CREDIT AND HOMEOWNERSHIP

*Vermont Development Credit Union**

The Challenge

To paraphrase Henry Thoreau, most poor people live "lives of quiet desperation" over the persistence of their poverty and lack of opportunity, and the hopelessness it breeds. In his book, *Assets and the Poor,* Michael Sherraden argues that persistent poverty reflects a lack of any financial base upon which to build a future. Existing policies that attempt to combat poverty fail to address this problem. Instead, they deal with symptoms and not the fundamental cause.

We lack the infrastructure for the poor to obtain fair and affordable financial services.

Policy interventions, especially through the tax system, do a good job of providing the middle class with wealth-building tools, providing a climate for self-help as people follow their own goals. Together with a competitive banking system, this creates an infrastructure that leverages individual motivation and capital to achieve private as well as public objectives. By contrast, policy interventions for people of low wealth consist of a top-down structure typically delivered via income/eligibility testing, grants, and entitlement programs. This approach perpetuates dependency and is compounded by continual shortage of funds, since the public sector and private philanthropy can never meet the total "need."

The underlying assumption of these policies is that poor people cannot be trusted to set their own goals and that government must do it for them. In addition, we lack the infrastructure for the poor to obtain fair and affordable financial services—what former Treasury Secretary Lawrence Summers called the "passport to the modern economy." Many

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social problems—poor housing conditions, lack of education and training, limited work and income opportunities, and family instability—find roots in this lack of fair and affordable financial services.

An estimated ten million families do not have an insured account with a depository financial institution and cannot begin to conduct basic transactions or build wealth through savings and market-rate borrowing. While the middle class and wealthy enjoy tax and other incentives to save and invest in home ownership and retirement assets, those with minimal or negative wealth lack opportunities or incentives to save and invest. Mainstream financial institutions increasingly target their services to higher-income clients, reducing "high-touch" services and charging higher fees and interest rates to those whose balances do not meet mechanically determined norms.

Credit and Homeownership

In our complex modern economy, where full participation requires the ability to finance major assets such as education, vehicles, and homes, the ability to borrow well has become an essential component of wealth building. Bank modernization, with its high fees and computerized credit scoring, increasingly cuts off people of low wealth from market rate credit. This drives them into the arms of the exploding predatory lending industry, where high interest rates and loan fees structured so as to make repayment impossible drag families into a downward spiral of negative wealth, anxiety, and hopelessness.

Solving these problems requires changes in both our public and financial infrastructures of policies, programs, and agencies and our financial infrastructures of banking and financial insitutions. It is the latter challenge we are addressing at the Vermont Development Credit Union (VDCU).

The Invention

A financial services toolbox for underserved populations.

The Solution: Getting the Idea to Fly

A Community Development Credit Union (CDCU) combines the structure of a depository financial institution with the social mission of a nonprofit. It requires the skills and resources of both.

Although social mission dominates its purpose, a CDCU is structured as a banking cooperative operating in the marketplace. Like any credit union, it offers an array of financial products and services, is owned by its member-depositors, and is closely supervised in all aspects of its operations and governance by state and/or federal regulatory bodies. It is much more complicated to create than a traditional nonprofit organization, and like any start-up business it demands time, commitment, and a sound business plan.

The business plan must be based on market research, including surveys, that confirms the need and identifies the size, locations, and profiles of targeted populations. In the case of VDCU, the need was confirmed by survey responses of nonprofit and social service organizations through-

ABOUT VERMONT DEVELOPMENT CREDIT UNION*

Vermont Development Credit Union was founded in 1989 by Burlington Ecumenical Action Ministry (BEAM) to bring capital and financial services to low-income Vermonters. Through direct loans to individuals and families, VDCU helps turn hope into opportunity and create wealth. Loans ranging from $50 to over $100,000 enable Vermonters to attain home ownership and better jobs, acquire education, and build small businesses. Affordable banking and saving services also assist underserved populations in achieving their financial goals. Nonprofit, member-owned, and federally insured, Vermont Development is the "bank" of choice for thousands of working families, women, immigrants, small businesses, students, seniors, and ordinary Vermonters. VDCU has 12,000 members in 205 Vermont towns and made 2,237 loans in 2003 totaling $29 million.

A significant growth in demand for VDCU's products and programs demonstrates the need for financial services among Vermont's low-income population. In 1990, its first full year of operation, the organization loaned $235,000. During its 15 years of operation, VDCU has loaned over $100 million. Each year VDCU provides tens of thousands of fair and affordable banking transactions in the form of check cashing, money orders, and electronic transfers. VDCU's success is attributable to its trademark counseling-based lending program and sound financial management. VDCU is helping to create a fair and affordable banking system for thousands of Vermonters. * VDCU is Opportunities Credit Union as of January 2005.

out Vermont. We later directly surveyed low-income populations and conducted focus groups with people of low wealth. These provided information about current financial habits, the degree, if any, to which this population used mainstream institutions, reasons why they did not, and the hierarchy of their financial services needs. Focus groups also provided useful information about the range and types of their financial problems as well as geographic and other capital access barriers.

