review board determines comfortable loan terms, defines interest rates and repayment timelines, and establishes the process to evaluate loan requests. Assessing "creditworthiness" in the absence of traditional definitions requires building new criteria that balance risk and social impact.

3. Patient capital and targeted grant support. Community organizations need to take new risks, which require a supportive environment. Nusenda and the W.K. Kellogg Foundation have paired program-related investments (PRIs) and a traditional grant to reduce barriers to entry for community organizations. First, the PRI secures the bulk of the loan. The PRI provides the partner organization with 90 percent of the resources needed to back the loan, and the community organization puts down 10 percent collateral. This structure reduces the barrier to entry for prospective community organization partners while still effectively sharing risk. Second, the traditional grant supports capacity building, particularly by providing organizations access to specialists to help recruit and support partner organizations interested in integrating low-interest loans into their efforts.

With funding from the W.K. Kellogg Foundation, the program now includes a cohort of nine community-based nonprofit organizations in New Mexico that are distributing loan funds to support local entrepreneurs, especially businesses owned by lower-income people of color and businesses in tribal communities. These organizations include the Family Independence Initiative, which focuses on increasing economic mobility in low- income communities, and Native Capital Access, a Native-led CDFI that serves Native American business owners.

Significant opportunity exists to adapt and expand the use of this model nationally to help serve the many business owners who are shut out of the traditional financial system today, and put them and their businesses on a path to prosperity. Co-op Capital has been proven to work at scale, bridging the gap between the deep relationships of community-based organizations and the business expertise of financial institutions. When it comes to addressing cycles of intergenerational poverty and racial inequity, no single organization, program, or state can do it alone. We hope that innovative approaches like this one, which has applications that are relevant throughout the lending industry, can take hold across the United States and build better conditions for everyone to succeed.

Robin Brulé is a large-system service designer with a proven track record of mobilizing cross-sector partners to improve outcomes. She is the senior vice president of community relations at Nusenda Credit Union, an Annie E. Casey Foundation Children and Family Fellow, and chief strategist of City Alive.

Alvin Warren is a program officer for the W. K. Kellogg Foundation and has helped lead City Alive since its inception. A member of Santa Clara Pueblo, he is a former New Mexico Cabinet secretary of Indian affairs and lieutenant governor of Santa Clara Pueblo.