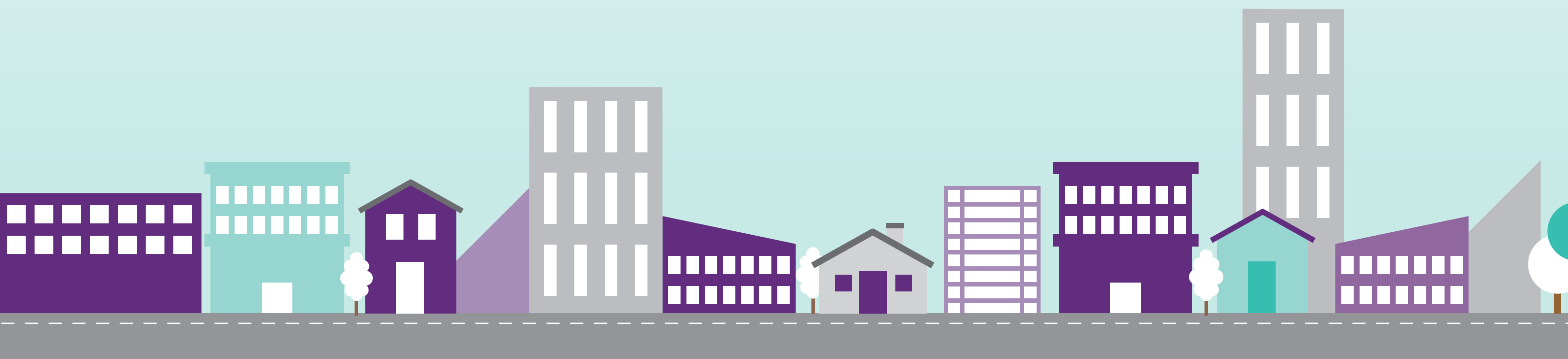
Community Investment

Lessons learned from the USA

Supported by:



Acknowledgements

I would like to acknowledge the support and sponsorship Citi has provided to enable five UK CDFIs and Big Society Capital to spend three days in New York City in Autumn 2018. I'm also grateful for the generosity of the individuals and organisations who gave up their time to share their experiences and perspectives.

CITI

With thanks to the Citi team that provided the sponsorship and organisation during the visit:

Bob Annibale

Colleen Galvin

Greg Schiefelbein

Helen Steblecki

Rachael Barber

UK CDFI ATTENDEES

With thanks to the UK CDFIs that attended the visit and shared their own experienced with the organisations we visited:

Andrew Austwick Finance for Enterprise

Duncan Parker Frederick's Foundation

John Peters SWIG Finance

Thomas Gillan Social Investment Scotland

Qammar Zamman First Enterprise

VISITED ORGANISATIONS

With thanks to the organisations that shared their perspectives:

Accion Serving the East Coast

BOC Capital/ BOC Network

Business Centre for New Americans

Community Development Venture Capital Association

Excelsior Growth Fund

Enterprise Capital Partners

Federal Reserve Bank of New York

Grameen America

NYC Department for Small Business Services

NYC Empire State Development

Opportunity Finance Network

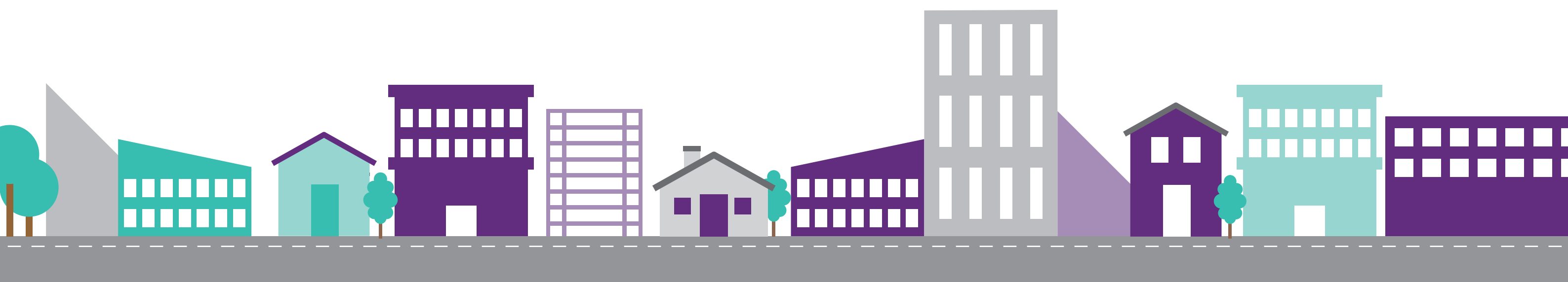
TruFund

And the thirteen other organisations who shared their perspectives in confidence.

AUTHOR

Rebecca McCartney

Investment Director
Big Society Capital
rmccartney@bigsocietycapital.com
+44 (0) 207 186 2552



Contents:

Introduction

We believe small businesses are essential in disadvantaged communities across the UK, both as employers of local people and drivers of economic activity. Yet many are unable to access mainstream finance to sustain and grow their businesses even if they are creditworthy.

There are alternative socially motivated lenders, deeply rooted in the communities they serve, that are partly meeting this need. The leading examples in the UK are Community Development Finance Institutions (CDFIs), however they face barriers to achieving long-term sustainability and securing significant capital at scale to fully meet the demand of underserved small businesses.

We believe there is an opportunity to support the UK CDFI sector reach a 'tipping point' where it can leverage significant capital to better meet the needs of small businesses, helping them to create or keep jobs and strengthen their local communities.

Together with partners, we aim to achieve this by providing mission-driven capital to CDFIs and by building a robust evidence base for CDFI lending including drawing on the lessons learned internationally.

With support and sponsorship from Citi, five UK CDFIs and Big Society Capital visited New York City for three days in autumn 2018 with the aim of learning from a more sophisticated and scaled US CDFI market. We chose to visit New York because it has one of the largest concentrations of CDFIs across the USA. While we hope we were able to draw out some lessons to bring back to the UK, from what is quite a different market context, we also recognise we were only scratching the surface on what we can learn from the US CDFI market.

We were fortunate to meet with five US CDFIs and five organisations or government bodies that support CDFIs. Outside of the visit, I spoke with another four CDFIs and eleven funders, representative bodies and thought leaders to supplement our understanding.

This report reflects our key learnings across four themes:

i. **CDFI Business Models** – Lessons range from the CDFIs' lending approach and the value-add they provide through technical assistance to the way they reach, retain and move-on clients.

ii. **Evidence, Visibility and Representation** – Lessons include the way the US is evidencing social, economic and financial impact of CDFI lending, how this is used in marketing activities and finally how CDFIs are represented to politicians, policy makers and investors.

iii. **The Role of the Public Sector** – US CDFIs have strong support from federal, state and local government, which brings out some lessons for the UK around the funding and broader support the public sector can provide.

iv. **Investment Opportunities** – The context for investing in CDFIs is markedly different in the US when compared to the UK, however lessons can be learnt on the role of different types of investors and some of the emerging product innovation.

My hope is that by sharing what we've learnt, we'll equip CDFIs, government, representative bodies and investors to consider what might be possible to adopt in the UK to support the CDFI market's growth. In addition, US CDFIs are similar in many ways to UK social investors, so there is much we can learn for the broader UK social impact investing market too.

I'm grateful for Citi's support, the CDFIs who participated in the visit but most importantly the many individuals and organisations that gave up their time to meet with us and who generously shared their experiences and reflections.

Rebecca McCartney
Investment Director, Big Society Capital

Overview of the US CDFI Market

WHAT ARE US CDFIS?

"Community Development Finance Institutions (CDFIs) share a common goal of expanding economic opportunity in low-income communities by providing access to financial products and services for local residents and businesses."

