Key Findings

BLUEPRINTS FOR INNOVATION

Denise R. Gabel

Chief Innovation Officer,
Filene Research Institute

filene

IDEAS • INNOVATION • IMPLEMENTATION

Key Findings

BLUEPRINTS FOR INNOVATION

Early 2011

Ready to implement

INTRODUCTION

HOW TO HELP MEMBERS…

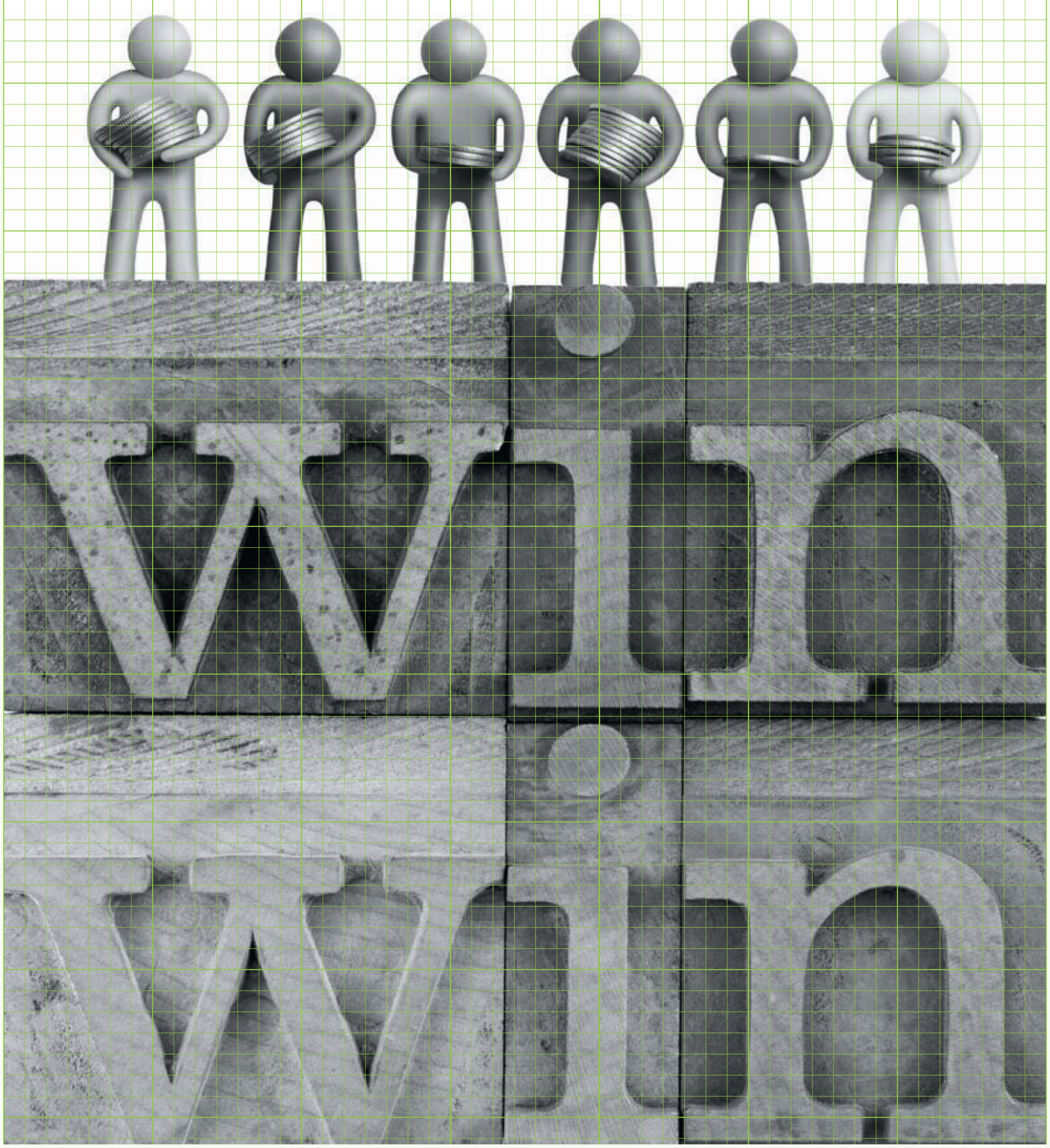
ADDITIONAL RESOURCES

**Currently calling for pilots*

filene

IDEAS • INNOVATION • IMPLEMENTATION

A SHARE-SECURED FINANCING SOLUTION



BLACK STAR

THE OPPORTUNITY

The brewpub Black Star Co-op (Austin, TX) had a problem. To get their space built out and open to the public, while anticipating cash flow challenges during the first months of operations, the pub and brewery needed financing. Soon. Even after two rounds of fundraising through member-investor shares and a bank loan for equipment, they anticipated a need for a line of credit to carry them through unexpected liquidity crunches. But they found, as have many cooperatives, that lending institutions struggle with financing their ventures.

U.S. credit unions, seemingly a natural source for cooperative financing, have only done so on a limited basis. Restrictions capping business loans at 12.25% of assets have resulted in credit unions holding only 5% of all small business loans. Credit unions are asking Congress to raise the cap to 25%, which, according to CUNA chief economist Bill Hampel, would make $25 billion in loans available over three years.[1]

Further, lending institutions in general have a hard time fitting a cooperative entity into their standard lending practices. An article in the Canadian monthly newspaper *The Dominion* does an excellent job of describing the gap between lenders and co-ops:

> "Securing financing is a challenge for any new business, but if you happen to be a cooperative it's particularly difficult," says Lynne Markell, Government Affairs Policy Advisor with the Canadian Co-operative Association (CCA). "Traditional lenders don't understand co-ops and there is a large dependence on members to provide the initial capital."

