Community Development Financial Institutions: A Study on Growth and Sustainability

June 2011

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The Babcock Foundation commissioned the attached report to increase our understanding of challenges CDFIs face at different points in their development. Bethany Chaney, the author, synthesized recent reports from the CDFI industry and interviewed 13 seasoned CDFI leaders in the Southeast to gather their wisdom.

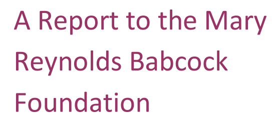
CDFIs are critical infrastructure organizations for helping low-wealth individuals and communities build and preserve precious financial assets. To give a sense of scale, assets under management in the 20 CDFIs currently receiving MRBF grants and Program Related Investments total almost $2 billion. These are depository banks and credit unions, loan funds, and venture capital funds.

Across our region, CDFIs help thousands of low-wealth people underserved by traditional financial institutions to own and keep homes, start and expand successful businesses, and rebuild their savings and credit ratings after financial setbacks such as losing a job or taking on predatory loans. They also help finance large-scale community projects like affordable housing construction and commercial developments.

Over time, some parts of CDFIs' businesses can become largely self-supporting. This self-generated income helps establish CDFIs as permanent institutions in their communities, affording them independence as advocates with low-wealth people and flexibility to develop new financial services and products.

This report's findings and conclusions inform the Babcock Foundation's continued support for CDFIs in the Southeast. We offer it to our CDFI partners, investors and potential investors as a resource to inform your investments.

Gayle Williams
Executive Director
Mary Reynolds Babcock Foundation



A Report to the Mary Reynolds Babcock Foundation

Bethany E. Chaney
May, 2011

[CDFI GROWTH AND SUSTAINABILITY]

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Executive Summary

Community Development Financial Institutions (CDFIs) are for-profit and non-profit financial institutions that provide access to credit and other financial services in low-income and minority markets that traditionally have been underserved by mainstream institutions.

The Mary Reynolds Babcock Foundation has been a long-time supporter of CDFIs in the Southeast through its grantmaking and program related investments. It is now considering the challenges and opportunities currently faced by the field and investment approaches to sustainability and growth. Access to CDFIs is uneven -- of 800 CDFIs nationally, there are only 172 operating in the Southeast. Size, capacity and target markets vary significantly.

The consideration of growth and impact was predicated in part by a 2008 study by the Aspen Institute examining CDFI sustainability strategies. The report found that most CDFIs view sustainability as *balancing a focus on mission, organization capacity and capitalization such that a CDFI can sustain or increase its impact over time*. In order to achieve this, CDFIs must pay attention to the three pieces of the "sustainability puzzle": market context, organizational structure and strategy, and implementation. Self-sufficiency, which varies across the industry, may be less important, and it is unlikely to be achievable for loan funds in particular. Regardless of structure, all CDFIs accept subsidy. "Smart subsidy" is what counts, and is defined as subsidy used to create efficiencies, expand capacity, implement new activities, or to grow.

A lot has changed since 2008. CDFIs have struggled during the recession, facing higher delinquencies and default rates, declines in philanthropic generosity, higher costs for and reduced access to capital, and lower profit margins. Nonetheless, CDFIs have continued to pursue sustainable strategies, including investments in technology, staff, operational restructuring, and partnerships. While some CDFIs have pursued growth strategies, others have decreased their footprint in pursuit of better and more sustainable impacts.

The availability of unrestricted net worth, or capital, is chief among the challenges described by CDFIs in the South. Growth and expansion cannot happen without it. CDFIs are also challenged by on-going capacity needs, including strong staffing, management systems, and market and business planning and analysis. In general, challenges in the resource environment are making it difficult for CDFIs to pursue growth strategies in isolation from their core sustainability needs.

Implications for the Babcock Foundation include:

- There are no one-sized models for CDFIs in the South, but there is room to replicate effective practices, including a disciplined focus on capital and the bottom line. The Foundation's strategy must recognize the different needs of different markets, while encouraging high operating standards.

- The ability and willingness to leverage debt and other resources is important for sustainability and growth. The Foundation can encourage and facilitate leverage through its capital investments, and by convening stakeholders around CDFI sustainability and growth.

- Expectations for growth, improved self-sufficiency, and impact need to be right-sized to accommodate and encourage conservative growth. It can take years for a CDFI to fully understand its market and how to shoulder the risk inherent in it, regardless of organizational capacity, skill and leadership.

CDFIs in the Southeast value the past contributions of the Mary Reynolds Babcock Foundation to the field, including the less tangible support it provides by raising questions, pursuing answers, convening CDFI stakeholders, and participating in innovative strategies. Future MRBF strategy should build on this support, not abandon it.

Background and Methodology

As it explores its role in supporting community development financial institutions (CDFIs) in the Southeast, the staff and board of the Mary Reynolds Babcock Foundation seek to better understand the sustainability challenges of these organizations at various points in their development, and in the context of today's economy.

This report was conceived as a learning tool, in part to gauge the challenges and opportunities faced by the field in this environment, and in part to inform the Foundation's future approach to investing in CDFI infrastructure and capacity in the Southeast. Three key methods were used to inform the report:

- Review of the Aspen Institute's *Approaches to CDFI Sustainability* (July 2008) and seven additional publications listed at the end of this report.

- Interviews with 13 CDFI leaders identified by the Foundation, representing diverse organizations in structure, business model, core products, regulatory accountability, size and maturity. Interview questions and brief descriptions of each CDFI are attached.

- Basic financial review and scans of participating CDFI websites and materials.

What Are Community Development Financial Institutions?

> *"The CDFI Fund was created for the purpose of promoting economic revitalization and community development through investment in and assistance to community development financial institutions (CDFIs). The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994, as a bipartisan initiative."*
>
> ***--The CDFI Fund, www.cdfifund.gov***

With the establishment of the U.S. Department of the Treasury's CDFI Fund, hundreds of community-based financial institutions serving low-income and underserved populations received formal recognition as essential contributors to community economic development across the country. While some had been founded as early as the late 1800s, it was not until 1994 that the term **community development financial institution (CDFI)** was coined, and with it, the opportunity to apply for a special designation from the U.S. Treasury that would

encourage new public, private and non-profit investment in these critical institutions. Today CDFIs take a number of forms:

Types of CDFIs[1]

- **Depository institutions**, including for-profit **Community Development Banks** and non-profit **Community Development Credit Unions (CDCUs)**, which offer a range of consumer and institutional savings, checking and lending services. These CDFIs are regulated and insured by the same agencies that govern other banks and credit unions.

- **Loan funds**, which are non-regulated, non-profit institutions that focus on one or more aspects of capital access and community development, including small business lending, home mortgages, and financing for housing and community facilities development.

- **Community development venture capital funds**, which are non-profit or for-profit institutions that deliver equity capital to businesses in distressed communities.

- **Community development intermediaries**, which act as a "go-between" between large investors and a defined population of CDCs, CDFIs and/or other non-profit organizations for various community revitalization activities.

The largest source of funding for CDFIs is the U.S. Treasury's CDFI Fund, which has awarded more than $1.11 billion to certified CDFIs and has introduced a number of new community development financing and technical assistance resources since inception.[2] CDFIs also raise operating support, equity and lending capital through other federal agencies (such as HUD and USDA), state and local government, banks, foundations, corporations, intermediaries, and individuals. Most bank funding for CDFIs has been directly encouraged by Community Reinvestment Act legislation, the CDFI Fund's Bank Enterprise Award program, and federal tax incentives such as New Markets Tax Credits. Ultimately, CDFIs are expected by all funders to operate in large part with income earned from their financial activities.

[1] List is adapted from the Federal Reserve Bank of Richmond, *Community Development Special Issue*, p. 1.
[2] www.cdfifund.gov

Key Findings from the Aspen Institute

> *"Progress in solving the sustainability puzzle requires a systemic approach, one that recognizes that the solution involves both an overarching vision or a model of how the organization will deliver on its mission over the long term, and a set of constantly fine-tuned processes and tactics that support it."*
>
> ***--The Aspen Institute, 2008***[3]

The Aspen Institute's 2008 study, *Approaches to CDFI Sustainability*, analyzed the organizational and financial data of more than 500 CDFIs, gathered from a number of industry databases and stretching across 2000-2005. It also gathered 250 responses from a 2007 on-line survey and conducted interviews for eight detailed case studies. The purpose of the study was to describe in one place, for the first time, the elements of a comprehensive sustainability strategy, and to understand lessons learned as CDFIs work toward sustainability goals.