CDFI Fund, US Department of the Treasury

There are four broad groups of CDFIs:

Community Development Banks	Community Development Loan Funds	Community Development Credit Unions	Community Development Venture Funds
Provide lending and investing in economically distressed communities.	Provide loans and development services for micro and small enterprises, housing and other organisation providing a service to the community.	Provide affordable credit and retail financial services to people who have low incomes, with some seeking to reach minority communities.	Provide equity investment in small and medium sized enterprises located in economically distressed communities.

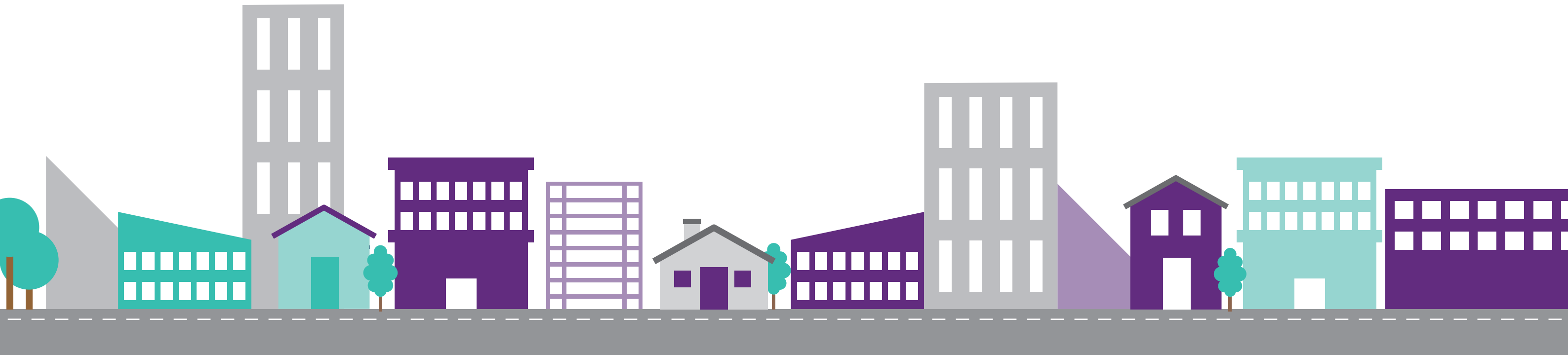
The focus of the learning visit and this report is on Community Development Loan Funds, in particular those that focus on micro and small enterprises.

BACKGROUND

The US CDFI market began to form in the late 1960s and early 1970s, where some of the first community development organisations came out of government's effort to reduce poverty and racial discrimination. Over the decades, the market has grown in particular from the 1990s when a number of government initiatives created the conditions to leverage significant financial and non-financial support for CDFIs. The major initiatives that shifted the landscape for CDFIs were:

- **The Community Reinvestment Act** (CRA) that encourages financial institutions to meet the credit needs in the communities where they operate, including low and moderate income areas.
- The **CDFI Fund** that provides capital grants, equity and revenue grants for technical assistance and capacity building. The US Department of the Treasury administers the CDFI Fund.
- The **New Markets Tax Credit Program** offers a tax incentive for investors who invest into community development investments in economically distressed communities.

There are many other initiatives at the federal, state and city level that have help the US CDFI market thrive, some of which are explored in this report.

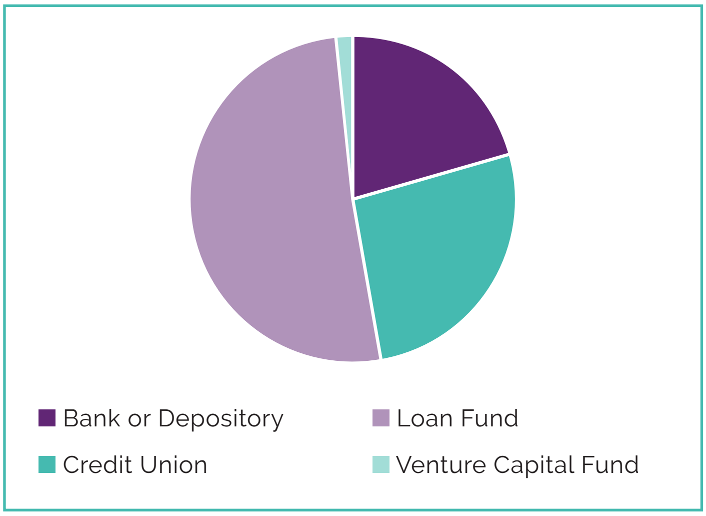


THE CURRENT MARKET

There are 1,066 certified CDFIs as of autumn 2018 operating across all 50 states and the District of Columbia, serving both rural and urban communities. There is also a mix of CDFIs serving all people in a community, and those focused on specific groups including minorities.

US-based CDFIs manage more than $150 billion with a focus on investing in economically distressed communities, creating jobs and affordable housing. The majority of the capital under management is in affordable housing and infrastructure, with a smaller proportion dedicated to micro and small business lending.

Number of CDFIs by type



Source: CDFI Fund

Photo by BCNA - Marisna Day Care

Photo by Grameen America - Dolores

Learning Theme 1: CDFI Business Model

CDFI LENDING APPROACH

The CDFIs we spoke to are focused on providing loans to small businesses and entrepreneurs, principally located in disadvantaged communities and/or run by someone from an underserved group. There has also been an increased focus in recent years from CDFIs and their partners on addressing racial inequalities in communities by supporting more minority owned small businesses.

Lesson 1: Generally, CDFI do not distinguish between enterprises and social enterprises in the USA unlike in the UK.

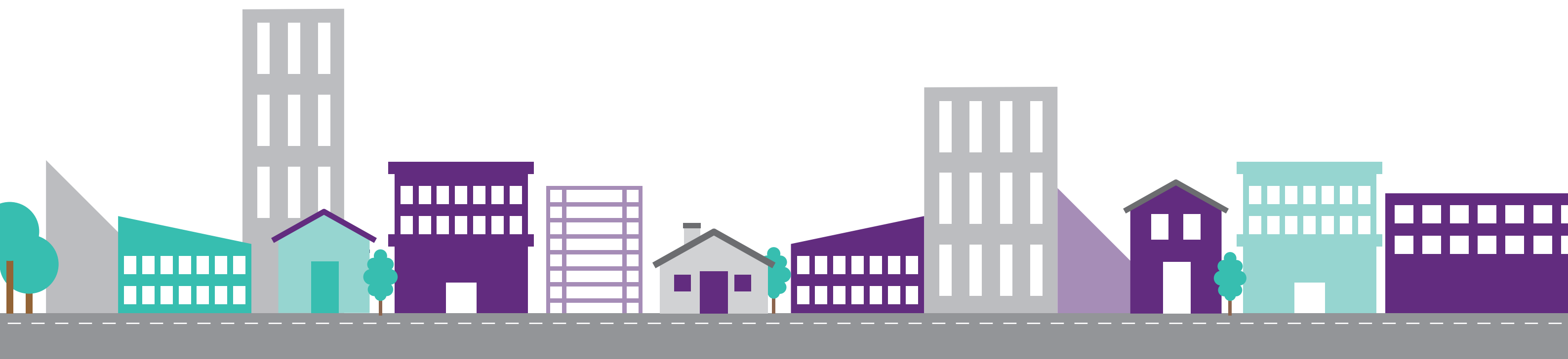
Some CDFIs focus specifically on non-profits or charities, such as the Non-profit Finance Fund, but the social enterprise model we see in the UK of employing or training those furthest from the labour market to deliver a product or service often wasn't given a specific 'social' label. This appears to be beginning to change though with an increased focus on impact investing and new opportunities to access socially motivated capital. For example, self-identified social enterprise restaurant Emma's Torch empowers refugees through culinary education and job readiness training.

