Native CDFIs: Access to Debt Capital Investments

In August, 2012, First Nations Oweesta conducted a survey of certified Native CDFIs – a 71-entity pool as of June 30, 2012 per the CDFI Fund. The participation rate of certified Native CDFIs was noteworthy, with 39 or 55% responding. The respondents reflected the full spectrum of the Native CDFI field. Entity types included financial institutions, nonprofit and for-profit loan funds, credit unions and one Business and Industrial Development Corporation. Length of operations ranged from one year to 105 years. Total assets ranged from $500,000 for a nonprofit loan fund to $110 million for a financial institution. Annual operating budgets ranged from as little as $50,000 for a small loan fund to $6 million for the BIDCO.

Nonetheless, it appears that Native CDFIs have limited opportunities to access debt capital. Only one-third or 13 of the 39 respondents have borrowed loan capital and the primary source was Oweesta (ten of the 13 that have secured Oweesta loans). Unlike many of their non-Native counterparts, only six Native CDFIs, or 15.4% of the respondent pool, have accessed debt capital from banks and/or foundations. Only four survey participants have borrowed capital from a bank and only five have received a foundation Program Related Investment (PRI) or loan.

Native CDFIs' limited use of debt capital investments required further exploration in light of survey respondents' challenges in serving their Target Markets. Nearly 48% were unable to satisfy a substantial volume of financing demand in their Target Markets since 2009. The loan capital deficits reported amounted to $4.9 million in 2009, nearly $5.6 million in 2010, and nearly $7.7 million in 2011. Further, these certified Native CDFIs are projecting a deficit of nearly $14.6 million in 2012. These totals do not include loan requests exceeding Native CDFIs' loan limits. Over the same time period, annual requests for over-the-limit loans ranged from $17.55 million to $22.4 million.

Oweesta therefore sought to shed light on the accessibility of traditional debt capital sources. In particular, Oweesta sought to ascertain the extent to which Native CDFIs' operations are aligned with potential investors' expectations. Oweesta interviewed five banks and six foundations operating on a national or regional basis. Although an investigation of limited scale, the findings are instructive. It appears that Native CDFIs generally are not well positioned to access debt capital from these sources. As individual requirements vary, the following only identifies the most salient considerations that can be generalized across most of the investors interviewed.

I. Traditional debt capital sources have very limited investments in Native CDFIs

Investors described making primarily large-scale investments in regional CDFIs and CDFI intermediaries. For these unsecured loans with a high level of risk, both banks and foundations conduct in-depth underwriting of a CDFI and its portfolio. In the majority of cases, investors find that it is not cost-effective to underwrite smaller loans. Together with other investment terms and underwriting requirements (each described below), this effectively limits the pool of Native CDFIs that would generally meet investor requirements. It should be noted, however, that at least one interviewee observed that this does not reflect an intentional investment strategy, but instead is due to the types of Native CDFIs applying for these loans. The survey of certified Native CDFIs would support this supposition, as only eight of the 39 respondents reported applying for debt capital from banks and/or foundations. However, it may be that Native CDFIs are not applying because they are aware that they cannot satisfy the general investment parameters and underwriting requirements described below. The following summarizes these investors' experience with Native CDFIs.

- Of the five banks interviewed, three indicated that they had not made any investments in Native CDFIs. Two banks described very limited portfolios, with one acknowledging that it would be hard for most Native CDFIs to meet their requirements given their limited operating histories. The remaining bank has seen a recent investment trend in Native CDFI intermediaries (i.e., lending to other Native CDFIs) but noted this may be a reflection of the types of Native CDFIs requesting bank loans.

- For the six foundations consulted, only one had a substantial history of investing in Native CDFIs (over 20 years). Another's portfolio currently holds four Native CDFI investments. Three foundations had not made any direct investments in Native CDFIs, but had funded local foundations to provide resources (grants and/or PRIs) to Native communities. The remaining foundation had not made any PRIs to Native CDFIs but had provided operating grants.

II. Investment Parameters Limiting Native CDFIs' Access to Debt Capital

Because these investments must be repaid, both foundations and banks are looking to mitigate risk. Balanced against the need to structure cost-effective investment programs, this effectively limits the pool of Native CDFIs that would be suitable candidates for a loan or PRI.