A lot has changed in the economy since the study was published. The industry has seen substantial consolidations and closures since 2008, and three of the eight organizations highlighted in the case studies are no longer in existence. (One other has faced near-closure.) The sustainability framework and key principles gleaned from the field are nonetheless relevant. How they are adapted by remaining CDFIs and their funders remains to be seen.

Sustainability Defined

The report found that most CDFIs recognize a difference between self-sufficiency and sustainability. Of the 261 organizations responding the Aspen Institute's survey, nearly 60% defined sustainability as "balancing a focus on mission, organization capacity and capitalization such that a CDFI can sustain or increase its impact over time." Less than 20% of organizations defined it as "achieving 100% cost recovery through revenues from customers," which is a more traditional view of self-sufficiency.[4] While the latter was an end-goal for nearly 60% of respondents, nearly one-third reported current target cost recovery goals of between 50% and 75%, substantially less than complete self-sufficiency.

The "Sustainability Puzzle"

According to the Aspen Institute, there are three sets of factors that represent the pieces of the CDFI "sustainability puzzle":

[3] *Approaches to CDFI Sustainability*, p. 21.
[4] Ibid., p. 14.

Pieces of the Sustainability Puzzle[5]

- **Market context**, or an understanding of the culture and features of the private market (customers and investors) and the civic market (public and charitable subsidy).

- **Organizational structure and strategy**, including the value propositions, mission, products, services, pricing, capitalization and delivery strategies.

- **Implementation or execution** factors, including leadership and staffing, operational competencies, efficiency, risk management and agility, among other intangibles.

The study suggests that organizations that tend to these components in a comprehensive, strategic, yet flexible manner are more capable of maintaining viability, even under the most difficult of circumstances. Nonetheless, the report cautions, "Sustainability is not a permanent state, but a condition that must be won and won over again."[6]

Among the five sustainability strategies favored by CDFIs surveyed were techniques to both generate income and to reduce costs:[7]

- Increasing loan volume
- Increasing efficiencies
- Reducing costs through strategic partnerships
- Introducing more profitable products and services
- Cross-subsidizing between profitable and unprofitable products and services

Generalized market expansion or geographic growth were not explicitly listed among the top five sustainability strategies.

The Role of Subsidy

Subsidy and sustainability are not directly opposed. Regardless of business model, CDFIs accept available subsidy, which is defined as grant income, third party contracts, or below-market financing from the philanthropic or public sectors. CDFIs differ on what form of subsidy they prefer and how it is used. The four most popular uses include:[8]

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[5] Aspen Institute, p. 22-23.
[6] Ibid., p. 25
[7] Ibid., p. 14
[8] Ibid., p. 14.

- Development services, such as training and technical assistance for borrowers
- Operational expenses specific to lending
- Technology and other infrastructure
- Geographic or demographic expansion

A CDFI's **self-sufficiency ratio,** or the ratio of earned income to total operating expenses, is one measure of the need for operational subsidy. This ratio varies considerably between regulated CDFIs (banks and credit unions) and non-regulated CDFIs (loan funds and venture funds), because both federal and state regulators expect to see complete or near-complete self-sufficiency, with some exceptions for start-up institutions or unusual circumstances. Median self-sufficiency ratios for regulated CDFIs ranged between 106% and 111% in 2005, while the median ratio for loan funds and venture funds was 63%. Only 11% of loan funds had achieved 100% self-sufficiency.

Not only is self-sufficiency less common for loan funds, progress toward increasing self-sufficiency ratios is slow for this sector – there was a median improvement of only three percentage points from 2001 to 2005. This is attributable in part to the fact that while regulated institutions can raise lending capital from the deposit, debt, and equity markets, loan funds are limited to the latter two. In addition, loan funds cannot survive as purely "spread lenders," as margins are quite thin regardless of volume. Subsidy, therefore, will continue to be a necessary component of sustainability *and* self-sufficiency for loan funds as they pursue additional strategies to serve their markets, achieve impact, and increase earned income.

The report confirms that using subsidy *smartly* is what counts, not whether a CDFI accesses it.

More Recent Industry Findings

> *"Notwithstanding the drop in number of CDFIs reporting capital constraints, respondents reported that if capital were not a constraint they could have deployed $43 million in additional capital in the fourth quarter… and could deploy over $1.76 billion in new capital in the next twelve months."*
>
> ***--OFN, CDFI Market Conditions Q4 2010***[9]

A review of literature from the industry finds that CDFIs have struggled during the recession, but that there is also significant optimism across sectors.

[9] Page 1.

The **Opportunity Finance Network's (OFN)** Q4 2010 scan of the CDFI industry suggested the CDFI operating environment was improving, indicated by a noticeable rebound in demand for CDFI services and increased lending. Of 117 organizations responding to its survey, 55% reported increases in loan applications from one year ago, while only 26% reported decreases. Loan originations also increased over the prior year for 46% of respondents, but more than one-third noted decreases attributed to weak application quality and tightened underwriting standards.[10] Whatever their circumstances, 67% of CDFIs expected to see demand continue to increase in 2011, in part due to continued market retractions by conventional lenders.[11] CDFI optimism across sectors was tempered by concern about state and local budgets, reductions of which would affect not only capitalization sources, but demand and risk factors for individual and commercial borrowers.[12]

Interestingly, OFN reported that for the fourth straight quarter, the number of CDFIs that were constrained by a lack of lending capital declined. Less than 18% of CDFIs reported lending capital constraints in Q4 2010, with medium-sized CDFIs ($10 million - $50 million in assets) more likely to feel constrained. Consumer lenders were more likely to report increases in the availability of capital for lending.[13] For CDFIs who borrowed money in order to relieve capital constraints, the average cost of this capital increased, a consistent trend since Q2 2009.[14]

Portfolio risk remained steady, with the proportion of loans at-risk hovering at 8.5%. However, average loans restructured was more than 7%, a substantial increase over the prior year.[15] Regionally, CDFIs in the Northeast reported the highest average risk, while sectorally, housing loans to individuals and loans to businesses had the highest portfolio risk. Housing loans to organizations and loans for community services/facilities had the least portfolio risk.

In a similar report issued by the **National Federation of Community Development Credit Unions (the Federation)**, CDCUs were found to have had slightly stronger asset and loan growth than mainstream credit unions, but their net worth fell below industry standards in part due to higher losses.[16] Just over half of CDCUs were unprofitable, attributed in part to charges imposed by the National Credit Union Administration to "cover the costs of corporate credit union stabilization and the losses among local credit unions."[17] Thirteen CDCUs were merged in

[10] Aspen Institute, p. 3.
[11] Ibid., p.1.
[12] Ibid., p. 2.
[13] Ibid., p. 4.
[14] Ibid., p. 2.
[15] Ibid., p. 5.
[16] NFCDCU, p. 2.
[17] Ibid., p. 3.

the first half of 2010, the majority of which were located in the South.[18] Most assets were merged into other CDCUs.[19]

The **Center for Financial Service Innovation (CFSI)**, which surveys a very broad spectrum of for-profit and non-profit suppliers of financial services that are considered beneficial to the underbanked market, notes some important trends. For-profit providers are more optimistic about growth than non-profits and are much more likely to indicate that competition for services to the underbanked will increase. Yet they also are more likely to expect decreases in profitability than non-profit providers.[20]

All providers believe that transaction and credit products, including prepaid cards and short-term credit instruments, are the greatest market opportunity for serving the underbanked. Savings products had lower prospects. Limited profitability and regulatory issues were two of the top challenges for providers serving the underbanked, while increasing market share and increasing presence within existing geographical footprints were two of the top opportunities.[21]

Finally, industry sources noted regulatory changes were affecting CDFIs in various ways. The Durbin Amendment to the Wall Street Reform and Consumer Protection Act (also known as Dodd-Frank) reduces electronic interchange fees paid on the use of debit cards by 70%. In addition, the Federal Reserve's new Credit CARD regulations eliminate the ability for banks to charge automatic overdraft fees on debit cards. The resulting loss of income from both regulations are forcing banks to raise or impose new fees on consumer products, most notably by abolishing free checking accounts. CDFI banks have been hit hard by this regulation,[22] but the Federation at least sees an opportunity for CDCUs to capture some low-income consumers priced out by mainstream institutions.[23]

[18] In 2010, 28 total credit unions covered by NCUA insurance failed, thus nearly half were CDCUs. In contrast, there were 17 failures by banks and savings institutions covered by FDIC insurance. (AltruShare, p. 4)
[19] NFCDCU., p. 6.
[20] CFSI, p. 4.
[21] Ibid., p. 2.
[22] By some estimates, banks with less than $1 billion in assets will not be able to afford compliance with Dodd-Frank.
[23] NFCDCU, p. 9.