The CDFIs reported the continuing challenges small businesses face accessing capital, especially those in disadvantaged areas, recent immigrants and/or those with a thin or no credit file. Simultaneously, these small businesses were under a multitude of pressures with limited capacity to engage in time-intensive processes to access capital from alternative sources, leading many to turn to online lenders for a quick and convenient loan despite the higher interest costs. Some of the CDFIs noted that a number of small businesses had approached them to refinance their high cost loans, which was not always possible due to the fee structures used by the online lenders that discourage early repayment.

This is the modern and developed market equivalent of a challenge microfinance institutions (MFIs) have experienced for decades in emerging markets where they have tried to move micro-entrepreneurs away from informal moneylenders to responsible MFIs. The US CDFIs are taking lessons from these global examples and innovating to improve the efficiency and timeliness of loan decisions so they are attractive and can support small businesses from their initial point of need.

Lesson 2: CDFIs need to offer a comparable or enhanced user experience to alternative lenders, as the social mission and additional support CDFIs offer is not sufficiently visible or a draw for time-poor small businesses. Where an online approach is used, some CDFI client groups can benefit from complementary human interaction to build a relationship with the lender.

> **"Excelsior Growth Fund's SmartLoanTM was developed after our experience of quickly making over 800 loans, each under $25k, in the aftermath of a major hurricane hitting New York. We developed a streamlined credit model and the portfolio performed very well. Seeing the opportunity in the marketplace caused by a lack of adequate provision from existing online lenders, we thought we could adapt the model to do larger loans quickly and efficiently, and be a responsible alternative to the online lenders, where loans are extremely expensive and there has been a lack of transparency."**
>
> **Steve Cohen, President - Excelsior Growth Fund**



Lesson 3: There is a trend of CDFIs moving away from generalist lending to focus on a specific business model or demographic. The benefits are:

i. improved client acquisition through more focused marketing efforts;

ii. simpler application processes without needing to loosen the underwriting process as the CDFI already understands the client's business model;

iii. improved underwriting with more data points on one model to refine decision making; and

iv. a more tailored package of support based on the specific needs of the client group.

There is a concentration risk by taking this approach but the CDFIs are often supporting multiple business models and the models chosen are those where there is an ongoing and persistent need such as with childcare.

> **BOC Capital's Contract Financing is a very effective tool to meet the short-term capital needs for businesses requiring cash flow for mobilization, production and receivables. It is an ideal solution for small businesses with government contracts or private sector purchase orders. BOC's customized Contract Financing is designed to assist minority-owned, woman-owned and small-scale contractors at a stage when a small business may not be able to access traditional commercial loans. It supports small businesses to secure and deliver on construction contracts, service contracts and purchase-orders, and thereby spurs the growth and inclusion of diverse businesses.**
>
> **Nancy Carin, Executive Director – BOC Capital**

CASE STUDY:

Taylor Made Contracting, a woman and minority owned firm, completed NYS Economic Development Corporation's 'Construct NYC' training (managed by BOC), gained pre-qualifications and won two contracts of approximately $200,000. The firm was approved for a $150,000 in Contract Financing and drew down $90,000 of that amount. Taylor Made Contracting employed the skills learned at Construct NYC along with Contract Financing to grow their revenue from $220,000 in 2016 to $1.1 million in 2017

Client of BOC Capital

CASE STUDY:

Lilibeth had been working at an office job for several years when she became pregnant with her daughter. She knew she wanted a career transition that would give her the flexibility to be more present and hands-on as a parent. She and her husband discussed the pros and cons of transitioning to the childcare business and ultimately decided to take the leap. Four months after opening their daycare, Lilibeth and her husband were already at full capacity.

Lilibeth was introduced to Accion while attending a conference for childcare providers in NYC. She received two loans from Accion, which she used for a variety of renovations to make the space more comfortable for the children, and most recently, to purchase a computer for the children to use.

Ten years after she and her husband opened their doors, Lilibeth now oversees three different sites. She has plans to return to school so she'll be able to open a storefront childcare centre.

Client of Accion East

Accion East

“To scale our mission whilst targeting our resources for the most vulnerable business owners, we decided to pursue an industry-focused outreached effort that identified key industries where low-to-moderate income business owners were highly represented. One such industry was childcare, where we piloted an approach in late October 2018. Initial results were promising in that we were able to achieve twice the productivity of our normal process and fulfilled the promise of conditionally approving applicants over the phone with no paperwork required to apply. Moreover, funds were received within five days, which is a third of our normal microloan process.”

Paul Quintero, CEO – Accion Serving the East Coast

Similar to UK CDFIs, all of the US CDFIs we met offered simple loan products to small businesses with the size and term of these loans being the main differentiating factor. The main difference to the UK was the price of these loans, and some were innovating to manage risk.

Lesson 4: The US CDFIs focus on reducing the loan's interest rate for the small business as far as practically possible. Those CDFIs we met during the visit priced loans for small businesses between 3% and 10%
per annum, compared to an average of 15%+ in the UK for loans to comparable small businesses. Other CDFIs may charge outside of these ranges that serve different markets, such as start-ups, or those that we did not visit.

This is in part due to cultural differences as there are usury levels in NYC for regulated lending entities, capping interest rates at 16% for individuals and 25% for businesses. While CDFIs are unregulated, they keep these in mind as responsible lenders. However, the main driver for this pricing difference, as will be discussed in more detail in Learning Theme 4, is that there is a high level of subsidy and concessionary capital in the USA which enable the CDFIs to offer a lower rate of interest.

More specific elements are outlined below:

i. **Lower cost of capital** - Some sources of concessionary capital stipulate a low interest rate is passed on to the small business or actively discounts the cost of capital for certain small businesses. Other first loss capital enables the CDFIs to leverage low cost bank debt to achieve a low weighted average cost of capital.

ii. **Lower default losses** - US CDFIs appear to experience lower defaults than UK CDFIs. This appears in part due to cultural differences between the countries, where greater emphasis is placed by individuals on their personal credit rating in the US when compared to the UK. Repayment of a US CDFI loan will improve a business owner's personal credit score unlike in the UK, so there appears to be more incentive to repay than might be the case in the UK.

iii. **Default coverage for CDFIs** - similar to the Enterprise Finance Guarantee in the UK, US CDFIs often benefit from a federal government guarantees to cover a high level of defaults (e.g federal guarantee program, SBA 7a).

iv. **Subsidy for CDFI operating costs** - Many US CDFIs receive grants to cover operating costs, with income from loan interest and fees meeting between 25% and 50% of costs. This low cost coverage is partly due to the deep technical assistance offered by CDFIs, but as in the UK, there are also relatively high transaction costs associated with making small loans to small businesses. This is a well-identified challenge in microfinance internationally, and is currently being tested in the UK through the £50 million Growth Fund (a Big Society Capital, the National Lottery Community Fund and Access fund of funds), which offers fund managers a grant for operating costs alongside investment to make small loans to charities and social enterprises.

Lesson 5: Some CDFIs have developed some innovative approaches to deliver loans to small businesses and manage repayments in such a way that it reduces risk for the CDFI and/or the client.

Examples of this include Grameen America's efforts to move its clients away from the cash economy by providing its loan on pre-paid debit cards, BOC Capital's arrangement of payment assignment directly from the contract owner under its Contract Financing program, and Accion Serving the East Coast's development of a line of credit product.