Traditional lending institutions seek applicants that are low-risk, high-return. Formally or informally, lenders impose a set of conditions upon those seeking financing to ensure they are a "desirable" investment. By requiring a particular kind of business plan, management structure, or certain profit margins, lenders can influence cooperatives seeking financing to conform with traditional notions of how businesses are run. What is desirable from the perspective of the lender may not be desirable for the cooperative members, or the values they are trying to maintain.

Cooperatives seeking to build an organization that redistributes resources and decision-making to their members or their community are faced with the awkward situation of seeking funds from institutions that will steer them towards values opposed to their own.[2]

1 *USA Today*, Credit Unions: Lift Cap on Small-Business Loans, March 1, 2010, http://www.usatoday.com/money/economy/2010-03-01-creditunions27_ST_N.htm.

2 *The Dominion*, Financing the Cooperative Movement For Better or Worse? April 5, 2010, http://www.dominionpaper.ca/articles/3270.

THE SOLUTION

The answer for Black Star was to find a way to structure the financing that would reduce the lender's risk while ensuring the co-op got the funding it needed through a share-secured line of credit at a credit union. Secured lending isn't new, but the twist is that the shares (certificates of deposit) pledged belong to the co-op's members. Here's how it works. A co-op member joins a credit union and opens a certificate at the current market rates. The deposited funds are then designated as collateral for the co-op's line of credit. The member accepts and signs a disclosure that their funds on deposit would be at risk if the co-op were to default on their loan.

Interesting – individuals putting up their money to build their own cooperative – like a member share at a credit union!

BLACK STAR CO-OP AT A GLANCE

Black Star set out to be the nation's first cooperatively owned brewery and pub, establishing an alternative business model for brewpubs and helping to expand the cooperative movement into new and innovative areas. After years of planning, hard work, and fundraising, it marked its grand opening on December 10, 2010 following a soft opening in September. To date it has over 2,500 members and it has raised more than $475,000 in member-investor shares.

What if credit unions could grow members at the same pace as their cooperative counterparts do?

MARKETING

There are two specific target markets for this product:

1. Cooperatives, either established or in a start-up capacity, that would secure financing from their credit union with support from their co-op member-owners.
2. Cooperative members as a continuation of their investment in the financial operations of the cooperative. Pledging funds for their cooperative should make it possible for the cooperative to borrow at a less-than-prevailing interest rate, resulting in lower operating costs.

The share-secured loan would be promoted to both groups via the credit union website as well as with in-branch signage and promotional materials. Direct networking with cooperative leaders is also an important strategy.

OPERATIONAL AND OTHER CONSIDERATIONS

The major operational issues are focused on the ability for the credit union to have:

- Data processing and/or record-keeping systems to accommodate pledging of one member's shares to another's loan.
- Staff adequately trained to provide education to both potential and existing members as well as those managing the cooperative to explain and cross-sell the product.
- Lenders fully prepared to handle the disclosure to the cooperative member placing funds into a term deposit and the risk associated with potential loan defaults.

PROOF OF CONCEPT

A test was launched with Black Star and A+ Federal Credit Union ($810 million, Austin, TX) with the idea of a share-secured line of credit. The concept was familiar as A+ currently offers share-secured loans to its members. Credit union chief executive officer Kerry Parker and senior vice president of lending (and new i³ member) Sharon Gaugler came to believe that structuring the cooperative loan in this fashion would sufficiently reduce the risk to the credit union for a loan that ordinarily would be a challenge to the credit union's underwriting criteria.

Gaugler and her team prepared the disclosures and loan product details with the appropriate legal and compliance reviews, met with Black Star representative Steven Yarak to work out the terms of the line of credit, and began the effort to offer the CD product. Black Star has been accepted as a select employee group of A+, and product discussions are continuing.

Additionally, Melissa Hoover, executive director of the United States Federation of Workers Cooperatives (USFWC), has expressed interest in options to market the CD-secured line of credit for other cooperatives nationwide.

MEMBER BENEFITS

- Connects cooperative members with credit unions that support and share cooperative principles.
- Contributes to the success of a cooperative that they support and patronize.

CREDIT UNION BENEFITS

- New member growth through members of the cooperative, as well as the cooperatives' business accounts.
- Increased deposits and loans.
- Fee and interest income.
- Reduced lending risk for the line of credit with the co-op CD as collateral.

GETTING STARTED

1. Visit **www.why.coop** to find cooperatives located in your credit union's field of membership and contact to build relationships. Why Co-op? is a collaborative website that connects cooperatives of all sectors. This i³ idea is currently under development with support from the National Cooperative Business Association (NCBA) with an expected launch date in early 2011.
2. Modify underwriting criteria and loan disclosures as needed.
3. Develop and implement staff training and marketing plans.

» **Visit http://filene.org/home/innovation for more information.**

BLACK STAR

C.J. Meyers, Teachers Federal Credit Union, Farmingville, NY; Yolanda Draine, First South Financial Credit Union, Bartlett, TN; Steven Yarak, Black Star Co-op, Austin, TX; Dawn Collins, Mt. Lehman Credit Union, Mt. Lehman, BC; Charlie Roberts, State Department Federal Credit Union, Alexandria, VA

ideas grow here

PO Box 2998
Madison, WI 53701-2998
Phone (608) 231-8550

www.filene.org

Publication #231 (1/11)
ISBN 978-1-936468-10-2

filene

IDEAS • INNOVATION • IMPLEMENTATION