CDFIs in the South: Gaps and Opportunities

> *"Measured by personal income per capita, the poorest states in the Southeast have fewer CDFI headquarters relative to the richer states."*
>
> ***--Federal Reserve Bank of Richmond, 2010***[24]

In its 2010 analysis of CDFIs in the Southeast, the Federal Reserve Bank of Richmond found that of approximately 800 certified CDFIs in the United States, 22% -- or 172 CDFIs -- are headquartered in the 13 states in the Southeast and the District of Columbia. Some CDFIs in the Southeast are multi-county and multi-state, therefore absolute market coverage is hard to know for sure. Nonetheless, the Federal Reserve notes that the six states with the lowest personal income per capita have fewer CDFIs, including Mississippi, West Virginia, Arkansas, South Carolina, Kentucky, and Alabama. CDFIs in Alabama, South Carolina and West Virginia have the lowest total asset levels.

Target markets served by individual CDFIs in the Southeast also vary. A large portion, 37%, serve multiple target markets. 20% serve only businesses, 15% serve consumers, 10% serve housing, and 3% serve non-profits. 15% did not report target market information. All but one state have CDFIs that serve all target markets, but not necessarily within a broad geography.

The Federal Reserve concludes that the analysis "raises a number of interesting research questions. What determined their choice of location? Have they been successful in serving their target population? How do we measure their impact?"[25] These are questions the Babcock Foundation is also asking, in context with overall concerns that access to CDFI services is both needed and lacking across the South.

Southern CDFIs and Post-2008 Sustainability

> *"CDFIs must have the fortitude not to move forward without all elements of a well-defined business plan in place: human capital, operating capacity and lending capital."*
>
> ***--Jane Henderson, Virginia Community Capital***

[24] *Community Scope*, Federal Reserve Bank of Richmond, 2010, p. 3. All data in this section is from this report.
[25] Ibid., p. 9.

Attached is a list of the organizations interviewed for this report, including six loan funds serving commercial, individual, or non-profit or public customers; two intermediary CDFIs; three credit unions, including two paired with loan funds; and two banks, also paired with loan funds. Seven CDFIs also are affiliated with non-profit organizations which serve critical functions, such as back-office support, access to the market through referrals or membership, credit counseling and technical assistance to customers, grantmaking, or policy-advocacy.[26]

Sustainability as Viewed by Southeastern CDFIs

As the rest of the field, the vast majority of CDFIs interviewed for this report were in general agreement that there is a difference between self-sufficiency and sustainability, with nearly all organizations adopting the more comprehensive definition and setting a target self-sufficiency ratio of between 50% and 80%. These CDFIs recognized that total cost recovery is ideal, but simply may be unrealistic given current size, particular markets served, and the inefficiency inherent in mission lending. Two regulated financial institutions equated sustainability with total cost recovery for core services, but not necessarily for new initiatives or defined growth plans. One organization uses the CDFI Fund's Minimum Prudent Standards (MPS) as its ideal benchmark. [27]

Consistent with the Aspen Institute findings, loan funds were less likely to believe that total cost recovery is achievable. "We've looked hard at the question of self-sufficiency. It's wishful thinking," says Justin Maxson of MACED. "Given the communities we serve and market failures we address, it is impossible to cover our total costs. We are interested in slow growth and self-sufficiency, but this won't come exclusively from the loan fund."

No one could claim they are where they want to be, even those who cover their core services with earned income in an average year. Those who do not reported self-sufficiency ratios as low as 25% for one business loan fund and as high as 90% for a bank. Southern Bancorp and Self-Help, the two largest and most diversified organizations, cover their costs but nonetheless are concerned about sustainability in the context of growth, impact, and the economy.

"Self-sustaining development lending is more difficult since the recession kicked in," says Bill Bynum of Hope Enterprise Corporation, which includes Hope Federal Credit Union and serves all or parts of four states in the Mississippi Delta. In an area that has experienced chronic lack

[26] For the purposes of this report, only CDFI sustainability was considered. The needs of affiliated non-profit organizations are briefly discussed in the final section.

[27] See exhibits. Note that the CDFI considers MPS for banks and credit unions to be that of their federal regulators, which do not distinguish between CDFI and non-CDFI institutions.

of capital investment, subsidy will continue to be needed "to keep rates at responsible levels, manage risk, and to cover the costs of technical assistance and outreach."

While all agreed attention to self-sufficiency is important, some questioned the implications, including mission creep. Jim King of the Federation of Appalachian Housing Enterprises (FAHE), a housing development intermediary, has an 85% self-sufficiency target. "If we exceed this," he wonders, "are we serving the population we need to be?"

The human element of sustainability is key, says Jane Henderson of Virginia Community Capital (VCC), a development bank and companion loan fund. "So many CDFIs are leader-dependent, and we are just now seeing changes as founders retire. Some will lose and some will close." This is why as a start-up VCC is very focused on process and institutionalization, including leadership development, more so than absolute self-sufficiency.

External Challenges to Sustainability and Growth

Consistent with the literature, CDFIs in the Southeast have faced enormous challenges during the recession, including higher delinquencies and default rates, declines in philanthropic generosity, higher costs for and reduced access to capital, and lower profit margins on lending and other financing activities.

The effects of these challenges have not been felt equally nor experienced in quite the same way across markets. For example, some CDFIs have seen borrower demand increase, especially microenterprise loan funds, which on the one hand have experienced an influx of bad referrals, and on the other hand, have seen more up-market borrowers knock on their doors that banks would have funded three years earlier. Other CDFIs have noted decreasing demand, particularly from commercial borrowers such as home builders. Latino Community Credit Union has witnessed substantially more conservative behavior from its borrowers, who have been concerned about overextending themselves in the midst of economic crisis and an escalated immigration debate. In the chronically distressed areas of Central Appalachia and Mid South Delta, housing markets already were depressed and economies had shorter distances to fall.

CDFIs in the South took advantage of a number of federal recovery programs, with several accessing the Neighborhood Stabilization Program, funding through the American Recovery and Reinvestment Act (ARRA), and/or the Community Development Capital Initiative, funded through the Troubled Asset Relief Program (TARP).

These and other government responses to the economy also caused considerable strain. CDFIs saw federal retraction from certain funding areas, such as housing, rural development, and biofuels. As noted above, Dodd-Frank has had the unintended consequence of unfairly burdening CDFIs, while a tightening of regulatory standards resulted in consolidations or closures among credit unions and CDFI banks. ARRA funding was time constrained and also had burdensome reporting requirements.

Among the most frequent external challenges cited by CDFIs in the Southeast included:

External Challenges

Retraction of philanthropy. CDFIs noted a reduced amount of philanthropy attributed to declining foundation endowments. They also noted the continued flight of philanthropy from rural places (particularly the Mississippi Delta) and general geographical limitations that make multi-state strategies difficult to sustain. Where philanthropy was not retracting, programmatic restrictions were nonetheless limiting.

Retraction of private investments. Failures and consolidations of mainstream banks, disinterest in the Community Reinvestment Act, and general unprofitability affected corporate grants, capitalization loans, participation loan volume, and investment in the Low Income Housing Tax Credit, which fuels affordable rental housing development. Private investors also tightened credit and underwriting standards, including collateral requirements, which made their investments unattractive to most CDFIs. CDFI banks suffered particular collateral damage from the notable failures of ShoreBank and Legacy Bank, which caused investors to take pause.

Continued reduction of government resources at all levels – federal, state and local. Housing subsidies in particular took a hit, as did general economic development resources unrelated to ARRA.

Failures in the liquidity markets. Secondary market intermediaries Fannie Mae and Freddie Mac, which purchased mortgage loans from mainstream financial institutions and CDFIs, have collapsed and may be gone for good. As a result, CDFIs have few options for packaging and selling their mortgages responsibly. Instead, they must hold more of these loans in portfolio, reducing the amount of capital they have available to reinvest in new asset-building loans. Similarly, several corporate credit unions have melted down, including in North Carolina. These 'credit unions for credit unions' require capital deposits from the credit unions that do business with them, and in

exchange provide liquidity instruments as well as check-clearing, electronic funds transfer, ATM networks and other services for which they charge fees. As they restructure to avoid failure, corporate credit unions are requiring larger capital investments and higher fees, which strains CDCU liquidity and profitability.