> **As we scale, providing loans on cards benefits both our members and the organization. It can reduce members' check-cashing costs, gives them full, immediate access to funds, and supports their transition from cash to digital forms of payment. Organizationally, the cards are faster and easier for staff to manage and offer a secure, paperless and centralized fund release process and greater data transparency.**
>
> Marcus Berkowitz, Vice President
> Technology and Innovation – Grameen America

> **To mitigate risk for the Contract Financing program, BOC Capital requires an 'Assignment of Payment' from the contract owner which includes government agencies, prime contractors or buyers. The borrower is directed to instruct their client that BOC requires assurances from the contract owner. Funds received are remitted to the borrower less loan payments, ensuring the loan funds are not diverted to other business needs."**
>
> Nancy Carin, Executive Director – BOC Capital

> **Small business owners face significant cashflow volatility and often pursue short-term opportunities to sustain or grow their business. In such an environment, a line of credit offering is a better match for their funding needs than a monthly amortizing loan. Studies have shown there is equal, if not more, demand for such a product in the marketplace. Moreover, we believe that financially, this product adjacency could also prove to be more economically viable for the long-term mission of the organization. We will be pursuing the development of a minimally viable product offering in late 2019.**
>
> Paul Quintero, CEO – Accion Serving the East Coast

CDFI BROADER VALUE ADD

CDFIs are not just lending organisations; instead, they offer a broader package of financial and non-financial support to help small businesses succeed.

Lesson 6: Technical assistance is viewed as an essential offer alongside loan capital to achieve the best outcomes for the small business and its community. This is often delivered by the CDFIs, but sometimes delivered by a partner in the community where the small business is located.

The emphasis and support for technical assistance in the UK has declined in recent years with stretched local government budgets, resulting in UK CDFIs being less able to offer broader support to small businesses without significantly increasing the interest rates charged to cover costs.

> **"Technical assistance is the key to CDFIs' low default rates and borrower success. Technical assistance helps clients make informed financial decisions that lead to reduced debt, improved personal credit, access to business capital and the creation of assets. CDFIs are invested in the success of local businesses and well positioned to offer these services."**
>
> Rachael Dubin, Senior Director
> NYS Empire State Development

> **BOC Capital benefits greatly from the business support offered through its affiliate BOC Network. The broad package of non-financial support helps build a close alliance with clients, and strengthens and provides transparency into the capacity and workings of the business. When planning, marketing, credit-building and management needs are addressed, BOC Capital is able to target impactful loans to underserved entrepreneurs who would not otherwise be funded.**
>
> **Nancy Carin, Executive Director – BOC Capital**

REACHING CLIENTS

The CDFIs we visited all expressed a view that there was sufficient demand to meet supply of capital offered by the range of CDFIs across New York State. Generally, the CDFIs reach clients through partners; however, some were exploring direct marketing which is discussed further in section 3.

Lesson 7: Given the scale of need, the CDFI business model is comfortably built on foundations of strong collaboration with government, funders and community-based organisations. CDFIs also appear to be creating their own products and/or client group niches. Therefore, there are multiple routes for CDFIs to reach small businesses and to establish referral points. This does not mean all small businesses are aware of CDFIs or there are no areas for improvement, but the infrastructure and collaborations appear to be better established than in the UK.

Many of the CDFIs were established and rooted in the communities they continue to serve today, enabling them to support some of the hardest to reach small businesses.

Lesson 8: CDFIs are able to achieve better outcomes for small businesses and communities by being deeply rooted in those communities they serve. Below are the ways they achieve this.

i. **By hiring from the communities they serve** – this can build trust with clients and an understanding of cultural nuances within that community.

ii. **By having a visible presence in the community** – this builds the awareness, trust and respect with key influencers and potential clients within the community, and ongoing support for existing clients.

iii. **By collaborating with anchor institutions in the community** – this leverages the relative strengths of the CDFIs and anchor institutions, building credibility for the CDFIs and enabling the CDFIs to reach more small businesses.

> **CDFIs can increase their visibility in the community through good engagement. They can do this by:**
>
> **a) Engage and be present in anchor institutions**
> **b) Give back to the community, for example teaching business skills at the community college**
> **c) Build good relationships with local government**
> **d) Perseverance – become a 24/7 banker."**
>
> **Senior Community Bank Executive**

> **Of the 14 staff that BCNA has hired, twelve are foreign born. Several of the staff were hired from the communities where BCNA wanted to increase micro and small business lending.**
>
> **Hiring staff from the communities where we operate is critical as they have the language skills, cultural sensitivity, and are our ears and eyes for external factors in the community which may impact BCNA's services and role in the community. We have also discovered that members from our community can speak in a culturally appropriate manner about the importance of repaying BCNA's loans! In addition, this is an opportunity to build skills and understanding of small business development in these communities by adding to the skills of a member of their community.**
>
> **Yanki Tshering, Executive Director - Business Centre for New Americans**

CASE STUDY:

Vish Dasma is an example of how BCNA builds its team – originally from India, Vish is a Senior Loan Officer at BCNA who joined with previous experience of working in banks to promote services to small businesses. BCNA needed to provide some training and coaching on how to underwrite microloans to small businesses, however his excitement and dedication to help business owners achieve success was greatly valued. Vish is based in BCNA's Jackson Heights, Queens office, one of the most diverse boroughs of NYC that has a growing and thriving South Asian population.

He has the intuitive understanding of how to communicate and maintain a positive relationship with not only the Indian community but also the many immigrant entrepreneurs from Bangladesh, Pakistan, Nepal, Indian and Bhutan. Vish is also invited often to represent BCNA at local community meetings as he is seen as someone who understands the challenges and needs of immigrant small business owners.

Photo by BNCA -
Vish Dasma, BCNA senior Loan Officer (right) with a BCNA Client

Banks are an ideal referral partner for CDFIs given the number of small businesses they interact with but are unable to support themselves.

However, similar to the UK, the US CDFIs receive few referrals from banks. The main reasons cited are a lack of incentives for the bank, limited infrastructure to make referrals easy, and a fragmented banking system meaning CDFIs often need to build relations at the branch level. This is not universal, however some CDFIs are proactively engaging with banks.

Lesson 9: A key incentive for banks to engage with CDFIs is that with support, the small businesses will be future bank customers. Many CDFIs focus on supporting small businesses to 'graduate' from CDFI borrowing to mainstream finance, and so are pump-priming small businesses rather than competing with banks.

> **We're focused on a transformation, rather than a transaction, with a small business**
>
> **Senior CDFI Leader**

Lesson 10: Where banks could see the benefits of forming partnerships or relationships with CDFIs, they needed to feel confidence in the outcome of a referral and have a long-term view that the small business will access mainstream banking in the future, hopefully with the partner bank.

> **Bank partnerships, either direct or through a network of several CDFIs, offer a real opportunity to scale our model. One significant concern for banks is the 'double decline'. This has been a real obstacle to meaningful 'second look' programs. With our product, we can identify about seven data points and give the bank confidence that we will do the deal when it meets those parameters. As banks develop their own technology solutions for small business loans, this creates even more opportunity as this entire process can be integrated and automated, and a decline at a bank can instantly become an approval at our CDFI. There are several operational and customer service barriers that have not yet enabled these partnerships to achieve scale but the value proposition is strong.**
>
> **Steven Cohen, President – Excelsior Growth Fund**

Finally, the CDFIs' clients are a good source of repeat business and/or referrals for other small businesses in their networks and communities. There were mixed views on the extent a repeat customer was a positive sign given some of the aims to support small businesses to 'graduate' onto bank borrowing, however some of the micro lenders felt repeat business was core to their business model.

Lesson 11: Depending on where the client is in their entrepreneurial journey will depend on how long it takes them to move towards being served by mainstream financial services. However, for some clients, this may not be desirable or appropriate, and instead the focus should be on what type of financial services are best for the small business.

