

CDFI Futures: An Industry at a Crossroads

March, 2016

Foreword: Another Fork in the Road

The CDFI industry has grown, transformed, and produced at a remarkable pace for more than 20 years.

In 2015, Opportunity Finance Network (OFN) commissioned two studies, one looking back at 20 years of data and the other looking forward at a set of strategic choices that will determine the next two decades.

The first, *20 Years of Opportunity Finance 1994–2013: An Analysis of Trends and Growth*, documented CDFI industry growth, transformation, and production.

This study, *CDFI Futures: An Industry at a Crossroads*, starts where the first study ends and builds on it. It includes a deep dive into the data from a different perspective—looking at CDFI efficacy over 20 years using a new model that seems to offer great insights. This also prompts a set of difficult questions about CDFI business models, sources of capital, competitive environment, policy strategies, purposes, and other challenging aspects of our work. All told, it spotlights a set of forces that the CDFI industry needs to address if its future is to be as remarkable as its past.

We selected Jeremy Nowak to write this paper for several reasons. He is a pioneer of the CDFI industry, a leading voice on community development and public policy issues, an advisor to a range of investors thinking outside the box about money and mission, and an expert in both public policy and financial systems.

OFN wanted Jeremy to ask questions to stimulate thought, debate, and discussion about the CDFI industry's future. He has done that in ways that can catalyze responses that will move us all forward, not always in ways we might expect.

We look forward to discussing the ideas in this paper with you and, together, developing a path forward. Over the coming year, OFN aims to organize a series of conversations that draw on this paper, our longitudinal study, and—most important—the work and experiences of CDFIs in practice.

I invite you to be part of that discussion.

A handwritten signature in black ink, appearing to read 'M. Pinsky', with a stylized, cursive script.

Mark Pinsky

President & CEO, Opportunity Finance Network

Acknowledgements and Authorship

Opportunity Finance Network (OFN) commissioned this report with support from Citi Foundation. Jeremy Nowak is the primary author. Ken Gross designed and carried out the factor analysis used in the report and is acknowledged as a contributing author. Ken Gross is the President of Quantitative Innovations which specializes in turning data into useful knowledge that guides public policy. Sarah Fitzgerald Brown assisted throughout the research, setting up and transcribing interviews and providing background reviews on FinTech and impact investing. OFN's staff and board provided valuable feedback during the entire process, as did participants at the 2015 OFN Annual Conference.

About the Author

Jeremy Nowak is President of J Nowak Associates, a consulting firm that specializes in social investment, public policy, and strategic planning. He was the President of the William Penn Foundation in 2011 and 2012 during which he helped develop the blueprint for their current grant making. Mr. Nowak was the founding CEO of Reinvestment Fund, that provided more than \$1 billion in support of housing, small businesses, and community facilities, during his tenure. Currently he is a Nonresident Senior Fellow at the Brookings Institution and a Nonresident Scholar at the University of Pennsylvania's Institute for Urban Research. In 2012 and 2013 he was appointed to chair the Board of the Federal Reserve Bank of Philadelphia. His tenure at the Fed ran from 2008 through 2013.

Citi Foundation generously supported OFN's research.

Citi Foundation



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Purpose, Methods, and Findings

This report examines growth obstacles and opportunities within the community development financial institutions (CDFI) industry. The report was motivated by a view among many practitioners and investors that the CDFI industry is at a pivotal time of change in response to new capitalization options, ongoing operating challenges, and shifts in the external environment.

The report uses both quantitative and qualitative research methods to explore this inflection point. We used Opportunity Finance Network (OFN) Member performance data to develop a CDFI Capacity Score™. That analysis should be viewed as exploratory, although we believe it has significant implications.

The qualitative method involved formal interviews with 25 practitioners and investors about the state of the industry. We interviewed practitioners representing organizations of different sizes, geographies, and portfolio strategies. We interviewed investors from foundations, banks, and government and two entrepreneurs whose business experience overlap with the CDFI world. (See Appendix A, List of Interviews)

OFN and J Nowak and Associates collaborated on developing the list of participants. The sample is not scientific by group representation or sample size. Moreover, these were conversations, not surveys, so no attempt was made to note that a percentage of respondents thought in a particular way. That said, the report represents common themes that emerged from the conversations.