Lack of economic diversity within markets. Several CDFIs noted the deep community economic development infrastructure in North Carolina, as well as the understanding within the private and public markets of how to deploy resources to stimulate diverse economies. But in Central Appalachia and the Delta, diverse economies and the resources to support them are lacking. As a result, one leader noted, it is difficult for CDFIs to make change effectively because "the job creation just isn't there."

Perhaps the greatest challenge facing CDFIs is continued uncertainty. Pointing to reduced investment in the Delta, Dominik Mjartan of Southern Bancorp says, "We're trying to resist the permanence of these challenges and are making the assumption that they aren't. But we're not scaling our impact as quickly as we'd like. We're spending a lot more time on advocating for resources to flow back into our communities." Others cite concerns about 2012 federal budget decisions around CDFI, SBA, USDA, CDBG and other public resources.

"Big changes are coming," says Michelle Mapp of Lowcountry Housing Trust. "Banks are saying 'FDIC has my hands tied' – they can't invest the way they used to."

Bill Bynum of Hope Enterprise Corporation agrees. "The secondary market has gone away for non-conforming mortgages. A twenty percent downpayment requirement may be imposed. If this happens, we'll see permanent changes in the homeownership market for many working families."

Some CDFIs see the changing environment as an opportunity to get better at what they do. Alison Yonas of Latino Community Credit Union says that while the political climate may be permanent, "CDFIs have to be nimble enough to move. We have to be proactive to maintain our competitiveness."

Internal Challenges to Sustainability and Growth

To some degree, internal challenges mirrored external challenges, but several are transcendent issues—they would exist regardless of the economy.

Internal Challenges

Staffing. Nearly every CDFI noted the importance of smart, committed staff for both deployment and administrative functions. Start-ups note they cannot afford the number or quality of staff that could move them forward quicker, while growing organizations complain that what they *can* afford often is not adequate to achieve the desired impact. Several organizations cited the need for staff training and/or leadership development opportunities, and two organizations that experienced executive level transitions in the recent past noted that managing this change was difficult for staff and board members.

Ability to generate earned income. A reduced interest rate environment for lending and upward pressures on cost of funds forced thinner margins. Lack of capital limited some CDFIs' lending volume or ability to roll out new income-generating products. Younger organizations are frustrated with the classic fundraising squeeze—funders need to see a track record before they will invest, yet organizations cannot build a track record without operating funds or capital to lend.

Portfolio development and management. Business lenders were most likely to cite an influx of bad referrals. These organizations spent a lot of time and human capacity working through a higher volume of unfundable deals to find a lower volume of workable ones. At the same time, they devoted more of their capacity to stabilizing portfolios, or intervening with technical assistance and work-out plans for distressed clients. As one CDFI leader noted, "Nothing sucks up your time like failure."

Infrastructure needs. Undergirding a number of internal challenges was the ongoing need for improved or more efficient organizational infrastructure, including back office staff, more sophisticated financial management systems and analytics, and marketing and communications capacity. Several organizations noted that the more vigorous regulatory environment was forcing them to make new administrative investments, such as paying for new lending certifications required by the SAFE Act.

Pressures of expansion or requests to expand. Nearly half of the CDFIs interviewed were in the midst of geographic expansion or were feeling pressure from communities or funders to consider expansion. Making decisions about expansion, funding it, and most importantly, managing it, were all challenging at some level, particularly for regulated institutions taking over failing institutions, sometimes at the request of regulators. Finding or maintaining balance as financially-vigilant mission lenders was a

concern to several organizations considering expansion for sustainability, impact, or both. Jim King of FAHE believes that CDFIs need to understand which market they best serve as they determine expansion strategies. "Current success is not a sole indicator," he says. "CDFIs that get good in places where there is low-hanging fruit are not necessarily good at going down-market. And vice versa."

Preferred Sustainability Strategies

"There's a reason banks don't do this."

--Marten Jenkins, Natural Capital Investment Fund

CDFIs in the Southeast pursued sustainability strategies during the recession consistent with the priority strategies described in the Aspen Institute's report, seeking to create both efficiencies and earned income. To some degree these strategies were designed to mitigate the negative effects of the economic climate, but not for all. "Mitigation doesn't help," said one CDFI leader, pointing to the need to stay focused on the longer term challenges, not just the recession. Another suggested that the only way for small CDFIs to mitigate current challenges was to "work longer, harder, and smarter." Regardless of their perspective, nearly every CDFI leader interviewed stressed the importance of business or strategic planning, and five had created or implemented new plans within the past 24 months.

Efficiencies

Three cost containment and efficiency steps led the list of preferred sustainability strategies for CDFIs in the Southeast.

Preferred Sustainability Strategies

Investment in Technology by far was the most commonly cited, with half of all organizations purchasing loan document software, automating their underwriting, introducing virtual interfaces for customers, using distance learning technology to provide development services, or adopting pipeline management, evaluation/monitoring or financial management systems in the past two years.

Investing in staff capacity and/or reworking staffing structures. CDFIs had very individualized approaches to building or "right-sizing" staff capacity, depending on the circumstances. A number of organizations reworked their regional structures—scaling them back to target lending more effectively, as in the case of Mountain BizWorks, or

stepping them up to meet growing demand more effectively, as in the case of Latino Community Credit Union. MACED chose to separate lending and portfolio management functions for the first time, resulting in a stronger portfolio and better revenue flows.

Partnerships and outsourcing. One-third of CDFIs reported they had committed to or renewed partnerships for technical assistance delivery, loan participations, or referrals. Still others cited long-standing partnerships for accounting, human resources, loan processing and servicing, or other activities.

As a former banker, Jane Henderson of Virginia Community Capital embraces cost containment, but as a CDFI manager, she does not believe it should be at the expense of institution-building. She cautions that CDFIs and their investors may be driving too much efficiency given the markets they serve. "These are inefficient markets and they always will be inefficient markets," she says. "If there was a lot of efficiency, there would be capital flowing." Martin Eakes of Self-Help tends to agree, noting that efficiencies are very important but "not so critical short-term."

Earned Income

Of the organizations interviewed, about one-third were in the process of designing or rolling-out new products or services as a means of diversifying income and attracting and serving new customers. Most were in support of particular strategic planning goals. Nearly a third of organizations were in the early stages of research and development—conducting market analyses, examining peer business models, or at the very least, talking about it.

New Products and Services – Current and Planned[28]

- Servicing for Individual Development Accounts (IDAs)
- SBA 504 guaranteed lending
- Fiscal agency
- Back-office service provision
- Brokering development or business loans for larger partners
- Brokering mortgages
- Healthy Food Financing programs
- New Markets Tax Credit brokering or direct allocation
- Community facilities
- Business/microenterprise lending
- Commercial real estate development or lending
- Energy efficiency products
- Increasing geography
- Consulting services to small businesses

[28] See glossary for definitions to several products listed here.

It is worth highlighting that green-related products and services in particular that are making new markets for a number of CDFIs, in keeping with national trends. For example:

- In 2008, Access to Capital for Entrepreneurs (ACE) launched a new branded product, **Georgia Green Loans**, and has collaborated with two other lenders to proliferate the program statewide. The purpose of the product is to enable small businesses to start or expand an eco-friendly product or service or "green" an existing business. Examples include organic farming, specialty food production or value-added products, new conservation products and/or services and updates of existing buildings and business processes. Maximum loan size is $50,000. Grace Fricks, President of ACE, says the product has attracted "a whole different clientele. The people who have applied are different than intended, but still capital constrained." The organization is researching a green products leasing program to provide some synergy with Georgia Green Loans, working with a leasing company broker and earning referral fees. "These sorts of things will be huge," says Fricks, "but you have to have the right person to implement them."

- MACED is demonstrating a number of energy-efficiency products and services throughout its service area. Its **How$martKY** program is a "pay as you save" model that enables homeowners to get energy-saving retrofits, and to pay for the retrofit in their monthly electric bills. MACED finances the retrofit through a partnership with four rural electric cooperatives. A similar effort to encourage energy efficiency is underway that is aimed at reducing costs for the nearly 200 small groceries operating in Kentucky's Appalachian counties. By purchasing new refrigeration systems, for example, a single store can save $40,000 annually and repay a $200,000 loan in short order.

  The latter program took a great deal of time and work to get right, as model and cost structure of the grocery business was new to MACED. "We have two priorities in our strategic plan," says Justin Maxson, President of MACED. "To make green real to impact low-income people, and to have a deeper impact on disadvantaged entrepreneurs. We're thinking about what technical assistance, technology and other strategies can do to help us achieve these goals, but these are likely to be more *expensive* options, not more efficient."