Lesson 12: The user experience of small businesses through a CDFI's process is essential to the CDFI's sustainability and/or scalability to attract other small businesses. This is because of the community-based approach CDFI's take and the need to build trust within that specific community, including with the small businesses, given the high level of word-of-mouth referrals.

> **After three years, we have an over 90 percent retention rate, with many of our members staying with us for the long-term. They benefit from the ability to access larger and larger loans and having the steady flow of capital, as well as peer support. It's a model that we know works and that our members find extremely valuable. Our members are the best champions for Grameen America's program. They tell their peers about their positive experiences with Grameen and word spreads quickly in the community. This has been one of the keys to our success and has enabled us to expand at the rate we have."**
>
> **Alethia Mendez, Vice President, Operations and Program Strategy – Grameen America**

CASE STUDY:

Daniela, from Queens, New York City, has been a member of Grameen America for several years and has received loans of increasing amounts; her most recent loan was for $9,500. She invested these funds in Moneytel, her money transfer business and internet café, and by staying in the program, she has been able to significantly expand. She used her first loan to reorganize and modernize her store. She used subsequent loans to hire two employees, and recent loans to buy a money counting machine, counterfeit bill detector and new computers, which are quicker and more advanced. "This program has been an excellent opportunity: The longer I've stayed, the bigger the loans I've been able to receive. I've been able to make meaningful improvements to the business.

Photo by Grameen America - Daniela, Grameen America Client

OPERATIONS

Many of the US CDFIs experienced challenges with maximising and embedding technology in their operations. It was noted as a strategic priority for a number of the CDFIs, with ongoing considerations about the extent the lending process should be automated versus in person. Grameen America is one such CDFI considering the role of technology, and published a detailed on its adoption of technology to scale.[1]

Lesson 13: Technology offers benefits to drive efficiency through automation and streamlining of operations, but it should not completely replace face-to-face engagement during the application process. This is especially the case for some client groups which may need more hands-on support to complete application forms or need guidance to go through the underwriting process.

Despite the extensive availability of support for CDFIs, funding is still a scarce resource relative to the number of CDFIs. As a result, there appears to be a number of CDFIs becoming stronger with some smaller CDFIs struggling that operate in a specific community and/or targeting a specific client group. However, a number of CDFIs felt there was an opportunity to maximise efficiencies through partnership between these two groups of CDFIs.

Lesson 14: CDFIs do not need to be experts at every part of the lending process. Smaller CDFIs with deep roots in their community should be rewarded for reaching small businesses but shouldn't need to have the full underwriting expertise in-house, instead making the most of more established CDFIs through service agreements or partnerships.

Photo by BCNA - Flowers and Flores

Photo by Grameen America - Guadalupe

[1] The Pivotal Role of Technology in Scaling (September 2018),

Learning Theme 2: Visibility of CDFIs

The US CDFI industry is well established compared to the UK resulting in greater visibility, awareness and representation. In addition, this CDFI support appears in part because of the widespread and political bipartisan promotion of small businesses and that CDFIs play a role in helping those small businesses that are underserved or are based in disadvantaged areas. This is rather than supporting CDFIs as an end in of themselves.

US CDFIs continue to face a number of challenges in this area, and all CDFIs we met expressed caution that enterprise lending CDFIs weren't as widely recognised in the broader CDFI market as would be preferred. Nevertheless, there are lessons for the UK from practices the US has adopted.

EVIDENCE OF CDFI LENDING

Similar to the UK, the CDFIs have struggled to articulate robustly the financial, social and economic impact of their activities. Social and economic impact is outputs focused, with emphasis placed on jobs created and sustained, rather than capturing the difference the jobs make to people's lives or the communities where they and the small business are based. CDFIs principally show their impact through telling client stories, which is only part of the picture. On CDFIs' financial performance, there are not universal definitions for key metrics making it challenging to compare performance between CDFIs. There are efforts to address these challenges, with a particular focus on promoting the use of data.

Lesson 1: Robust data and evidence on the needs for small businesses underpins stakeholders' support for CDFIs as the provider of capital and technical assistance for small businesses.

The Small Business Credit Survey is one example of this approach, which is run jointly by the twelve Federal Reserve Banks across the US. The annual survey asks 500 businesses rooted in communities across the US to report on their financing needs, decisions and outcomes. This benefits policy makers, researchers, investors and lenders (including CDFIs) by providing the underlying evidence of the demand for small business finance. More information can be found at: www.fedsmallbusiness.org.

Lesson 2: The promotion and release of open data by a government unit dedicated to CDFIs, the US Department of the Treasury's CDFI Fund, meets the calls for greater transparency from stakeholders, increases credibility and the foundations for meaningful analysis on the state of the sector.

The CDFI Fund periodically publishes the primary source data it receives from the reporting required by the CDFI Fund's awardees across the multiple programmes it manages. This granular level of detail, accompanied by summary reports, offers a richer and more transparent view of the US CDFI market than we've managed in the UK. More detail on this data can be found at: www.cdfifund.gov.

Lesson 3: The research function of the Opportunity Finance Network (OFN) as the largest CDFI membership body can lead and champion the building of a robust evidence base for the whole market, and consider standardised metrics and approaches for the sector to adopt.

> **OFN publishes and disseminates industry-wide CDFI data and borrower stories each year because measurable performance and impact are crucial to highlighting the vital role of CDFIs. Some may find it surprising that CDFIs do well during economic downturns and often outperform or at least perform as well as mainstream banks. CDFIs currently manage more than $150 billion to create jobs, affordable housing, and community facilities in all 50 states. OFN shares these takeaways with policymakers, funders, and investors as we seek to grow capital sources and find new partners to help expand opportunities in underserved communities.**
>
> **Donna Fabiani, Executive Vice President, Knowledge Sharing – Opportunity Finance Network**

Lesson 4: Data is only one part of the evidence base; there is an important emphasis telling the stories of the clients the CDFI is serving in underserved communities. This is for government and funders, but also for small businesses to see stories just like their own.

Lesson 5: Similar to the UK, there are calls in the US from investors for greater visibility on the performance of CDFIs.

Aeris is one organisation trying to address this through its rating of CDFIs and capture of ongoing monitoring data for the benefit of investors. There are currently 175 CDFIs rated by Aeris, principally larger CDFIs focused on real estate investment. For those investors that pay an access fee, they can see the performance of CDFIs to support CDFI selection, access a CDFI's rating report and ongoing monitoring data.

There was mixed feedback on the usefulness of Aeris for enterprise lending US CDFIs. Those that had undergone the rating found it helpful for internal continuous development, but did not find it broadening their investor base beyond the banks that invested through their CRA programmes. Others felt that they were too small, and the largest CDFIs had undergone an S&P rating to access the mainstream capital markets.

Enterprise Community Partners is also developing a solution to this challenge – it is developing a benchmark CDFI index that tracks historic and ongoing performance of the US CDFI market. The aim is to increase awareness, raise transparency, support product creation and help CDFIs to access the capital markets.

MARKETING TO SMALL BUSINESSES

Similar to the UK, the US CDFIs had challenges reaching their target small business clients and identified awareness amongst small businesses and partners as a barrier to scaling. Therefore, many of the CDFIs are focused on increasing their marketing directly to clients to reach them at the right time, and to expand the pool of potential clients in addition to the referral routes outlined in Learning Theme 1.

Lesson 6: Given the broad support for small businesses, there is a lot of general marketing around public spaces, such as on the subway, and in local anchor institutions. This provides a positive platform from which CDFIs can advertise their offer to small businesses. However, the CDFIs cannot compete with the online lenders' marketing budgets and so have to be creative to maximise their marketing spend. Some are using their strategy to focus on specific business models to run targeted marketing campaigns and others are using targeted online marketing through sites such as Facebook.

