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Growing Opportunities in Bank/CDFI Partnerships

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Sagla, an Eritrean women-owned catering and restaurant cooperative in Jamaica Plain, MA, began six years ago with the assistance of Cooperative Economics for Women, a nonprofit co-op developer in Boston, MA. After operating from borrowed kitchens and using word of mouth marketing efforts, a restaurant space became available in the highly expensive Boston real estate market. With the help of individuals associated with Haymarket People's Fund, Cooperative Fund of New England, a National Community Capital Member, gave Sagla a startup restaurant loan for operating funds

Congress created the Community Development Financial Institutions Fund in 1994 to provide new sources of capital for economically disadvantaged communities that had been left out of the financial mainstream. Since then the concept has flourished. Today, more than 550 CDFIs manage over \$6 billion in assets, a growing share of which they developed in partnership with banks.

CDFIs are private financial institutions that operate just outside the margins of conventional financial services, linking unconventional customers and markets to the economic mainstream, and vice-versa. All CDFIs have community development missions, which give them incentives to pursue opportunities that often do not appeal on economics alone. In this way, CDFIs serve and cultivate markets that banks and other conventional financial institutions usually do not reach.

The CDFI industry has developed extensive relationships with the banking industry that are generating profits and opening new market opportunities. Today, bank/CDFI partnerships are increasingly important as the banking industry changes and community development needs grow. Bank/CDFI partnerships offer opportunities to develop markets, grow future borrowers, manage risk, and generate both profit and CRA credit.

The CDFI Industry

The CDFI industry today finances business start-ups and expansions, affordable housing, and community institutions, ranging from childcare centers to arts facilities. Business finance ranges from microenterprises to mid-sized companies. Housing finance includes single- and multi-family rental and home purchase. Some CDFIs provide consumer finance and venture capital, while other CDFIs that are regulated financial institutions also take deposits.

There are four types of CDFIs: community development banks, credit unions, loan funds, and venture funds. CDFIs address the market conditions and needs in the communities, regions, states,

or markets they serve—a loan fund might best meet market demand in one community while a bank might better serve another market.

CDFIs raise capital from banks, nonbank financial service companies, foundations, religious institutions, individuals, and government. To operate effectively, they use long-term and low-cost debt, equity investments, capital grants, and operating grants. CDFIs that are insured depositories can also take consumer deposits.

Bank Investment in CDFIs: A Growing Opportunity

Since 1995, bank financing of CDFIs has more than quadrupled, making banks one of the fastest growing sources of CDFI capital, according to National Community Capital Association's (NCCA) Annual Survey. In addition, the average size of bank loans to CDFIs has more than doubled to over \$270,000. Several factors have been critical:

- The 1995 Community Reinvestment Act revisions explicitly recognized loans to and investments in CDFIs. As a result, banks know that regulators will recognize their work with CDFIs.
- CDFIs have demonstrated an impressive record of making effective and prudent use of bank financing in serving and developing markets that banks are increasingly unable to serve. The NCCA survey found that, on average, CDFIs have grown more than 38 percent per year over the past decade, fully deploying their capital, and have experienced loss rates of less than 2 percent. That financing has helped produced more than 140,000 jobs and 120,000 affordable housing units.
- The CDFI Fund's Bank Enterprise Award Program has encouraged bank/CDFI partnerships by providing cash awards for banks increased investment in CDFIs. Banks have won more than \$179 million in awards through this innovative program.

CDFIs have helped banks re-assess their initial perceptions of risk in underserved markets, and many have re-entered these markets often in partnership with CDFIs. In the process, CDFIs and banks have demonstrated that financing non-conforming customers works if it is done in a way that recognizes the particular idiosyncrasies of that market. Together they have helped prove many things that now constitute mainstream banking thinking:

- That managing risk in non-financial and non-traditional ways (such as with intensive technical assistance) can work.
- That unconventional financial customers are important to banks and other conventional financial service companies because they are future customers and solid assets.
- That community-centered groups can organize capital, manage it responsibly, pair it with organized people, and create measurable changes in communities.

Why Banks Work with CDFIs

Banks partner with CDFIs to enter niche markets, cultivate future customers, and deliver mainstream and alternative financial products and services to underserved communities. Many banks rely on CDFIs for their expert understanding of the local markets, ability to manage risk, and the critical technical assistance they provide their customers. These value-added credit enhancements enable banks to pursue opportunities in unfamiliar and/or untested markets.

Banks tend to view CDFIs as “credit enhancements,” because their work in markets reduces bank risk. At the same time, CDFI financing often provides real credit enhancements to bank

financing—when a CDFI provides subordinated debt underneath a bank’s commercial credit, for example.

NCCA has developed various performance benchmarks which an investor could use when evaluating the capacity of a CDFI in which they are considering making an investment (see “Banks Investing in CDFIs: Financial Measures to Consider” at the end of this article).