There were two challenges cited most among those who were not at all ready to think about new products or services. The first challenge was how to pay for the steps needed to examine opportunities and create product-specific business plans. The second was how to pay for rolling out the products and services—staffing, technology, and capital. As Bill Bynum of HOPE points out, "In some cases, it's like funding a start-up."

Marten Jenkins of the Natural Capital Investment Fund is challenged in a slightly different way. While he wants to introduce new products, he needs them to be available across his entire service area which, thanks to a grant from the Ford Foundation, now includes six states. The problem is that most capital resources come with geographic or sectoral restrictions, or as in the case of federal programs, are administered differently on a state-by-state basis. While the organization conducted a generalized market study paid for by the CDFI Fund and the Babcock Foundation, it cannot afford product-based studies needed to make sound choices. "Guaranteed loans, SBA 504, microlending—all of these are being pushed at us. But it's hard to get the money to examine them."

"We want our products to be flexible and responsive to community needs, rather than to be boxed into only certain products or product types," says Deborah McKetty of the Greenville Housing Fund, a young organization which is considering becoming a mortgage broker and possibly expanding to business loans down the line as a means to grow and serve the community. "We want to be a regional community loan facility that enables innovation," she says, realizing that a lot of learning lies ahead before the goal can be reality. Martin Eakes of Self-Help, however, is concerned about broad diversification strategies for CDFIs. "CDFIs need to be focused and lean. They have to pick specialties and be niche players."

Considerations for Growth

> *"A CDFI is like a bicycle. The front wheel is the mission. It turns and adapts, and it leads the organization. The back wheel is the capital base, on which sustainability, risk, and transaction costs are seated. The two wheels need to be balanced or you won't get anywhere."*
>
> ***--Martin Eakes, Self-Help***

To what degree must CDFIs invest capacity and capital in pursuit of efficiencies and sustainability at different points in their life cycles, and what kind of investment provides the most sustainable impact organizationally and for the communities they serve?

It is a big question, and unfortunately there are few clear patterns among CDFIs to suggest firm answers. Nonetheless, Martin Eakes of Self-Help, the oldest and largest CDFI in the mix, notes a few basic principles that should ground any investment and growth strategy.

The first rule of thumb noted by Eakes is that financial institutions can only grow as rapidly as return on equity (ROE), or profitability divided by net worth. Net worth and total assets will grow at the same rate.

If a $1 million loan fund is 100% equity and has a 3% ROE, it will earn $30,000 in profit, which is added to its net worth. The next year, assuming no new equity has been raised and all other costs remain proportionally the same, the $1,030,000 fund will earn another $30,900, and the next year, $31,827. Over three years, the organization will have earned $92,727 and will have grown its net worth to $1,092,727. In this very simple scenario, the 3% annual ROE results in a 3% annual growth in equity and assets.

A second rule of thumb is that low-cost debt, or leverage, can increase both the size of a loan fund and the growth of that loan fund over time.

For example, if the $1 million loan fund borrows $4 million to add to its lending capital, it increases its size and potential impact to $5 million. If properly managed, the loan fund will grow at a faster rate than if it had not borrowed money to re-lend. Because there is a cost to the borrowed funds, the return on those funds will be lower than the 3% return from the cost-free equity base, in this example, 1%. The borrowed funds will earn $40,000 in the first year, on top of the $30,000 earned by the equity base, for a total of $70,000, or 7% ROE. Thus, the overall assets of the loan fund can grow by 7%.

Eakes points out that the power of compounding has a dramatic impact on growth over time. An all-equity loan fund that earns 3% ROE over 30 years will grow by a factor of only 2.43 to $2,430,000. If the same loan fund leverages $4 of debt for each $1 of equity over time, and if it earns 7% ROE as in the previous example, it would grow to be $38.1 million over 30 years. This is a substantial 15-fold difference in scale, strength, ability to lend, and overall impact.

The example above is simplified and dependent on an organization's ability to maximize its returns through efficiencies, smart lending, and sound portfolio management. But if an organization is paying close attention to these factors, the point is the same: leverage should be part of any organization's sustainability strategy. *Not* leveraging debt with equity is a missed opportunity for income growth, asset accumulation, and impact.

Given that a piece of growth is leverage, what is the right amount? Industry leaders say that for every $1 of equity, an organization can raise an additional $7 - $10 in debt safely, depending on size and experience. Eakes is more cautious and says that a 15-20% equity position is a good place for most loan funds to be, well-leveraged yet secure. With the ability to scale-up with

insured deposits, which is a form of debt, Eakes argues that depository institutions tend to grow too quickly, which is one reason so many financial institutions have failed in the recession. The average capital base for a CDFI credit union is about 10%, although smaller ones are likely to be closer to 7%. In contrast, loan funds are most often *underleveraged*, maintaining a 30% to 40% equity ratio, missing growth opportunities as well as greater self-sufficiency and impact.

Finally, for CDFIs to get to and maintain sustainability, people management, leadership, and financial capacity all have to be present. Of these, says Eakes, the most important is leadership. To get to scale, he says, "You can't outstrip the experience of senior staff, or the CDFI will fail."

When asked to describe the most essential catalysts for their own past growth, CDFI responses were consistent with the principles outlined above. Half cited the legitimacy, capital grants and leverage afforded them through CDFI certification, and half cited smart, committed staff and board members as among the two greatest success factors. Others noted leverage and/or longevity of a particular funding source or partnership. Less tangible catalysts included leadership development opportunities and education or new knowledge within the industry.

A small handful of CDFIs benefited from a jump start or "big boost" of one kind or another. Among these were Self-Help, which received a $50 million capital grant in 1998 to implement a secondary market facility, effectively doubling its net worth. Virginia Community Capital was able to capitalize its bank and loan fund with a $15 million award from the State of Virginia, which sought to consolidate a number of publicly-run loan funds. Latino Community Credit Union has benefited tremendously from a contractual operational partnership with State Employees' Credit Union that helped the CDFI become fully-operational and grow much more quickly than otherwise.

These opportunities are rare. In their absence, and to *prepare* for them, CDFIs are best served by slow but steady capital-based growth strategies—acting as a tortoise, rather than a hare.

What Does Smart Subsidy Look Like?

> *"What counts is how it is used, how well subsidy reinforces a stronger market orientation, and how well the organization has positioned itself to survive if the subsidy declines or disappears."*
>
> ***--The Aspen Institute***[29]

[29] Page 25.

For the most part, CDFIs agree that "smart" subsidy, whether grant funds, low-cost loans, or equity investments, firm up foundations for growth by providing a well-directed catalyst for growth or by filling implementation/operating shortfalls until earnings from growth catch up.

Capital

When asked to be specific about what they believe CDFIs need in order to grow, all twelve CDFIs listed **unrestricted net worth**, or capital that accumulates from earnings or from grants, at the top. When asked why, nearly all said leverage – the ability to secure debt up to ten times that of a capital grant. Loan funds were more likely to cite the added benefit of reduced cost of funds, and regulated institutions cited safety and soundness mandates. Several CDFIs noted the importance of capital in enabling high-mission (i.e.: riskier) lending and impacts.

As noted above, CDFI certification is the single most important lever that opens doors to **capital grants**, the largest and least restrictive of which are made available by the U.S. Treasury's CDFI Fund, with some exceptions. Foundations and some banks provide capital grants but are more likely to restrict them to lending, lending reserves, or to particular product or geographic deployment. Even with restrictions, net capital affects net worth ratios in the same way as it would without restrictions. However, some investors and accountants view certain restricted net assets less favorably when evaluating the overall risk carried by a CDFI, or when evaluating 'match' for grants.

Some CDFIs have access to certain kinds of capital resources that other CDFIs do not. Community development credit unions are able to take on **secondary capital**, which is a long-term investment that regulators view as equity, the value of which depreciates in even increments over the life of the investment. Because there is a cost to secondary capital, it is "smartly" used as a bridge to support growth, and less smartly used as a primary means to meet regulatory requirements in the absence of concerted growth.