Lesson 7: Marketing needs to be sensitive to the communities that the CDFIs are targeting. In some communities, it may be not be culturally appropriate to openly advertise lending. CDFIs are able to navigate these sensitivities by rooting themselves and/or employing staff from the communities the CDFIs target.

Lesson 8: Small businesses are attracted to those CDFIs whose ethos, and messaging, is an enabler that will support the business to succeed and promotes the view that the small business knows its business best. Small businesses do not appear to respond well to the use of messaging that includes the terms 'underserved', 'disadvantaged', or similar as it infers that they are coming from a position of weakness.

REPRESENTING CDFI INTERESTS

Given the diverse types of CDFIs and geographies they cover in the US, there are a number of representative bodies providing knowledge, networks and capital (see Learning Theme 4 for more information on the role of representative bodies in capital raising).

Lesson 9: There are benefits to having representative bodies that focus on a type of CDFI or the activities in a specific geography that then feed into a broader coalition of CDFIs. This is because the needs and target stakeholders to influence are slightly different for each group, enabling the separate representative bodies to focus clearly on the key issues.

Below shows a sample of these representative bodies that focus on a particular type of CDFI.

Opportunity Finance Network (OFN)	Association for Enterprise Opportunity (AEO)	Community Development Venture Capital Association	Community Development Bankers Association	Native CDFI Network
Established in 1986, OFN is a network of US CDFIs that are committed to high-performance, and supports and enhances the work of individual CDFIs by offering a national and diverse perspective.	Set up in 1991, the AEO is the voice of innovation in microfinance and microbusiness in the US by providing research innovation and advocacy to its members and broader market.	Providing support since 1993, the CDVCA represents VC investors that provide equity capital to businesses in underinvested markets. It offers advocacy, education, communications and funds to its members.	The CDBA is the national trade association of the community development bank sector, and acts as the voice and champion of banks and thrifts with a mission of serving low and moderate income communities	Formed in 2009, the Native CDFI Network acts as the national voice and advocate for those CDFIs creating access to capital and resources to Native peoples.
www.ofn.org	www.aeoworks.org	www.cdvca.org	www.cdbanks.org	www.nativecdfi.net

Separately, there is a national organisation that brings these different CDFI types together.

CASE STUDY:

Formed in 1992, the **CDFI Coalition** brings these representative bodies together and acts as the lead national organisation promoting the work of CDFIs. It represents CDFIs from all 50 states and the District of Columbia as well as all types of CDFI. Its board membership is made up of a mix of both the representative bodies and rotating CDFIs.

Mission: "The CDFI Coalition is the unified national voice of community development finance institutions. Our mission is to encourage fair access to financial resources for America's underserved people and communities"

Lesson 10: Focused, larger representative bodies can still experience fairly significant diversity in its membership given the scale of the US CDFI market. While they need to work harder to manage often-divergent views, they also benefit from promoting peer learning between their members.The OFN shows good practice in balancing these needs – 90% of its nearly 250 members are non-regulated loan funds, but these serve diverse communities and range in size from $1 million in assets to more than $100 million in assets.

> **"OFN places a high value on peer learning. We promote peer learning by offering practitioner-led curricula at our signature industry events, facilitating CDFI knowledge networks that focus on particular financing sectors, and offering a range of leadership and other capacity building programs. In all our initiatives, we seek to include diverse members. We also encourage our members to collaborate with each other to expand their collective impact. We believe that large and small, rural and urban, regulated and unregulated CDFIs all have something to teach each other. Innovation and best practices are found not only in the largest, most sophisticated CDFIs but also in the many smaller, lesser known CDFIs."**
>
> **Donna Fabiani, Executive Vice President, Knowledge Sharing – Opportunity Finance Network**

In addition to providing knowledge, networks and capital, representation of CDFIs also increases visibility with key stakeholders in government and with investors.

Lesson 11: The representative bodies take the lead on advocating for CDFIs, but leverage the powerful stories the CDFIs can tell themselves of their clients in the areas they work. In the past, OFN has organised 'Advocacy Days' where CDFIs from across the country descend on Capitol Hill to meet with their representatives and tell stories from their communities where CDFIs have supported them. A number of CDFIs explained this was especially helpful as they didn't have the capacity or access to networks to undertake this type of activity independently.

> **"Given how dependent BCNA is on government support, it is critical we are able to communicate to our elected officials the impact of our services to their constituents. However, with only 14 full time staff, it is impossible to have an effective advocacy strategy so we benefit greatly from the Advocacy Days organized by OFN. The OFN staff have the expertise to provide CDFIs like BCNA with guidance and coaching on which legislation is pending, who to meet with, and how to present the data on the impact of our services."**
>
> **Yanki Tshering, Executive Director – Business Centre for New Americans**

Lesson 12: Professional lobbying organisations are engaged to advocate on CDFIs behalf with a specific mandate to influence politicians and policy makers, demonstrating the benefits of engaging specialist skills.

Lesson 13: Representation doesn't need to come from membership bodies, and can be effective when there's a 'champion' from the stakeholder group the CDFIs are seeking to influence. This was seen within banks, other investors and the public sector.

Lesson 14: Legislation can give CDFIs a voice, forcing their visibility with key stakeholders. Banks are rated on how well they deliver their CRA commitments, which can affect their ability to merge with or acquire another bank. The CDFIs have a voice in the regulatory approvals process for these mergers and acquisitions in particular how well the bank is thought to have met its CRA obligations.

Learning theme 3: Role of the Public Sector

In the US, there is a dedicated department in the US Department of the Treasury for CDFIs, the CDFI Fund. In addition, there is sometimes specific departments and/or personnel in local government at the state or city level. New York State is particularly well resourced and this is not universal across all US states.

Nevertheless, the relative infrastructure and level of resource focused on CDFIs in the US compared to the US creates a different dynamic than in the UK where there is no dedicated resource at national or local government level looking solely at policy and programmes for CDFIs. This in part plays out in the US by a clear alignment between CDFI activity and government policy, and policy-led product development rather than from CDFIs themselves.

Lesson 1: Local and national government are not focused on supporting CDFIs as an end in of themselves, but instead frame their support in the context of the communities each CDFI serves and the small businesses they support. This shapes the way government allocates the financial and non-financial resources to support CDFIs.

> **I believe the best way to facilitate the flow of capital to small businesses is to provide CDFIs with the resources they need to be more effective. When the problem we are trying to solve is, how do we support small businesses, the answer starts with supporting CDFIs.**
>
> **Rachael Dubin, Senior Director**
> **NYS Empire State Development**

Government plays an instrumental role in the functioning of the US CDFI industry. This can be broken down into the following areas:

- **i.** Accreditation of CDFIs;
- **ii.** Provider of capital and credit enhancement products to support lending to small businesses;
- **iii.** Provider of grants to CDFIs to cover CDFIs' core operating costs and technical assistance for small businesses;
- **iv.** Provider of support for CDFIs whether as a partner to move into new geographies, to refer small businesses or to facilitate learning amongst CDFIs; and
- **v.** Fostering a supportive policy environment for small businesses including the provision of evidence.