Why CDFIs Work with Banks

CDFIs seek to bank partners for four primary reasons:

Liquidity—Almost all CDFI financing is non-conforming, and no secondary market exists for CDFI assets. As a result, productive CDFIs constantly face liquidity shortages.

Leverage—Because CDFIs seek to bring capital into underserved markets, many are willing to accept relatively higher risk to leverage more bank capital into a deal. CDFIs must use this limited capital strategically to encourage banks and other funders to participate.

Access to technical financial expertise—CDFIs cannot afford to reinvent wheels, so they often rely on their bank partners’ expertise. Many bankers enjoy the challenges of applying their professional talents to the non-traditional credit facilities that CDFIs often wrestle with.

Positioning CDFI borrowers for future bank relationships—CDFIs help season borrowers so that they can become traditional bank customers in the future. In some instances, CDFIs negotiate with banks up-front that the banks will ultimately purchase the CDFI’s loans that are performing adequately.

Bank-CDFI Partnerships: Looking Forward

In the late 1990s, banks and CDFIs sometimes found themselves competing for deals. Banks wondered why they were investing in their competitors, while CDFIs wondered why banks invested in them and then competed for business. The reason was simple, if not evident: in prosperous times, banks were moving down-market in pursuit of assets. Aided in part by CDFI experience, facilitated by technological advances, and encouraged by CRA incentives, banks saw and pursued new market opportunities.

CDFIs had only one option to move further out in the margins by financing child care providers, charter schools, primary health care providers, and other niches that were outside the reach of conventional finance.

Looking forward, bank/CDFI partnerships are likely to expand further as banks and other conventional financial institutions continue their evolution following Gramm-Leach-Bliley. Two other factors could significantly affect how banks and CDFIs work together in coming years:

New Markets Tax Credits— It is anyone’s guess how the New Markets Tax Credit (NMTC) will affect bank/CDFI partnerships. The tax credits will provide approximately a 30 percent net-present-value tax credit for investments in qualifying CDFIs and other community development entities, including those owned by banks. With credits available over the next five years for up to \$15 billion in new investments, the NMTC could carve new channels in the flow of bank capital into economically disadvantaged markets.

CRA regulatory review—Regulators have opened the formal review process. With five years of

experience since the 1995 changes took effect in 1997, expect regulators to look for lessons learned.

Conclusion

CDFI financing tends to work slowly—that is, its contribution to a bank’s bottom line comes over many years. Because CDFIs serve what one banker calls her bank’s “undermarket,” however, their value is not always immediately apparent. However, CDFIs are pursuing growing market opportunities in thousands of economically disadvantaged communities around the nation. Ultimately, their success will depend in part on whether they demonstrate to banks that at least some of these market opportunities are worth pursuing. Based on the past, success seems likely—for CDFIs and banks.

For more information, contact Mark Pinsky, President, National Community Capital Association, at (215) 923-4754, or at the Web site: www.communitycapital.org.

Banks Investing in CDFIs: Financial Measures to Consider

Banks planning to invest in CDFIs need to analyze multiple aspects of a CDFI's operations to assess whether the CDFI has a viable and sustainable community development strategy. The bank also must ensure that the CDFI's mission, market and performance are consistent with the bank's strategy.¹

There are many different ratios and statistics to consider, and those ratios can vary depending on your strategy, the CDFI's strategy, and the type of CDFI you are considering investing in. Some key statistics and ratios organized by peer groups appear below. Investors can use this information to compare a CDFI in which they are considering investing to a peer group of similar organizations, and ascertain what additional questions to ask to understand the CDFI's performance.

Key Ratios by Peer Group²

Peer Groups	B1	B2	B3	H1	H2	H3
Financing						
Total Financing Outstanding Per CDFI	\$771,366	\$3,038,787	\$8,630,265	\$893,445	\$4,096,027	\$14,912,288
Average Size of Loans Outstanding	\$24,864	\$35,630	\$68,291	\$41,042	\$91,389	\$194,241
Liquidity Ratio	39.8%	25.2%	29.6%	34.3%	31.6%	16.2%
Loan Loss Reserve Ratio	16.0%	9.3%	8.7%	7.4%	6.8%	9.5%
Delinquencies > 90 days	10.6%	6.2%	5.0%	2.3%	1.3%	1.0%
Capitalization						
Total Capital Per CDFI	\$1,376,946	\$4,559,979	\$14,109,581	\$2,055,985	\$7,384,901	\$27,545,409
Equity as a % total capital	43%	47%	58%	44%	22%	31%
EQ2* as a % of total capital	3%	2%	2%	3%	6%	3%
Borrowed Capital as a % of total capital	53%	51%	40%	53%	71%	66%
Cost of Capital (including equity)	2.0%	1.5%	1.1%	1.8%	2.1%	2.4%
Efficiency and Operations						
Self Sufficiency	26.4%	61.1%	72.3%	46.2%	64.3%	57.6%
Spread (rate charged - cost of capital)	8.5%	7.7%	7.2%	4.5%	4.4%	4.2%
Expense/FTE	\$104,921	\$104,165	\$159,476	\$113,058	\$126,307	\$168,323