Non-profit CDFIs other than credit unions can access a similar tool, called **Equity Equivalent Investment (EQ2)**, which can be used to support diverse needs such as large real estate projects, near-equity investments for businesses, or simply capitalization. This product, however, has not been offered as rigorously in the South, where there are few CRA motivations to invest risk capital outside of a limited number of urban areas. Foundations have not ventured into EQ2 either, although they can. While a couple of loan funds had accessed EQ2 in the past five years, one CDFI leader interviewed lamented the product as "dead."[30]

[30] CDFIs noted that Wells Fargo Bank (formerly Wachovia) is offering the tool in the South on a very limited basis, while RBC Bank is also trying it out but has less experience with it. In addition to banks who have not used the

Banks technically can raise equity by selling **stock**, but there is no true stock market for private CDFI banks. While they have the option to "go public" and list on an exchange, most CDFI banks fear the erosion of mission, vision and values as shareholders demand more or faster profits.[31] In addition, going public increases regulatory and administrative burdens. Both CDFI banks interviewed for this report are keen to solve this problem, whether by offering a kind of privately-placed preferred stock, or by other innovative means.

Operating Support

As noted in the Aspen Institute report, using subsidy for operations is not in opposition to self-sufficiency if it is needed to advance **non-core operations** specific to expansion, efficiencies, revenue growth, or other positive changes for a CDFI. Specific non-core expenses noted by CDFIs in the South as 'smart' uses of subsidy include:

Sample Non-Core Operations

- Market analysis and business planning
- Start-up staffing and expenses associated with new product roll-outs, market penetration, or geographic expansion, including marketing and communications needs
- Attracting and retaining talent as organizations become more sophisticated
- Advancing back office functions and efficiencies to meet the needs of growth
- Data collection/evaluation
- Lending, servicing, and financial management systems

While they agree non-core expenses are the smartest use of subsidy, loan fund leaders across the board noted that **core operations** are persistently underfunded regardless of growth and are thus in need of on-going subsidy. This is also consistent with the Aspen Institute's analysis. These CDFIs value patient funders that understand the mission-business of a CDFI, yet they also recognize the importance of having a diverse funding base. Both are elusive goals in the South, particularly in rural areas. "No one gives you the long-term operating support with the capital," says Grace Fricks of ACE, "but to get self-sufficient you need full-time staff." Operating support with the least restrictions, in higher amounts, and for longer periods of commitment are, for obvious reasons, preferred.

tool, it may be that the learning curve for EQ2 is high for other stakeholders that matter – such as accountants, auditors and boards of directors.

[31] A few publicly-traded banks are certified CDFIs.

Liquidity and Lending Resources

Surprisingly, very few CDFIs specifically mentioned lending capital or liquidity as what they would need most in order to grow, with the exception of mortgage lenders, who are concerned by the collapse of the secondary market. It is possible that CDFI leaders interviewed simply view net capital as the highest priority need since it affects all else, including the ability to leverage liquidity resources.

For those that did specifically mention lending capital, **foundation PRIs** were the preferred source as they are seen as both less restrictive and least expensive of the available debt capital, although several CDFI leaders wished terms could be longer and amounts could be bigger. "Most funding in the sector comes in $50,000 increments," says Grace Fricks of ACE. "That's not even one loan. If you make $90,000 to $250,000 loans, that eats up just one ARC [Appalachian Regional Commission] grant!"

While some CDFIs have access to **intermediary resources for re-lending**, one large CDFI noted that it had outgrown intermediary resources and really needed the opportunity to ask for investments directly. However, some foundation and corporate investors prefer to invest in CDFIs solely through intermediaries, and to limit the proportion of those investments that can be placed with any single CDFI. Off balance-sheet resources (such as lines of credit or resources provided by an affiliated entity on demand) were not mentioned in the course of discussions as an available or preferred source of liquidity, which does not necessarily mean they are absent.

Finally, related to lending are **guarantee pools** that enable CDFIs to collateralize riskier loans and/or to provide the risk capital necessary to leverage a mainstream lender as a participant in larger deals. Two loan funds noted the inadequacy of federal guarantee programs, either in terms of restrictions or general unwieldiness.

Implications for MRBF

> *"Resilience is about a blend of resources that balances income with capacity and impacts."*
>
> ***--Justin Maxson, MACED***

The Mary Reynolds Babcock Foundation has the most sophisticated toolkit available for CDFIs in the South. More than that, the CDFIs interviewed for this report saw the Foundation's support as instrumental in opening doors to new relationships, helping them leverage private and public funding, and providing reliable support when other funders scaled back. Yet as it considers

how best to support CDFI impact throughout the region, it is clear that the work of institutionalization of high-potential CDFIs is not finished. To increase CDFI effectiveness and impact in the South, the Foundation must continue to support the *resilience* of CDFIs alongside selective investments in well-planned market penetration and/or geographic expansion.

Lessons Learned

Despite some common experiences and a few basic principles on which CDFI strength and growth plans can be evaluated, there are no obvious patterns or absolute roadmaps for increasing CDFI capacity at particular points along the life cycle. Diversification strategies for one loan fund simply may be too dangerous for one in a different marketplace. What may take one credit union five years to accomplish may take ten for another. Regardless, the following lessons gleaned from the literature and CDFIs in the South may help inform the Foundation's investment strategy:

Lessons from the South

- There are no one-sized models. Business models, values, life cycle speeds and shapes, efficiencies, operating environments, and regulatory issues vary considerably by market. There are even fewer absolute truths for loan funds than for regulated institutions, which at the very least must meet certain financial requirements regardless of market. The Aspen Institute suggests what can be replicated are "*practices* that effective CDFIs are using, and *the type of culture* that prizes a disciplined focus on the bottom line."[32]

- Capital-based models are most successful. This means recognizing the fundamental value of accumulated unrestricted net worth, and sticking to conservative but not overly-cautious standards.

- While capital matters for all organizations, so does leverage. Organizations that are unwilling or unable to fully-leverage their capital base within safe standards will see slower sustainability gains, and fewer impacts.

- The "big boosts" are rare. As a result, expectations for growth, improved self-sufficiency and impact need to be right-sized to accommodate and encourage conservative growth.

- It can take years for a CDFI to fully understand its market and how to shoulder the risk inherent in it. Regardless of organizational capacity, skill and leadership, debt may be

[32] Aspen Institute, p. 25. Writer's emphasis in italics.

the least effective tool for CDFIs that are relatively new to a marketplace or that are expanding their products and services within their current market for the first time.

Specific Suggestions

When asked how the Babcock Foundation could best support the sustainability needs of CDFIs while also encouraging bigger impacts in the future, CDFIs suggested both financial and non-financial support to help them address all factors of the "sustainability puzzle."

Suggested Support for CDFIs in the South

- Make bigger and/or longer-term grant and PRI investments, or leverage other funders to participate in larger investments.
- Investigate opportunities to fund guarantee pools, whether collaboratively with other funders, alone, or in other ways.
- Go beyond deposit-making for regulated CDFIs. For example, help CDFI banks develop and test an equity-raising model (both Southern Bancorp and Virginia Community Capital have ideas to share), or increase secondary capital opportunities to support well-planned credit union growth, such as Hope Credit Union's merger strategies.
- Test ways to invest endowment/corpus in CDFIs, and document and disseminate the results. One strategy could be investments in the CDFI Bond Program, a nascent opportunity discussed further below.
- Broaden assistance for non-core expenses such as market research and business planning, but not at the expense of core operating support. While statewide market analysis is helpful, regional and product-specific analysis is the most important for strategic decision-making for loan funds in particular.
- Explore and actively engage with the pending **CDFI Bond Program**, enacted by the Small Business Jobs Act of 2010 and to be administered by the CDFI Fund. The bond program would offer a new source of long-term, low cost capital that CDFIs can use to expand their capacity and impacts. Rules governing the Bond Program are supposed to be finalized by September 2011, and the Opportunity Finance Network is coordinating a CDFI Bond Alliance to help shape these rules.[33]

[33] http://www.opportunityfinance.net/financing/finance_main.aspx?id=5462

- Continue and expand the Foundation's role as convener. Half of those interviewed mentioned opportunities to connect CDFIs for peer-learning and regional strategizing and replication; to bring together foundations and banks to encourage collaboration and higher-impact investments; and to educate local and state government leaders about the importance of public support for CDFIs.

- One approach to convening is to collaborate with high-potential CDFIs and their community partners to define right-sized approaches to and goals for market penetration and/or growth in particularly underserved regions of the South. Recognize that strategies that include geographic retraction in favor of market depth may be better for sustainable organizational and community impact than strategies that include geographic expansion but that result in scattered loans.

In addition to these suggestions, as the Foundation considers CDFI sustainability strategies, the subsidy needs of affiliated non-profit organizations will be relevant on a case-by-case basis. For example, the Center for Responsible Lending, which is affiliated with Self-Help, and the Mississippi Economic Policy Center, which is affiliated with Hope Enterprise Corporation, both play critical research and policy roles that bolster the strategies and resource environments for CDFIs across the region. The Latino Community Development Center, which is the membership portal for Latino Community Credit Union, also implements the credit union's financial education initiatives. Affiliated non-profit organizations can be critical support systems for both CDFI customers and the financial institutions themselves.