> **The number one issue that small businesses face when starting and growing is access to capital. We work with businesses to address this need by connecting them to our network of over 40 lenders. We've found that, since the majority of businesses we serve are not qualified for bank financing, there is a real need for alternative lenders like CDFIs. In fact, nearly 70% of our customers obtain financing assistance from alternative lenders. CDFIs are crucial partners in ensuring New York City's small business owners can build successful businesses that contribute to a thriving local economy.**
>
> **Gregg Bishop, Commissioner**
> **NYC Department of Small Business Services**

> **Empire State Development (ESD) supports CDFIs in several ways. ESD provides low-interest loans to fund borrower loans, loan loss reserves to cover claims, and grants that allow CDFIs to implement projects that address specific needs. Grants can be used to subsidised the delivery of technical assistance, reduce the cost of capital, or even launch a new loan product. ESD also provides grants to assist CDFIs to target specific populations and regions in New York State. Increasingly, ESD convenes CDFIs to share best practices and explore common challenges. Going forward, ESD will work to build connections between banks and CDFIs in their community.**
>
> **Rachael Dubin, Senior Director**
> **NYS Empire State Development**

ACCREDITATION

The US has a widely recognised standard definition of a CDFI based on what the organisation is trying to achieve rather than a specific legal form or self-identification:

Lesson 2: Having a standard definition of what a CDFI is forms the basis for how CDFIs are accredited, helping build a common language, understanding and trust amongst all stakeholders.

A CDFI seeking certification must demonstrate it:

1. **Is a legal entity at the time of application;**
2. **Has a primary mission of promoting community development;**
3. **Is a financing entity;**
4. **Primarily serves one or more target markets (i.e. communities);**
5. **Provides development services in conjunction with its financing activities;**
6. **Maintains accountability to its defined target markets; and**
7. **Is a non-governmental entity and not under the control of any government entity.**

Source: www.cdfifund.gov/programs-training/certification.

PROVIDING CAPITAL AND CREDIT ENHANCEMENTS

There are initiatives at the federal, state and city level to provide capital and credit enhancements. As seen in Learning Theme 1, this not only helps pass on a lower cost of capital to the small businesses but also leverages significant capital into the sector.

Lesson 3: Credit enhancement and/or first loss capital offers an attractive risk adjusted return for investors (principally the banks that are induced to make CRA-eligible investments). This credit enhancement is either in the form of capital, guarantee or tax credits.

A general observation is that investors have moved towards credit-enhanced programmes, such as charter schools and health centres, showing how dedicated public sector programmes can draw investors to a specific type of activity.

Lesson 4: The high levels of subsidy creates a two tiered capital structure of subsidy and bank debt given the high level of loss coverage for the senior lender. There is little opportunity for mezzanine debt in the structures.

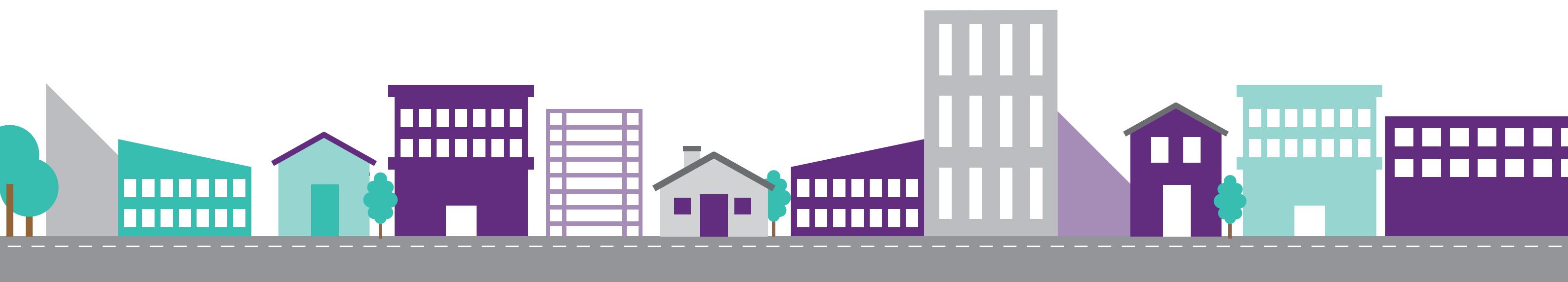
Photo by Excelsior Growth Fund - Salon Cristina

Below are a number of programmes offering capital, guarantee or tax incentives, which is by no means an exhaustive list:

CAPITAL	
NYS Empire State Development Corporation Small Business Revolving Loan Fund	**NYC Small Business Services Contract Financing Loan Fund**
A $25 million fund providing loans to CDFIs ranging from $250,000 to £7.5 million to in turn make loans to small businesses.	A $10 million fund providing loans to CDFI to in turn make loans to small businesses hoping to work on a project with a NYC entity. The small business loans are up to $500,000 at a low 3% interest rate.

GUARANTEE AND INSURANCE	
US Small Business Administration 7a Loan Program	**NYS Empire State Development Capital Access Program**
Guarantees 85% for loans of up to $150,000 and 75% for loans greater than $150,000 up to $5 million for businesses that have exhausted financing options.	A loan loss portfolio insurance program that begins with the borrower and lender making a shared contribution of 3 to 7 percent of the loan amount, which is match by ESD. This reserve account increases and can be used to reimburse any defaults.

TAX CREDIT	
New Markets Tax Credit (NMTC)	**Opportunity Zones**
The NMTC aims to attract private investment into low-income communities by offering investors a 39% tax credit against their federal income tax in exchange for making equity investments in specialised community development intermediaries.	A tax incentive for investors to reinvest their capital gains into dedicated Opportunity Zones. Investors receive a 10% exclusion of the deferred gains for investments held 5+ years, raising to 15% for investment held for 7+ years.



PROVIDING GRANTS FOR OPERATING COSTS

There are also initiatives at the federal, state and city level providing operating cost coverage for the CDFIs and funding for technical assistance the CDFIs deliver to small businesses. Cost contribution is also provided to community development organisations that act as partners and referral pathways for the CDFIs.

Lesson 5: Government at all levels values technical assistance for small businesses, which drives the support for CDFI operating costs.

Lesson 6: More flexible funding can support product development and new approaches to reach more underserved small businesses.

While public subsidy is available in many sectors, the question is how to use it most effectively. There remains an unanswered and largely untested question on whether the level of subsidy a CDFI receives leads to inefficiencies or stifles innovation.

Below outlines two examples at the federal and state level of grant programmes supporting operating costs:

CDFI Fund's Assistance Program	NYS Empire State Development Loan Packaging Assistance Grant Program
One element of the Program's grant is for capacity development to help CDFIs move towards organisational sustainability. Uses for these grants include training and providing benefits to staff, hiring consultants or purchasing equipment.	A ~$565,000 grant program to CDFIs that have capital available but insufficient resources to package loans and required grant support to expand its loan activity whether to new geographies, sector or types of businesses. ESD have not rolled the Program out yet.

BROADER SUPPORT

Lesson 7: The public sector can act as a non-partisan data and research source bringing credibility to information for investors and other funders.

The Federal Reserve Banks' Small Business Credit Survey is one such example, as well as the data provided by the CDFI Fund (both detailed in Learning Theme 2)

Lesson 8: Local government can facilitate a CDFI's expansion by helping it to develop its proposition to meet local need and enter new markets. It can do this by providing access to networks, market intelligence and capital.

CDFIs experienced this support where they wanted to proactively expand into new communities, but also where they are asked to do so by the local government to meet an identified unmet need for small businesses.

FOSTER A SUPPORTIVE ENVIRONMENT FOR BUSINESSES

Lesson 9: Bipartisan support for small businesses acts as the basis for policies and funding for those organisations enabling small businesses to sustain and scale.

Learning theme 4: Investment Opportunity

The most active investors in the US CDFI market are the banks, which is driven by the Community Reinvestment Act (CRA). Generally, banks will invest the vast majority into real estate-focused CDFIs given a preference for lower risk investments and the need to deploy significant CRA dollars. The small business CDFIs can only absorb a small portion of the available CRA dollars.

Lesson 1: Too great an inducement to invest from government can cause market distortions. There is a potential supply and demand mismatch as banks compete for the same project or investment to deploy required levels of capital into defined underserved communities.