1. Generally, many Native CDFIs have insufficient assets to qualify for a typical bank or foundation investment. Many debt capital sources have investment "floors" – the minimum investment amount considered to be sufficient to justify the cost of underwriting the loan or PRI. The maximum investment is generally calculated as a percentage of total assets, net assets, total loan capital or the outstanding portfolio. For many Native CDFIs the maximum investment amount would fall short of investors' typical "floor."

   - Even for regional foundations, an investment of $200,000 or $250,000 would be considered "small." Foundations reported average investments ranging from $500,000 to $3 million. One foundation indicated that it would limit PRIs to 10% of total assets, while another specified that all of its investments were subject to a financial covenant requiring the CDFI to maintain a 15% unrestricted net asset ratio.

   - Only one bank regularly makes investments as small as $100,000. Generally, banks reported a $1 million average investment, with one indicating a recent investment trend of $2 million to $3 million. One bank reported limiting investments to 10% of outstanding loans, while another stated that its investment limit would be 25% of total loan capital. However, the latter bank also indicated that it might go up to 25% of net assets if it was the only debt investor.

2. Opportunities to secure smaller investments are limited. In some cases investments may be smaller than the "typical" sizes described above. In certain cases a Native CDFI may fit within a narrow exception to this general rule – by conforming to a foundation's program priorities or if a bank has a new investment need because of an expanded CRA assessment area. For example, one bank recently acquired another institution, expanding its commercial footprint by several states. The bank was therefore actively seeking investments in the newly appended region. In another case, a bank acknowledged that it made a smaller investment because a key competitor had already invested in a specific CDFI.

III. Investment Terms may Deter Many Native CDFIs

Based on the survey of certified Native CDFIs, it appears that standard investment terms are not well-suited for many lending programs. Many Native CDFIs would first need to make fundamental changes in their business models in order to prudently access these debt capital sources. Reluctance to take on debt that must be repaid also severely limits Native CDFIs' ability to diversify loan capital sources. Debt capital has served as a key resource for the industry generally, helping the vast majority of CDFIs to broaden their Target Market reach. Yet most Native CDFIs continue to overlook this ready source to augment available lending capital.

1. Existing debt capital sources are not a good fit for the many Native CDFIs making longer term loans such as 15-year and 30-year residential mortgages. Interviewees generally do not want to tie up their investment capital for longer than ten years. One bank regularly makes 10-year loans. In every other case, banks reported a preference for loans of five years or less, noting that a 10-year loan is difficult to secure. Minimum terms for foundation PRIs ranged from five to ten years. Some foundations reported maximum terms of seven years, while most offered investments of up to ten years.

2. In order to access debt capital and still maintain current interest rate spreads, many Native CDFIs would need to increase rates charged to borrowers. Many Native CDFIs charge interest rates substantially below market in order to make loans affordable to lower-income Target Market members. But sizable discounts from market generate minimal interest rate spreads over cost of funds. Consequently, many Native CDFIs rely heavily on equity capital. In the survey of certified Native CDFIs, nearly 65% reported equity capital of 90% or more, with 41.2% reporting 100% equity capital. As a higher cost of funds would necessitate increased interest rate charges to borrowers, this would further decrease access to financing for lower-income Target Market members.

    - Foundation PRIs generally may be more accommodating for Native CDFIs operating on slim margins. One foundation reported a minimum rate of 0%, while others started at 1%. One foundation charged a set 1%. Otherwise, foundations' maximum rates ranged from 1.5% to 3%.

    - Interest rates on bank loans generally are higher, though some bank investments are comparable to foundation PRIs. One bank offered a set 2%, while another indicated that its lowest rate was 1%. Maximum rates ranged from 3.5% to 4%.