Finally, it is clear that across the South CDFIs are extraordinarily grateful for the support the Mary Reynolds Babcock Foundation already offers, not the least of which is the opportunity to build a meaningful relationship with a funder in support of shared community economic development goals.

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Exhibit A Interview Questions

1. Which definition of sustainability best fits your CDFI? Is there a gap between your definition and/or ideal level of sustainability and what the investment market demands? Between your ideal and your internally generated income?

2. What have been the top three external challenges affecting your business decisions or growth since 2008? To what degree are these challenges exacerbated or mitigated by your location (in the Southeast/in a rural area), your market (business v. personal lending), and the need for or availability of technical assistance? To what degree do you think these challenges might be permanent?

3. What have been the most pressing internal (management) challenges affecting your sustainability or growth during the same period? How are you mitigating these challenges, and what resources are you using to do so?

4. Have you made any major adjustments to your approach to products and services development or deployment in the past three years? What kinds of efficiencies have you sought or are you seeking (think deployment, technical assistance and technology)?

5. As you look back over your institution's entire history, what was the most helpful to get you where you are now? Based on what you know of the current CDFI environment, what would be needed by a CDFI like yours in order to finance market penetration with your current or new products? What about geographic expansion—what would that look like?

6. What is your assessment of the public, private and philanthropic appetite to support CDFIs now and in the future, with either debt or equity? What tools do growth-oriented CDFIs really need outside investors to provide?

Exhibit B Description of Participating CDFIs

Access to Capital for Entrepreneurs (ACE) www.aceloans.org
Cleveland, GA **Grace Fricks, CEO**

Founded in 1999, ACE is a certified CDFI loan fund serving 68 counties, including all of North Georgia and the Atlanta metro area. ACE offers small business loans for existing and start-up businesses. Its Georgia Green Loans are delivered statewide through a number of partnerships, and are designed for small businesses to start or expand an eco-friendly product or service or "green" an existing business. ACE is an SBA Microloan Intermediary and a USDA Intermediary Relender, and in 2009, received a national capacity building SBA PRIME grant to assist organizations across the nation develop a green program. ACE is a 2009 member of the competitive Aspen Institute Scale Academy Working Group.

Federation of Appalachian Housing Enterprises (FAHE) www.fahe.org
Berea, KY **Jim King, CEO and President**

Founded in 1980, FAHE is a network of 48 organizations across Central Appalachia that provides access to capital for a variety of community development projects. FAHE offers construction loans, letters of credit, equipment financing, and land acquisition loans to its members, who use these funds for housing, daycare centers, retirement centers, community-based businesses and more. FAHE recently introduced JustChoice Lending, the organization's first venture as a direct mortgage lending provider. FAHE operates FAHE Capital, an equity fund established in partnership with Virginia Community Development Corporation, which has leveraged $15 million in private equity via Low Income Housing Tax Credits.

Greenville Housing Fund (GHF) www.greenvillehousingfund.org
Greenville, SC **Deborah McKetty, Executive Director**

Founded in 2008, GHF is a non-profit housing trust fund with a mission to support the production of workforce and affordable housing in Greenville County, SC. GHF makes available resources for new construction, rehabilitation of existing homes, property acquisition, predevelopment expenses, and gap financing. It also has a rental assistance program, a homebuyer assistance program, Homes for Teachers, and in partnership with the United Way, has established the Greenville Individual Development Account Network.

Hope Enterprise Corporation (HOPE) www.hope-ec.org
Jackson, MS **William Bynum, CEO**

Founded in 1994 as Enterprise Corporation of the Delta, HOPE serves Arkansas, Louisiana, Mississippi and greater Memphis, Tennessee. HOPE Federal Credit Union offers consumer and mortgage loan products through its 14-branch network, while commercial and non-profit borrowers are served through HOPE's commercial loan fund. HOPE has received allocations for and/or syndicated New Markets Tax Credits and Low Income Housing Tax Credits; is a lending partner in the Goldman Sachs 10,000 Small Businesses initiative; and participates in numerous partnership efforts, including the New Orleans Fresh Food Retailer Initiative. HOPE also manages the Mississippi Economic Policy Center.

Latino Community Credit Union www.latinoccu.org
Durham, NC **Alison Beck Yonas, Vice President for Finance**

Founded in 2000, Latino CCU offers a complete array of bilingual financial services, credit options, mortgages, and financial education to the Hispanic community and other low-income people in North Carolina. It is considered to be the national model for credit unions and CDFIs seeking to serve immigrant communities and the unbanked. In collaboration with the National Endowment for Financial Education (NEFE), LCCU developed a groundbreaking bilingual financial education curriculum, called *Building a Better Future*. It opened its eleventh branch location in 2011.

Lowcountry Housing Trust (LHT) www.lowcountryhousingtrust.org
North Charleston, SC **Michelle Mapp, Executive Director**

LHT is an affordable housing advocate and lender that serves as the model for housing trusts in South Carolina. Serving a four-county area, LHT aims to bridge the gap between governments and developers; developers and non-profits; and families and the need for affordable housing. LHT offers development loans and subsidy for affordable housing projects, downpayment assistance, energy efficient loans, and impact fee discounts. LHT also provides consulting services and technical assistance to non-profit and for-profit developers and municipalities.

Mountain Association for Community Economic Development www.maced.org
Berea, KY **Justin Maxson, President**

With a 30-year history, MACED serves eastern Kentucky and Central Appalachia. In addition to How$martKY, discussed above, MACED provides financial investments and technical assistance to individuals, businesses, non-profits and communities; conducts research to inform and support public policy; and crafts innovative development tools to create greater impact. Business lending and technical assistance products are sectorally targeted to health care and other critical care services; cultural resources; natural resource businesses; and agricultural diversification. MACED launched the Kentucky Center for Economic Policy in 2011.

Mountain BizWorks www.mountainbizworks.org
Asheville, NC **Shaw Canale, CEO**

Founded in 1989, Mountain BizWorks serves small businesses in Western North Carolina with financial services, training, consulting and policy advocacy. Products include term loans up to five years, short-term loans, lines of credit, and microenterprise loans. Mountain BizWorks is a certified SBA Women's Business Center and hosts an annual Women's Business Conference. In addition to its Asheville headquarters, it operates two satellite offices.

National Federation of CDCUs www.natfed.org
New York, NY **Terri Fowlkes, Director of Investments**

Established in 1974 the Federation's mission is to strengthen community development credit unions (CDCUs) that serve low-income, urban and rural communities. On behalf of its members, the Federation advocates for and provides financial, technical, and human resources to CDCUs. Its community development investment program, which is supported by the Mary Reynolds Babcock Foundation, provides deposits, secondary capital loans, and grants to CDCUs.

Natural Capital Investment Fund (NCIF) **www.ncifund.org**
Shepherdstown, WV **Marten Jenkins, President**

Founded in 2001, NCIF is a business loan fund that provides debt and equity financing to small businesses in West Virginia and five additional states: Kentucky, Ohio, North Carolina, Tennessee, and Virginia. Products include start-up and business expansion loans, small business energy loans, equity investments, and New Markets Tax Credit qualified loans. Preferred sectors include heritage and recreation-based tourism, value-added and sustainable agriculture, water/wastewater treatment, sustainable forestry and forest products, integrated waste management, and recycling. NCIF is affiliated with The Conservation Fund, a national nonprofit with a dual mission of land and water conservation and economic development.

Self-Help **www.self-help.org**
Durham, NC **Martin Eakes, CEO**

Founded in North Carolina in 1980, Self-Help is now a national community development advocate and multi-faceted CDFI comprising a community development loan fund, two federal credit unions, and a real estate development arm. Through its lending affiliates, Self-Help offers consumer savings and loan products; home loans; a secondary market program; commercial loans; loans for community facilities, such as charter schools and non-profits. Self-Help also founded the Center for Responsible Lending and is considered a national model for effective CDFI growth and development.

Southern Bancorp **www.banksouthern.com**
Arkadelphia, AR **Dominik Mjartan, VP, Corporate Strategy & Communications**

Southern Bancorp is a for-profit CDFI and rural development bank with over $1 billion in assets and 45 branch offices from Missouri to the Gulf Coast. Seeking to effect regional change, Southern Bancorp and its affiliates primarily concentrate their efforts in targeted areas of Arkansas and Mississippi. Southern Bancorp Capital Partners is the affiliated non-profit CDFI loan fund specializing in comprehensive community and economic development activities, including microenterprise loans. The Southern Good Faith Fund is also a nonprofit affiliate that provides specialized financial and non-financial services, including asset-building programs and public policy work.

