

To: CDFI Advisory Board
From: Michael Swack, Director, Center for Impact Finance, Carsey School, University of New Hampshire
Date: August 25, 2020
Re: Three wishes issues to build/scale the CDFI field

If I was granted 3 wishes on **how the CDFI Fund could help build the field**

But first, some very brief background:

In general, the research shows that while CDFIs are much more "progressive" than banks in how they distribute resources. That is, CDFIs do a good job of targeting underserved neighborhoods and borrowers and serve borrowers not served by conventional lenders and financial markets. However, CDFIs represent a tiny share of the capital flows in any given community. For example, in 2017, banks reported making \$146.3 billion in small business, non-farm loans under \$100,000 (CRA). Data from the CDFI Fund indicates CDFIs made \$181 million of small business loans under \$100k, less than 1% (about 0.12%) of the bank lending activity. There is some microlending activity excluded, so arguably CDFIs are doing better than that, but in no way are they a significant market share, even when you look just at the smaller loans. For 2018 the numbers improve slightly, mostly because of a decline in bank lending, to 0.27%. So there continues to be a real need for the field to scale. This is consistent with the large scale studies we did of the CDFI field in 2012 and 2015. (See <https://scholars.unh.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1165&context=carsey> and <https://scholars.unh.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1235&context=carsey>)

Three Wishes

Wish #1: Invest in building and funding an infrastructure to support all CDFIs, particularly smaller, rural and Native CDFIs.

Kirsten Moy said it over 15 years ago in her paper for the Aspen Institute, "New Pathways to Scale for Community Development Finance" (https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/12_2004_pnv_new_pathways_to_scale.pdf)

An industry of small, place-based institutions with limited resources cannot be expected to scale-up solely through the growth of individual organizations. The CDFI industry is composed primarily of small-scale organizations with only a handful that have grown to a large enough size to exert influence in their local or regional markets. And none are of sufficient size to influence the market on a national level or to serve as the industry driver.

If the CDFI industry is going to pursue scale, industry structure becomes more important to that process...paying attention to scale effects at the industry level would support greater delivery of product and thus impact, by focusing the field on investments in standards and infrastructure that improve the efficient delivery of a range of development financial services across all organizations in the industry. Building organizational and industry infrastructure will ultimately enable product delivery at larger volumes (CDFI industry notion of greater scale) producing a more powerful impact.

This is perhaps more true today than it was back then. The CDFI Fund, in order to support the range of CDFIs, particularly smaller and rural CDFIs, should invest in the field by helping to develop or fund an

operating platform for CDFIs.

CDFIs need to grow pipelines and serve more people – and focus on lending and providing technical assistance to borrowers. CDFIs should be spending less time and money on developing documentation, compliance, standard audits, HR, job descriptions and more. Building this type of operating platform would be much easier today than it was 15 years ago. A great example of this type of platform is the childcare platform developed by CCA Global Partners. Started in 2009, this platform now serves over 25,000 child care centers (very marginal businesses!) providing them with tools and assistance on everything from budgeting tools, reporting (including meeting various state compliance requirements), audit assistance, HR, job descriptions and more. The savings to individual child care providers is significant and they can focus more on educating children! The CDFI Fund should invest in building infrastructure. Make it easier for small CDFIs to focus their efforts on lending. The cost of building an industry platform would be relatively small, compared to the improved quality and efficiency of operations for hundreds of CDFIs.

Wish #2: Build balance sheets and build equity – find sources other than CDFI Fund. The CDFI Fund could invest in equity instruments that would leverage private sector equity investment in CDFIs – including non-profit CDFIs.

Today, access to equity capital is a big problem for CDFIs and it is limiting the ability of the field to grow. Equity is typically sourced through grants. Grant money to the CDFI field is very limited and is very dependent on public sector funds, particularly the CDFI Fund. In addition to anecdotal data from several CDFIs about the need for equity, we reviewed the most recent data from Aeris, the CDFI rating agency:

1. Net asset and leverage ratios for all CDFIs reporting to the Aeris Cloud from the 5 years from 2013-2017; and
2. Total assets, net assets and leverage ratios for CDFIs > \$100 mil in assets from 2013-2017.

In both cases, net asset ratios have declined over the last five years, while leverage ratios have increased, supporting our hypothesis. Additionally, many CDFIs have directly reported to us that they are capital constrained. A group of those CDFIs has agreed to participate in this project (see below.)

Obstacles for CDFIs in obtaining equity

1. Non-profits generally are not structured to obtain equity. A major barrier to entry is that nonprofit CDFIs cannot issue dividend-paying ownership shares.
2. Capital market investors are looking for asset, revenue and or surplus growth in the investments they make. Non-profits also do not produce a consistent level of (a) growth; or (b) surplus that together provide the cash needed to pay dividends.
3. Most CDFIs are too small—and are likely to remain too small—to access the capital markets on their own.
4. Investors, who are largely unfamiliar with CDFI organizational risk, are unlikely provide equity at a price commensurate with the risk.
5. CDFIs are reluctant to seek debt or equity in the capital markets because it appears to be more expensive than grants and other subsidized funding.
6. CDFIs do not want to compromise relationships with local banks and institutions that provide the subsidized funding.

Our Center is currently working with 10 CDFIs and several potential investors to develop a basic model to attract equity investment to CDFIs. Investment by the CDFI Fund into instruments like this could bring significant new private equity to the field.

Solutions

1. Portions of CDFI activities do in fact generate sufficient growth and surplus to attract private sector capital, and if they can be structured properly and amalgamated, they can be financed with private sector funds that are long term, flexible and plentiful, and offer *accurate* risk-adjusted rates of return.
2. Potential equity sources in the capital markets are comparatively more expensive than grants or other forms of subsidized funding. However, the cost of grant restrictions, and the cost of fundraising are often excluded from these comparisons. To make the comparisons accurate, they should be included.
3. Any capital market solution must also promote continued financial and resource support from the CDFI Fund, local banks and other institutions.

Wish #3: The CDFI Fund should provide guarantees to help CDFIs access long-term, fixed rate affordable capital – through, for example, the Federal Home Loan Bank (FHLB).

The Fund can help address the liquidity issue faced by many CDFIs— an asset liability management issue. CDFIs are constantly trying to fund long-term needs with short term money. The CDFI Fund could consider using guarantees, a low cost way to help CDFIs access the type of money they need. CDFIs could get long term funds with guarantees from the CDFI Fund. For example, CDFIs can be members of the FHLB, but typically don't have "appropriate collateral" to access the low-cost, long-term, fixed-rate funds offered by the FHLB. If Fund could offer guarantees to support CDFI access to FHLB funds that could significantly benefit CDFIs. Again, this would be a relatively low cost to the CDFI Fund, with very high returns to CDFIs and the communities they serve.