The business plan must include detailed financial projections. Balance sheet, income statement, start-up funding, and cash-flow analysis must demonstrate that you have sufficient equity capital, operating capital, and deposits, and show how and when the organization will achieve a break-even level of operation. You must design your basic financial products, including their pricing. You must analyze what mix of services will work, and decide what location, hours, and format you will offer. Your marketing plan should show how you will reach the targeted population. Your business plan must show how your CDCU will become financially self-sustaining, with adequate interest, loan, and fee income to cover operating expenses. CDCUs must consistently demonstrate safety and soundness to their regulators.

Credit and Homeownership

The fact that a CDCU is a regulated institution adds another layer of complexity to the business plan: the need to obtain a state or federal credit union charter and National Credit Union Administration deposit insurance. You should pursue these accreditations in tandem, using your business plan to demonstrate that you have the resources, expertise, policies, and legal structures in place to meet regulators' requirements. Once you receive approval, the regulators will designate your CDCU as a "low-income credit union," requiring that at least 50 percent of your projected members earn 80 percent or less of the area median income. This designation allows your CDCU to accept deposits from nonmembers and make use of a special form of long-term subordinated debt (Secondary Capital) to build your equity base.

By their nature CDCUs do not make large profits, so they cannot finance all of their growth internally. Some "high mission" services will not pay for themselves. As a result some level of assistance will always be needed to support the full expression of your organization's mission and growth. The preferred solution to this need will be to create or ally with a dedicated 501(c)(3) nonprofit partner. This nonprofit should undertake the planning and fundraising necessary to expand your capital base, finance new projects, and perhaps offer directly some services such as education and community development programs that are not, by their nature, self-supporting.

Your business plan should determine the order in which services are introduced. Lending will be the engine that supports growth. Be aware that the basic banking service of a teller station—deposits, check cashing, money orders—is not a money-maker and must be managed judiciously from the start. Begin by offering affordable personal loans for vehicles, education and training, household equipment, and family and personal needs. There is good demand for these loans and, provided you make them safely and efficiently, they will generate profit to offset the losses from the teller station. After you become confident and successful at the basic operations you can add to your lending mix. Home improve-

ment loans, affordable mortgage loans, and business loans all have high social impact and market demand, but are considerably more complex.

Systems and information technology play a much greater role in a depository financial institution than in a typical nonprofit. You will need to purchase a real-time data-processing system specifically designed for credit unions or contract with a service bureau for such a system. Your regulators will require you to have detailed, written policies and procedures for every aspect of operations and management.

Board members or volunteers from the mainstream financial services industry can assist you, but knowledgeable staff must be the mainstay and provide leadership. You will need to supplement traditional banking expertise with a methodology that serves your target population soundly and cost-effectively. Seek help from successful community development credit unions and banks as well as their national trade associations, but adapt it to your special needs and target population.

Credit and Homeownership

Funding your CDCU will require three kinds of money: net capital (equity), deposits, and operating funds. "Net capital" or equity is money that belongs to the credit union free and clear of any obligations. This net capital protects it against loan losses and negative operating performance. As the credit union grows, net capital must keep pace. VDCU attempts to maintain a minimum ratio of net capital to total capital of between 10 percent and 15 percent. By this measure, a $1 million credit union should have $100,000 to $150,000 in net capital.

Deposits are savings accounts, money market accounts, and certificates of deposit provided by members and social investors. These federally insured investments are the main sources for lending. Deposits from social investors for community development purposes create a powerful tool. With net capital of $100,000 and a 10 percent net capital ratio, a CDCU can attract an additional $900,000 in deposits and build a $1 million loan fund.

A start-up CDCU must acquire sufficient operating funds to cover the early period when costs outstrip income. These funds must be in addition to its net capital. Your business plan's financial projections will show the amount you will need.

The best sources of start-up funds are local foundations and private donors. Some states have public funds designated for community economic development activities. Regional and national banks may be a source through the incentives given them by the Community Reinvestment Act. As a form of a Community Development Financial

Institution (CDFI), your CDCU can become certified by the U. S. Treasury's CDFI Fund (www.cdfifund.gov), making it eligible to apply for technical assistance funding for start-up activities. There are also some national "intermediaries" including trade associations that may be of help. Once your CDCU becomes certified by the Treasury Department you become eligible to apply for financial assistance from the CDFI Fund, which provides awards on a 1-for-1 matching basis. A small number of states also have their own CDFI funds. Find out what funding CDFIs are eligible for in your state.