Early versions of the research were vetted with OFN's Board of Directors and OFN Members at the OFN Annual Conference in November, 2015. Participants in both forums were generous with their observations and comments.

We reviewed CDFI studies, including those prepared for the U.S. Department of the Treasury's CDFI Fund, as well as reports on impact investing and FinTech from trade groups, consulting firms, and the financial press. Finally, we reviewed historical sources on social reform and finance in the U.S. to provide context to issues regarding the future direction of the industry. (See Appendix B, Bibliography)

There are eight principle findings in the report:

- 1. Stages of Growth:** The CDFI movement has gone through two distinct phases of development: proof of concept (1970s–1999) and steady growth (1999–today) characterized by the changing asset composition of organizational balance sheets. Public sector grants and bank investors largely fuel today's steady growth period.
- 2. CDFI Capacity:** We developed a data framework for measuring CDFI capacity based on three variables: change in capital available for lending, percentage of assets deployed for loans, and operating losses/gains. Using this model, the industry's capacity showed high levels of volatility during and after the Great Recession. The model did not draw any direct correlation between total assets (the largest CDFIs) and the capacity score of a CDFI.
- 3. Products and Place:** One component of the growth of selected large CDFIs is geographic expansion. There is some increase in the number of national and multi-state CDFIs, although as a percentage of all CDFIs and their capital available for lending, the shift is not substantial. Our capacity model does not show a significant difference among CDFIs that employ different geographic strategies.

4. Impact Investments: The widespread interest in impact investments outside the CDFI field has the potential to support the next phase of CDFI growth, but only if there are suitable products that bridge the needs of impact investors and CDFIs. The CDFI industry must vigorously join the impact investment field through intentional product development and marketing in order to close the gap between the two sectors.

5. Technology Orientation: FinTech, including marketplace lending, could transform parts of the CDFI small business lending market, although its impact today is far from clear. Regardless of FinTech's success, CDFIs must *step up* technological sophistication and employ new forms of market acquisition, something already happening among a small subset of CDFIs.

6. Capital Transformation Phase: There is a third phase of CDFI growth emerging today that could transcend the operating logic of phase two with respect to capital diversification and higher levels of profitability. The CDFI leadership institutions in this phase will continue to be depository and non-depository, but may also include higher-production small business lenders aided by innovations in technology.

7. Accelerating Change: To assist CDFIs in a new phase of growth, the field needs more business mentorship and investment to support innovation. Existing models that support for-profit business growth, including equity-like investing, accelerators, and the general availability of R&D funding, ought to be pursued by government, private funders, and trade groups.

8. Social Reform: As the industry grows, CDFIs can increase impact and maintain their social reform identity by linking the credibility of their practice to issues other than the preservation and expansion of CDFI programs. CDFI lessons regarding constructive forms of debt, the limits to a debt approach to prosperity, and the role of hybrid institutions in development, have to be better articulated.

The eight findings lead to a simple growth and development logic, partially based on historical fact and partially based on future state speculation:

1. Growth: CDFIs have grown through a capital access model based largely on bank debt and public equity. That model has underwritten the industry's credibility and social impact, and helped the field weather a significant period of national economic decline.

2. Limits: The standard CDFI growth model is limited due to a lack of diversification of capital sources, assumptions regarding high levels of public and private subsidy, and the limited ability of most CDFIs to generate enough retained earnings from operations to grow.

3. Change: Selected CDFIs are poised to exceed prior practices and assumptions through accessing more conventional capital markets and new forms of social impact capital, generating higher levels of profitability and making better use of data and technology.

4. Enabling Environment: The next phase of CDFI growth requires increased innovation infrastructure, a more networked approach to CDFI growth, and greater clarity around a CDFI social reform identity.

The purpose of this report is to focus and inform thinking by CDFIs, their funders and investors, and others interested in the CDFI industry or impact investment fields. We hope this report stimulates conversation, reflection, and ultimately, action.

From Proof of Concept to Steady Growth

CDFI development has proceeded through two stages of growth: a proof of concept period that began in the 1970s and ended in the late 1990s and a steady growth stage that began in the late 1990s and continues today.

The pioneers of the early CDFI movement were small community-centered lending institutions that lacked significant support from the public sector and conventional depository institutions. Among those CDFIs, the sources of borrowed funds or deposits overwhelmingly comprised religious institutions, civic groups, foundations, and individuals.