Notes:

Peer Group B1: Loan Funds with Business as primary financing activity, total capital < \$2.5 million

Peer Group B2: Loan Funds with Business as primary financing activity, total capital \$2.5 million - \$8 million

Peer Group B3: Loan Funds with Business as primary financing activity, total capital > \$8 million

Peer Group H1: Loan Funds with Housing/Community Facilities as primary financing activity, total capital < \$4 million

Peer Group H2: Loan Funds with Housing/Community Facilities as primary financing activity, total capital \$4 million - \$13 million

Peer Group H3: Loan Funds with Housing/Community Facilities as primary financing activity, total capital > \$13 million

*EQ2, or Equity Equivalent Capital, is highly subordinated debt with features such as a rolling term which enable it to function like equity. Visit www.communitycapital.org to order a technical assistance memo, "Equity Equivalent Primer" to learn about the leveraged CRA credit banks can get for investing in EQ2 with CDFIs.

¹ Visit www.communitycapital.org to order "Best Practices for CDFIs: Key Principles for Performance" to help identify the 15 Performance Principles and 108 Best Practices which are critical to a CDFI's institutional strength.

² Source: National Community Capital's "CDFIs: Side By Side". To order, please visit www.communitycapital.org. This publication has many more statistics for these peer groups, data on community development credit union and venture capital peer groups, as well as 5-year trend analysis data.

FOCUS ON A FEW KEY CDFI RATIOS

CDFIs can differ from conventional financial institutions. As with any financial institution, the ratios listed below are key. Prospective CDFI investors should consider variables that affect CDFIs that may not be true in other investments.

Loan Loss Reserve Ratio: Loan loss reserves are an estimate of the amount of financing which may ultimately be uncollectible, and act as an insurance reserve for potential problem loans. Loan loss reserves are one component of a CDFI's risk management strategy, and should be considered in conjunction with other risk management components such as equity-to-total capital ratios, underwriting and monitoring procedures, collateral, etc. Loan loss reserve ratios vary depending on the type of lending, quality of portfolio, historical loan losses, and areas of aggregate risk in the portfolio. Typically, business lenders have higher loan loss reserves and higher loss rates.

Calculation: Loan loss reserve / Gross loans outstanding

Equity Capital as a % of Total Capital: Equity Capital acts as a cushion to protect senior debt investors from losses, helps reduce CDFIs' cost of funds, and enhances financing flexibility, such as undertaking longer-term loans. The higher the percentage of equity, the stronger the CDFI's capital structure. High levels of equity also give CDFIs the flexibility to increase their capital, by leveraging their equity to raise additional debt, and help CDFIs lower their cost of capital.

Calculation: Equity capital / Total capital.

Liquidity: Liquidity measures the percentage of capital that is not deployed (either outstanding or committed) in community development projects. Many CDFI have liquidity policies requiring a 10-15% reserve to ensure that they have capital to repay investors, which indicates that they have no capital available to lend if liquidity ratios fall to those levels. Liquidity ratios vary among CDFIs based on when a CDFI receives new capital and when loans are repaid. Liquidity ratios should be considered over time and in comparison to growth in capital and loans outstanding. Larger CDFIs often have lower liquidity ratios than smaller CDFIs. Larger organizations often have more sophisticated ways to manage liquidity, such as lines-of-credit and bank participations. Some larger CDFIs also have internal systems that allow them, based on an analysis of historical liquidity and commitments, to commit a greater percentage of their available capital.

Calculation: $1 - ((\text{Gross Loans/Investments Outstanding} + \text{Loans/Investments Committed}) / \text{Total Capital})$

Self-Sufficiency: Self-sufficiency ratios measure the extent to which a CDFI is covering its expenses through its earned revenue. Higher self-sufficiency ratios allow CDFIs to be more independent in program growth and allow CDFI staff to focus on growing their lending/investing pool (rather than raising operating funds). Self-sufficiency ratios vary tremendously across the industry, as they depend on a number of factors, including cost of funds, percentage of equity capital, salary levels, average loan size, the extent of a CDFI's technical assistance and other non-revenue generating programs, and a CDFI's interest rates charged. CDFIs have different strategies and goals with respect to self-sufficiency. Some CDFIs strive to be entirely self-sufficient, others strive to be self-sufficient in their "core" loan program (while subsidizing other activities such as R&D), while others have goals of 50% self-sufficiency. In general, larger CDFIs tend to have higher self-sufficiency ratios, as they often have higher equity bases, have a higher percentage of their capital deployed, and achieve certain efficiencies from scale.

Calculation: Earned Revenue / Total expenses. Earned Revenue includes fee income, investment and loan interest, contract revenue and other earned revenue.