Throughout the country, there are still only a very few "social mission depositories," such as community development credit unions or community development banks, in existence. You should find out whether one exists in your region before starting out on this challenging, but rewarding, journey.

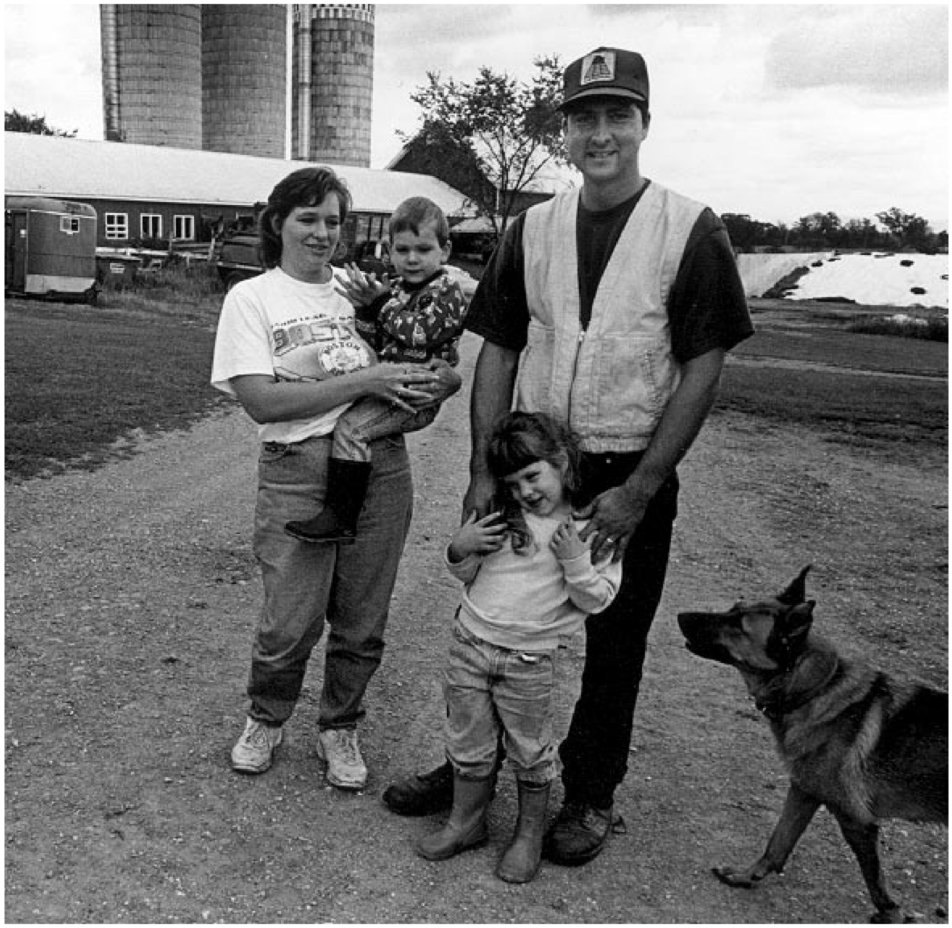
Measuring and Adapting: Did It Fly?

A CDCU must constantly assess its performance as a financial institution and a social mission organization. This requires measurement in multiple dimensions, including: (1) financial safety and soundness; (2) population and communities served; (3) volume of services provided; (4) economic and social impact; and (5) operational yield and productivity.

Management, the Board of Directors, and external regulators ensure the financial soundness of the credit union by continuously monitoring statistics like interest rate spread, liquidity, delinquency, and net capital ratio. Assemble an Asset and Liability Management Committee to examine forward commitments and associated interest rates on both sides of the balance sheet.

Measurement systems should gather and track information about the population using your services. This information will help you manage and grow your CDCU. However, the CDCU may not have the time or expertise to develop or implement these measurement systems. This is where partnership with a local college or university can help leverage time and money. Researchers often need to conduct analyses using pragmatic examples. For researchers interested in consumer finance, CDCU data provide a golden opportunity. A university partner can help a CDCU think through what information it should collect from its members and how the measurement system should be set up to make the data most useable.

Credit and Homeownership



Research partnerships can also add value when it comes to analyzing output and social impact data. Such analysis may help you obtain funding and communicate how CDCUs add value to people's lives. At the very least, you will want to track the number and dollar value of the services you provide. These "output" figures are a first approximation of your community impact. You can also use them to compare your performance to that of other CDCUs and CDFIs. Measuring social impact is not easy, and different CDCUs will choose different indicators in this area. Among the social impact factors which interest funders are "banking the unbanked," building wealth, first-time homeownership, job creation by small business, serving minorities, and providing affordable alternatives to predatory lending.