Virginia Community Capital (VCC) **www.vccva.org**
Christiansburg and Richmond, VA **Jane Henderson**

Founded in 1995 as a microenterprise loan fund, VCC received an equity infusion in 2005 that quickly transformed it into a multi-faceted organization, including a non-profit CDFI loan fund, a direct development arm, and a for-profit CDFI bank. VCC offers consumer savings products; affordable housing, community facilities, and other real estate development loans; small business and New Markets Tax Credit loan programs; and technical assistance and advisory services to help small businesses, non-profits and government entities operate more effectively.

Exhibit C CDFI Fund's Minimum Prudent Standards (MPS) [34]

Measure	Non-Regulated CDFIs
Capital Measures the underlying financial strength of an Applicant and whether it has sufficient cushion of assets to cover unexpected losses. The capital ratio identifies the percentage of the CDFI's total assets unencumbered by debt.	**Net Asset Ratio ≥ .20** Net Assets divided by Total Assets
Deployment Measures how much of the Applicant's available funds is lent out or invested.	**Deployment Ratio ≥ .50**
Earnings Measures whether the Applicant is earning sufficient revenue to cover its expenses.	**Net Income ≥ $0** Gross Revenues (including grants or other contributions) less Total Expenses. For-profit Applicants should deduct total pre-tax expenses from Total Revenue.
Earnings Measures whether the Applicant is earning sufficient revenue to cover its expenses.	**Earnings Ratio** There is no MPS for this measure; explain the ratio in the narrative.
Self-Sufficiency Measures the percentage of operating costs a CDFI can cover with earned revenue.	**Self-Sufficiency Ratio = ≥ .40 (non-profit) ≥ .70 (for-profit)**
Operating Liquidity Measures whether the Applicant has sufficient cash to cover at least three months of operating expenses. The operating ratio reports the availability of cash to cover short-term operating expenses.	**Operating Liquidity Ratio= 1.00** Cash and Cash Equivalents that are not restricted in a manner that prevents their use in satisfying obligations represented by operating expenses DIVIDED BY 25% of total operating expenses for the four most recently completed quarters.
Asset-Liability Management Measures whether the structure of the Applicant's debt is appropriate for its financial products.	**Current Ratio = 1.25** Current assets divided by current liabilities.

Loan Portfolio Quality Minimum Prudent Standard (MPS) for Non-Regulated Entities

Product Grouping	Portfolio-at-Risk (PAR)	Annual Net Loan Loss Ratio	Loan Loss Reserves (LLR) Or Provision for Losses
Affordable Housing-First Lien	≤ 7.00%	≤ 1%	Loan Loss Reserves are expected to be no less than half the actual Portfolio-at-risk and no more than one and a half times the actual portfolio at risk: .5 PAR ≤ LLR ≤ 1.5 PAR
Affordable Housing-Subordinate Lien	≤ 7.00%	≤ 3%	
Business	≤ 10.00%	≤ 5%	
Consumer and Micro-enterprise	≤ 12.00%	≤ 9%	
Overall MPS	≤ 15.00%	Narrative Only	

[34] For non-regulated CDFIs only. Regulated CDFIs are subject to their regulatory standards.

Exhibit D Glossary

Equity Equivalent investment (EQ2): An unsecured investment in a CDFI that is fully-subordinated to all other investments, which means it would be the last investment to be repaid in the event of liquidation. An investment must meet a total of six tests to qualify as EQ2 for Community Reinvestment Act (CRA) and accounting purposes, including a rolling term and an interest rate that is not tied to income, usually well below market. EQ2 acts like permanent capital by enabling a CDFI to innovate and/or increase lending, leverage new debt, and reduce risk to other investors. However, an EQ2 does require interest payments and eventually must be repaid, unlike permanent capital. As a result, it cannot be viewed as a permanent source of financial strength or self-sufficiency.

Healthy Food Financing Initiative: A program promoted by the Obama Administration to eliminate "food desserts" and bring grocery stores and other healthy food retailers to underserved urban and rural communities.

Individual Development Account (IDA): A matched savings account program designed to help low-income people accumulate savings and leverage additional assets, such as a home or a small business. The program is federally-recognized, and savings are matched by public and private donations. Non-profits administer IDAs in partnership with a regulated financial institution.

Interchange Fees: Fees paid between the bank that issues a credit or debit card and the bank that handles the card payments or debit transactions for a particular merchant. Most often it is the merchant's bank that pays the fee to the card issuer, passing the fee on to the merchant. Sometimes it is the other way around, as in the case of ATM transactions completed through a machine owned by a bank other than the one that issued the card.

Leverage: For a CDFI, to borrow money in order to multiply outputs (loans or investments) and outcomes (results, including income and community development impacts). A CDFI that does not produce more outputs and outcomes as a result of taking on new debt would not be *leveraging* these funds wisely.

Liquidity: In the simplest terms, liquidity is the amount of capital that is available to a CDFI for lending or investments. Sources of liquidity may be cash or credit. Liquidity can be affected by lending demand and volume; interest rates charged by investors; regulatory requirements; central bank/corporate credit union deposit requirements; unusual expenses or losses; or the availability of secondary markets for loans and investments.

Margin: More accurately used as Net Interest Margin, this term refers to the difference between the interest earned on loans and investments and the interest paid on borrowings and/or deposits (or cost of funds), divided by average earning assets. For example, if in a year a CDFI earns $6,000 on loans, pays out $3,000 in interest to investors, and has average loans outstanding of $100,000, the calculation would be: ($6,000 - $3,000)/$100,000, or 3% net interest margin.

Net Worth: The total assets of a CDFI minus its total liabilities. The terms net worth, net assets, net capital, total equity and shareholders equity are often used interchangeably. Net worth generally comprises capital that accumulates from earnings or from grants, but may also include secondary capital or EQ2.

New Markets Tax Credits: A program administered by the U.S. Treasury's CDFI Fund designed to incentivize equity investments in low-income communities. Investments in designated Community Development Entities, including certified CDFIs, receive a 39% federal tax credit over seven years. The CDE must in turn deploy the investment in qualified low-income communities for such purposes as loans or equity investments in small businesses, mortgages, or real estate development.

Off-Balance Sheet Resource: A loan or other financial resource available to a CDFI through a third party, but which have not been "drawn down," or used. Perhaps the most common off-balance sheet resource is a line of credit. Only that portion of a line of credit that is drawn down, and thus is repayable, is reflected on a CDFI balance sheet. Undisbursed grants or multi-year contributions are not considered off-balance sheet resources.

Participation Loan: An arrangement whereby two or more lenders pool their resources to provide a loan to a single borrower. Participation loans enable lenders to share risk (and profits) and to make loans in amounts that are higher than their limitations as individual lenders. Participation loans are particularly useful in advancing CDFI commercial or small business lending, and in attracting mainstream financial institutions into a deal.

SBA 504: Guaranteed loan program administered by the U.S. Small Business Administration for the acquisition of fixed assets for small business expansion or modernization.

Secondary Capital: Subordinated and uninsured investments in community development credit unions (CDCUs). The term of the investment must be five years or more. Investments are held in, and interest accumulated in, a designated secondary capital deposit account. In the

event of operating losses that exceed available reserves and undivided earnings, funds in the secondary capital account can be used to cover the losses. Viewed as capital by regulators, secondary capital functions similarly to EQ2 (described above), boosting a CDCU's ability to take on new deposits and increase lending without jeopardizing safety and soundness. However, as there is a cost to the funds, and as the proportion of the investment that is considered capital depreciates in equal increments over time, secondary capital is best used as a bridge for growth, not as a means of permanent sustainability.

Self-Sufficiency Ratio: The ratio of earned income to total operating expenses. A CDFI with a self-sufficiency ratio of less than 1.0 is not covering its costs with income from its own activities and requires operational subsidy.

Spread: The difference between the interest rate charged for a loan and the lender's cost of funds. For example, if a CDFI charges 10% for business loans that are funded with a 3% program related investment, the spread is 7%. However, because there also is a cost to underwriting and administering a loan, spread is not equivalent to profit.

Subsidy: A source of income or cost reduction that is not generated directly from a CDFI's own operations. The Aspen Institute describes subsidy as grant income, third party contracts, or below-market financing from the philanthropic or public sectors.