3. Many Native CDFIs are reluctant to acquire debt capital that requires a balloon payment at maturity unless they can be assured of renewals. Per the survey of certified Native CDFIs, nearly 60% reported either concerns about balloon payments or needing more confidence that loans would be renewed. However, such terms generally are not available in the current marketplace. Most investors noted that their loans must be repaid before they would consider another investment and extensions were rarely offered. Seven of the 11 debt capital sources (or 64%) indicated that their investments required a balloon payment at maturity. Four described "stepped down" principal payments in the last two or three years that would fully amortize the loan by maturity. One bank noted that multiple loans were possible so long as the CDFI applied in different CRA exam periods. Another bank indicated that if a CDFI could document sufficient demand, it might consider an additional investment. In that case, the original loan would be extended to match the second.

IV. Inability to Satisfy Investor Underwriting Requirements

On the surface, a large number of Native CDFIs could satisfy investors' underwriting requirements. However, it appears that the underwriting process delves deeply into the management experience and capacity of CDFIs. The following describes only those underwriting considerations that most impact Native CDFIs' ability to access these investments.

1. The lack of prior experience managing and repaying debt capital investments significantly reduces access for many Native CDFIs. As indicated previously, only 15.4% of respondents to Oweesta's survey of certified Native CDFIs reported that they have secured debt capital from banks and/or foundations. Consequently, the percentage of Native CDFIs that could demonstrate repayment of a debt capital investment is substantially limited. Foundations generally are more accommodating to this lack of experience – five of six said they are willing to be first investor. Some foundations note that a strong equity position must be present to counterbalance the lack of debt capital experience. In contrast, banks generally require a CDFI to demonstrate that it has repaid a prior investment. Only one bank indicated that it has been the first investor on many occasions.

   Although prior debt capital repayment is not universally required, all investors require a demonstrated ability to repay debt. Some investors measured ability to repay debt by requiring net asset and operating liquidity ratios exceeding the CDFI Fund's Minimum Prudent Standards (MPS). Net asset ratio requirements of as high as 30% were reported as compared to the MPS of 20%. For operating liquidity, some investors specified unrestricted cash covering at least six months of expenses, as compared to the MPS of three months. For Native CDFIs relying on restricted operating grants and generating limited earned revenue, this last requirement may be difficult to satisfy.

Oweesta plays a critical role in helping build Native CDFIs' capacity to access debt capital. Of the 39 certified Native CDFIs surveyed, 10 or 25.6% had obtained loans from Oweesta. Oweesta is able to provide loans on terms that are more accessible for a wider range of Native CDFIs. By expanding this role, Oweesta can increase the number of Native CDFIs that have successfully repaid debt capital investments.

2. <u>Many Native CDFIs meet investors' minimum requirements for lending and portfolio management experience; however, supplementary investor considerations may outweigh this experience</u>. All interviewees would consider investing in a Native CDFI with five years of experience. Exceptions include two banks that require a minimum of three years. Two foundations will invest in less experienced CDFIs that fit their program priorities. One will consider a CDFI with two years of experience. Another will invest in start-ups that can demonstrate there are no alternative lenders serving their market provided they have a good business plan. Despite meeting minimum experience requirements, many Native CDFIs would be unable to access this debt capital because some investors' analysis of experience impose further requirements:

    - For some investors, management resumes must demonstrate 10 to 15 years of experience in the key areas of finance and financial management, plus a proven track record. Many Native CDFIs operating in remote areas have had to build this capacity from the ground up and therefore could not satisfy this additional concern.

    - Portfolio performance must generally conform to CDFI industry standards. A number of investors specified that if portfolio quality is not on par with the field generally, a Native CDFI must establish a compelling case for why the investment is still sound. This requirement is difficult to meet in the absence of either complete portfolio turnover (see Underwriting Parameters, below) or other research for the Native CDFI field documenting that, despite higher portfolio risk, a Native CDFI's risk mitigation strategies successfully preserve the loan capital base. This is a key consideration as investors' paramount concern is how well they are protected from risk of loss.

    - Some investors want to see complete turnover in a CDFI's portfolio before they will consider investing. For Native CDFIs that are making longer term loans, this would mean that they would have to have substantially more lending experience than that cited by interviewees.

    - A number of investors noted that less experienced and smaller CDFIs generally do not have the capacity to collect and analyze robust impact data. Investors emphasized the need to measure both social and economic impact, beyond the standard measures reported to the CDFI Fund. Some investors elaborated that cumulative economic impact in the community would include immediate and longer-term job creation, increased incomes and assets, as well consideration of economic multipliers.