Your management team should develop its own internal measures of yield and productivity to aid in budgeting and directing resources. As a measure of productivity, you may track the number of loans closed compared with the number of applications and inquiries received. As your organization grows, you will be able to compare productivity among types of loans and services.

Make sure what you measure is helpful in pursuing your mission. While it requires discipline, gathering key data and information consistently over time will guide your growth and priorities. Review your performance monthly, or even weekly. Each year, establish "stretch objectives" for key indicators that move your CDCU toward its mission.

The Ripple Effect: Expect it and Encourage it

As your CDCU becomes established, seek opportunities to leverage your work through partnerships. Your CDCU can be a powerful partner for traditional nonprofits by bringing wealth-building financial tools to common constituencies. Combining your financial resources and unique wealth-building expertise with nonprofits' specific knowledge of their clients will create exciting opportunities for the nonprofits, their clients, and you. Here's an example: Vermont's community action agencies granted $250,000 to VDCU to make loans for the purchase of used vehicles by their clients who were moving from welfare to work. VDCU had the necessary understanding and lending expertise to make these loans successfully and could leverage the $250,000 grant with deposits to commit up to $1.25 million for this program. To date approximately $1 million has been loaned for this purpose.

At another level, you will eventually be able to partner with institutions such as the Federal Home Loan Bank, the Small Business Administration, Department of Housing and Urban Development, and Fannie Mae. These institutions are under federal mandate to seek partnerships with community-based financial institutions and will enable you to bring powerful financial resources and add sophisticated funding products to your target population.

Over time, a long-term, mutually respectful relationship with your target low-wealth population will enable you to advocate for their needs, influencing policy in such areas as predatory lending, affordable housing, and small business.

Caution

To succeed, you must do more than simply open your doors. You must develop effective methodologies to control delinquency among an economically fragile population and to serve this labor-intensive market efficiently. Vermont Development Credit Union's counseling-based lending system identifies and supports credit-worthy borrowers who do not pass standard credit tests, and keeps tight control of costs. The latter is especially important with such services as the teller station and financial education that will require permanent cross-subsidy or grant support.

Your CDCU must be market-based, providing services your target population finds useful and is willing to pay for. Be aware of the anxiety and apprehension many low-income people bring to their request for assistance with financial matters. They may feel guilt and shame over their lack of resources. Therefore, a culture of respect must pervade your organization. This is as important as the services you provide. Recognize also that sustainability depends on achieving a balance in membership and services by marketing across the entire spectrum of low- to moderate-income households.

Credit and Homeownership

Working harder and earning less can be stressful on your staff. Train and support those who are committed to the mission and reinforce the satisfaction they gain from their work by creating logical salary structures, effective evaluation systems, and open communication.

Summary

This country needs a social-mission banking system for its low-wealth population. Vermont Development provides a model. Our growth, as high as 40 percent a year, shows no sign of abating and is accompanied by a highly positive impact on the lives of our members, as verified through independent research. Further evidence of this need comes from national research and from such works as Sherraden's *Assets and the Poor.* The demand for fair and affordable financial services is huge and growing. The field is wide open, but be prepared for fast growth and the managerial, financial, and human demands that are its inevitable accompaniment.

GLOSSARY/RESOURCES

Community Development Credit Union (CDCU):
A credit union with a community development mission. Typically, CDCUs serve a low-income community or population.

Community Development Financial Institutions (CDFIs):
Specialized financial institutions that provide credit and community development services to low-income individuals and/or distressed communities. CDCUs are just one form of CDFI; others include revolving loan funds and community development venture capital funds.

CDFI Fund:

An agency of the U. S. Treasury created in 1994 to expand the availability of credit, investment capital, and financial services in distressed urban and rural communities by stimulating the creation and expansion of CDFIs. The CDFI Fund certifies CDFIs and administers grant and tax credit programs.
www.cdfifund.gov

National Credit Union Administration (NCUA):

Independent federal agency that charters and supervises federal credit unions. NCUA operates the National Credit Union Share Insurance Fund (NCUSIF), insuring the savings of 80 million account holders in all federal credit unions and many state-chartered credit unions. NCUA also gathers, analyzes, and publishes credit union financial data.
www.ncua.gov

National Federation of Community Development Credit Unions (NFCDCU):

An association of 200 community-development and low-income credit unions.
www.natfed.org

National Community Capital Association (NCCA):

A national association of CDFIs, including many leading CDCUs.
www.communitycapital.org

Sherraden, M. *Assets and the Poor: A New American Welfare Policy.* New York: M. E. Sharpe, 1991.

Vermont Development Credit Union:

www.vdcu.org