Anecdotally, this is leading to some banks undercutting others on price to secure an investment and potentially investing in a way that isn't optimal for the community.

This government policy has determined the way the majority of CDFIs are capitalised, and given this is not realistically replicable in the UK, the below lessons are focused on broader reflections and innovations that sit outside of CRA.

Banks are also playing a role in supporting broader community development initiatives either as a core part of their business development and/or CSR activities.

Lesson 2: Banks can play a role in grant funding CDFIs to both support social and economic impact in the communities the banks operate, but also as a business development opportunity given the small businesses could be future customers once they have scaled and/or improved their credit profile.

> **At Citi, we recognize that CDFIs are vital community intermediaries, providing affordable credit access, lending and education to a diverse mix of small business owners and aspiring entrepreneurs. By leveraging their local presence and relationships, CDFIs deliver growth and complement the efforts of larger financial institutions to expand financial access, rather than of duplicating them.**
>
> **Colleen Galvin, Senior Vice President – Citi Community Development**

ROLE OF REPRESENTATIVE BODIES

A number of the CDFI representative bodies are also providers of capital to their members, acting as a knowledgeable intermediary with dedicated fund management skills.

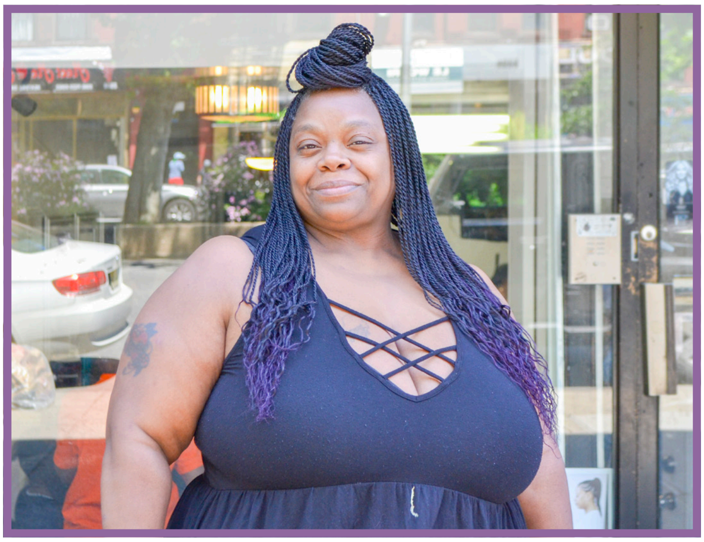


Photo by Grameen America - Heather

Lesson 3: The right balance needs to be struck for representative bodies providing capital to its members between independent investment decisions and benefiting from the knowledge of running a membership organisation. There needs to be discipline and the right incentive structures within the membership organisation to invest in only the strongest CDFIs, using membership activity to strengthen others.

OTHER INVESTORS

Where foundations had been a major source of funds in past decades, many of the CDFIs commented that few provided capital unless it was for a specific programme or initiative.

Lesson 4: Foundation funds offer the opportunity for product innovation and to pilot new approaches that can be scaled and supported by other investors if successful.

The McArthur Foundation is one such example that has invested in CDFIs whose approach includes taking early risk to foster innovation. This was seen in its approach to investing in Benefit Chicago and its other place based investments.

To a more limited extent CDFIs have received investment from individuals and non-bank corporations, however these are in the minority.

PRODUCT INNOVATION

The CDFI market in the US appears to be drawing on practices in the mainstream financial markets to leverage more capital into CDFIs.

Lesson 5: Creating a secondary market for banks to buy CDFIs' small business loans creates opportunities for partnership and liquidity. This is supported by the US Federal Small Business Administration's guarantee (similar to Enterprise Finance Guarantee).

This is an attractive product to banks in particular who want exposure to small business lending but are unable to bear the high transaction costs of making the loans directly or deem the individual small businesses higher risk than the bank's risk parameters.

Lesson 6: Bond platforms can offer a route for smaller CDFIs to access funds from the capital markets. This infrastructure removes the capacity and capability strains of smaller organisations, with benefits of scale for an aggregated product.

The OFN is the qualified issuer of one such platform, and issued the first ever CDFI Bond which was a $100 million bond on behalf of Clearinghouse CDFI for community development financing in California and Nevada.

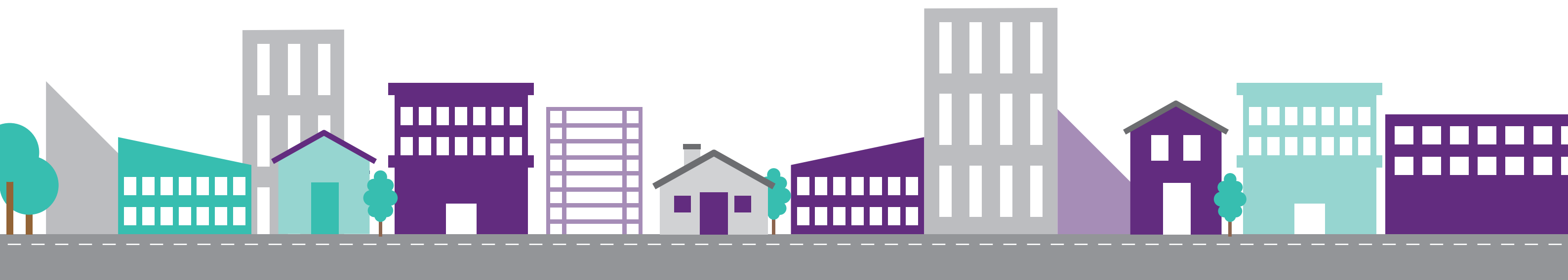
RISK

We heard mixed perspectives on the level of risk investors were willing to take, and in turn the level of risk that CDFIs would take in their investment activities.

Lesson 7: Both the risk profile of bank lending and the coverage requirement tending towards on-balance sheet lending, could limit the CDFI's ability to take risk. The CDFI needs to ensure it can repay its investors, as well as preserve its own organisational position given the loan book is inextricably linked with the financial position of the CDFI.

Lesson 8: To help investors diversify risk across CDFIs and lessen transaction costs, a number of fund of funds have emerged that will provide capital to multiple CDFIs.

These have typically been for real estate CDFIs and CDVAs, however the model offers a good exemplar for other CDFIs.



Conclusion

The three-day visit and subsequent meetings gave a rich, if inevitably incomplete, insight into the US CDFI market and the many lessons that have been learned over the past decades and continue to emerge today. Some of these practices and lessons are very specific to the US context, reflecting the history of CDFIs and the society in which they operate. These haven't been the focus of this report as they would be hard to replicate in the UK. However other lessons, or aspects of practices, that could have a direct relevance are drawn out throughout the report.

The hope is that these lessons and practices will be considered by key stakeholders in the UK CDFI market. This includes the CDFIs themselves, Responsible Finance as the representative body, supporters of small business, local and national government, investors and other thought leaders considering the role of community investment in the UK.

To help each of these stakeholder groups navigate the most relevant learning themes, the below diagram shows the likely relevance for each under the four themes.

Learning Theme 1: CDFI Business Model	**Learning Theme 2: Evidence, Visibility and Representation**	**Learning Theme 3: The Role of the Public Sector**	**Learning Theme 4: Investment Opportunity**
CDFIs Representative bodies Supporter of Small Business Government	CDFIs Representative bodies Government Thought leaders Government	Government Representative bodies Investors	Government Investors

We welcome feedback and reflections on the content of this report, and to hear further lessons that others have learned in the US or elsewhere that might support the UK CDFI market to meet its potential for the benefit of small businesses. Get in touch with Rebecca McCartney at rmccartney@bigsocietycapital.com.