In this phase, banks were more apt to be grantors than lenders, although Community Reinvestment Act (CRA) agreements in the late 1980s led to some bank lending to CDFIs.

Available public money was more frequently state or local than federal. Federal support was available for large community development corporations or community action agencies, several of which had small business and housing loan funds and many of whom eventually self-identified as CDFIs. Those sources had their policy roots in War on Poverty programs from the 1960s, many of which were curtailed in the 1980s.¹

The key challenge for early CDFIs was to create credible lending and risk management practices. They had to prove their ability to connect the demand for financing by borrowers unable to get conventional debt with social investors interested in providing that capital. Moreover, they wanted to avoid the mistakes of a number of small business loan funds created in the 1960s and early 1970s (many of which had religious community sponsorship), most of which failed to build strong lending systems.

The early CDFIs also wanted to demonstrate more independence than public sector loan funds attached to housing and economic development agencies. There was an important parallel to this in Asia, Africa, and Latin America where microfinance groups were independent of state-managed development banks and more sustainable than the typical non-governmental organizations that did not use capital as their core development tool.²

Support from religious communities and foundations was particularly critical during the proof of concept period. National foundations had just developed their program related investment (PRI) departments. Through their early investments, the Ford and MacArthur Foundations emerged as the philanthropic support system that most influenced CDFI portfolio management standards.

The proof of concept period negotiated a practical space between markets and *public purpose*. Defining that space was the industry's major innovation. Proof of concept succeeded for two reasons:

- 1. Performing Loan Portfolios:** The industry was able to demonstrate the capacity to make loans and repay investors. While data on lending and charge-offs prior to the mid-1990s is scarce, what we have for the limited number of OFN Members in 1994 shows an average net charge-off rate of 1.9%.³

¹ For a perspective on the grassroots aspects of this period, see Orleck and Hazirjian, *The War on Poverty: A New Grassroots History, 1964-1980* (University of Georgia Press, 2011).

² For a good historical discussion of these issues see Bipasha Baruah, *NGOs in Microfinance: Learning from the Past, Accepting Limitations, and Moving Forward* (Geography Compass, 2010).

³ Based on fiscal year 1994 data for 42 OFN Member CDFIs.

2. National Organizational and Policy Success: The industry was able to organize itself through trade groups in the late 1980s and early 1990s and eventually become the driver of federal legislation that led to the CDFI Fund.⁴ While CDFIs met to exchange ideas and practices in annual meetings prior to the CDFI Fund, it was the potential for federal support that galvanized the industry.

In 1992, a CDFI was large if it had assets of \$10 million to \$20 million. CDFIs were a small part of community development and inconsequential to the banking sector. The drive toward market and civic relevance defined the next phase of growth. Increased legitimation came from the federal government and banks.