3. Many Native CDFIs cannot provide three years of audited financial statements to investors. Every one of the banks and foundations interviewed specified that at least three years of audited financial statements are required. One bank required five years of audited financials. Given the scarce resources available to most Native CDFIs, even after they are sufficiently established, many consider the cost of an audit to be prohibitive. For many Native CDFIs the trade-off is one of immediate returns (delivering much needed financial education and other development services to highly distressed Target Markets) as compared to some future return (of being able to deliver increased financing to the community). Other factors noted by a number of interviewees as adversely impacting their assessment of investment risk include:

    - Internal control findings because of limited staff size would be a concern, especially for banks that are held to regulatory safety and soundness standards.

    - For audit findings generally, a key consideration will be how management has responded – whether the CDFI has incorporated procedures that soundly address the issue.

    - Prior period adjustments and reclassifications to conform to GAAP also raise substantial questions. When audited financials are not comparable from year to year, it may hamper an investor's ability to conclude that the loan or PRI is a wise investment.

    - Every CDFI needs to ensure that it has an auditor that is familiar with the CDFI industry, appropriate balance sheet classifications and portfolio management standards. Failure to correctly classify assets and liabilities can substantially impact the financial ratio analysis. When an audit presents such problems, it is difficult to make the case for an investment because it shows that the CDFI's management is not cognizant of these issues. The lack of awareness generates substantial questions regarding management capacity, thereby increasing the perceived investment risk.

    Some foundations noted that these and similar concerns could possibly be addressed by providing a capacity-building grant or by requiring a fiscal agent.

4. Although many Native CDFIs have demonstrated capacity to deploy an investment, others may struggle to satisfy investors' documentation requirements. Investors universally required deployment ratios demonstrating a need for more loan capital, though all would consider loan pipelines and documented unsatisfied demand. Altogether, this information must show the capacity to deploy 75% to 85% of the investment within two years. As noted earlier, smaller and less experienced Native CDFIs may encounter substantial challenges in meeting these requirements, especially if unmet demand cannot be corroborated by historical lending activity. In such cases, a Native CDFI must substantiate the need for more loan capital based on a robust analysis

of unmet financing demand, including a sound methodology that incorporates an appropriate borrower readiness measure in quantifying demand. The limited data available to Oweesta suggests that only a small percentage of Native CDFIs could meet this standard.

These elevated requirements for documenting demand may present a major stumbling block for Native CDFIs, particularly those that began lending with only sufficient loan capital to support small loans despite market need for much larger loans. One respondent to the survey of certified Native CDFIs started lending with only $40,000 of loan capital. Some Native CDFIs have started by offering only Credit Builder Loans (i.e., consumer loans of $500 to $1,000) in order to build a sufficient portfolio to obtain CDFI Fund certification. Even though a Native CDFI may have since acquired additional loan capital, many are reluctant to offer larger loans if they cannot guarantee influxes of additional capital to sustain loan volume. Some Native CDFIs have had to suspend residential lending activity for this very reason. For such Native CDFIs, historical track records and limited capacity to document demand would severely constrain their ability to raise debt capital.

5. Investors are increasingly relying on ratings from CARS (CDFI Assessment and Rating System) to streamline the underwriting process. Only two Native CDFIs have been rated thus far. In order to obtain this rating, a Native CDFI must have at least three years of audits, though the analysis is based on performance over five years. Although a CDFI must be sound, the rating is not the key consideration for investors. According to Paige Chapel, President and CEO of CARS, investors place greater importance on the fact that a CDFI has completed the rating process – as rated agencies strive to improve their rating, this contributes to enhanced capacity for the CDFI. The cost of obtaining a rating is based on total assets. In 2012 the minimum cost is $6,000 for CDFIs having total assets of $15 million or less, plus a one-time fee to cover two days on site for analysts. As the rating is effective for three years, the annualized cost is closer to $2,000. As with annual audits, many Native CDFIs may be reluctant to incur this additional expense given their scarce financial resources. However, as investors are increasingly relying on CARS ratings, Native CDFIs may wish to incorporate audit and CARS rating costs in their longer range financial planning.