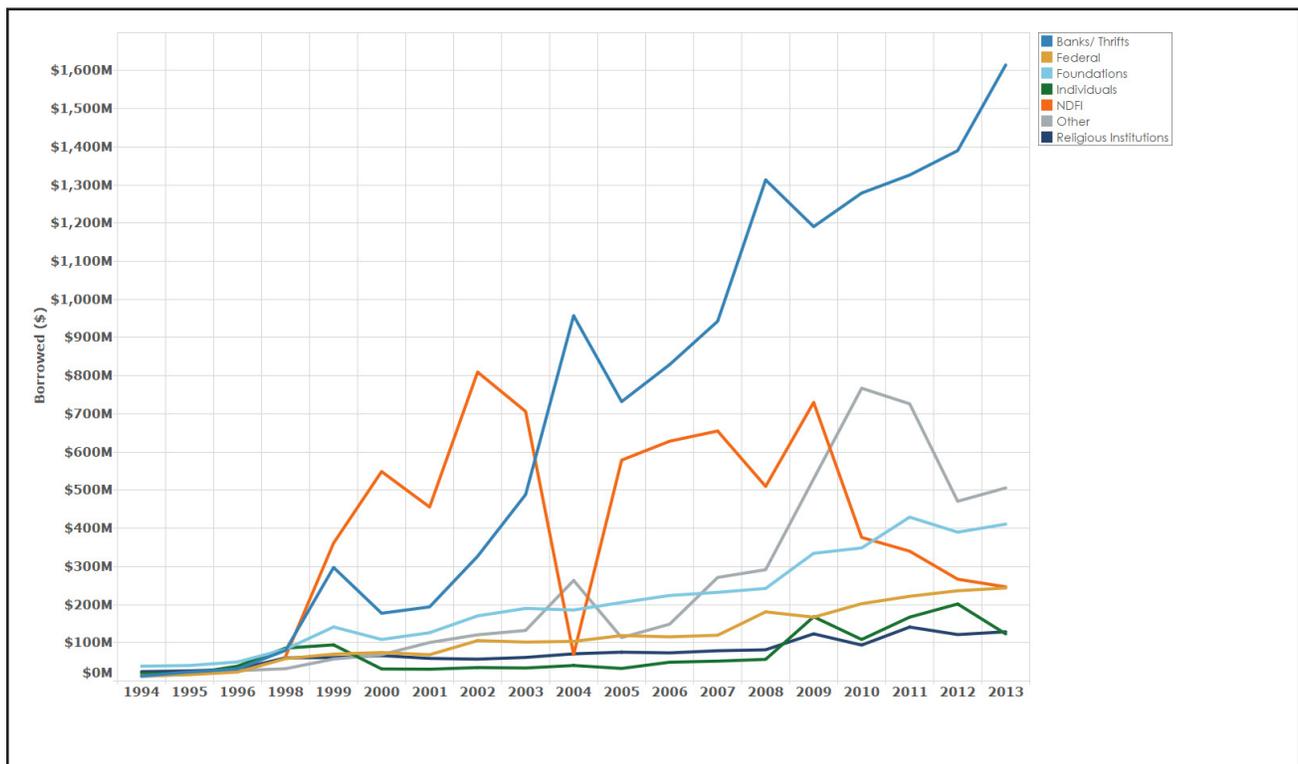
Two shifts in public policy marked the transition from proof of concept to steady growth: the creation of the CDFI Fund in 1994 created access to substantial public funding and changes to the Community Reinvestment Act (CRA) in 1995 incited banks to lend to CDFIs. The development of the New Markets Tax Credit (NMTC) program in 2001 was also very influential.

From one period to the next, the change was dramatic. OFN data shows that in 1994 non-CDFI depositories had invested about \$12.7 million into OFN Member CDFIs. That number shot up to \$1.7 billion by 2013.

CDFIs' sources of debt capital moved from foundation to bank dominance by the late 1990s. It took three to five years from the start of the CDFI Fund to transform the private investor composition of the industry. The chart below demonstrates this transition. It should be noted, as the chart demonstrates, that other investor segments also increased, but quite modestly. The only other segment with steady growth during that period is foundations.

The proof of concept period negotiated a practical space between markets and *public purpose*. Defining that space was the industry's major innovation.

Figure 1: Sources of Borrowed Funds



⁴ In 1994, Congress approved and President Clinton signed the Riegle Community Development and Regulatory Improvement Act, which created the CDFI Fund.

The availability of public grant funding transformed CDFIs. The CDFI Fund created an equity base for expansion and leverage, and set in motion a model of public grants and bank liabilities as the standard CDFI *fuel for growth*.⁵ The results of the steady growth period are reflected in the numbers presented by BBC Research and Consulting based on OFN's longitudinal performance data: from 2000 until 2013 the average assets of OFN Members grew by 128% and their average loans outstanding grew by 117%.⁶

The steady growth period was sustained by demonstrating: 1) portfolio resilience during economic downturns and 2) appeal to broad political and policy interests.

Portfolio Resilience

Existing data on charge-offs and loss reserves during the recession of 2001 and more severe recession of 2008 show that CDFIs mirrored other financial institutions in terms of weakening portfolios and balance sheets. This was particularly so in the recession of 2008 because CDFIs were relevant enough (size of portfolio) to feel a market shock, and the 2008 recession was heavily driven by the housing market, where substantial CDFI activity existed.

In general, CDFIs emerged from both downturns in good shape. Four points in this regard are worth noting, however:

1. Balance sheet strength: Many CDFIs benefitted from the high net assets (net worth) ratios and significant loss reserves required by major investors, which allowed CDFIs to incur losses and still maintain balance sheet strength. From a conventional business perspective, CDFIs are under-leveraged. But given the impact of the last recession, a number of CDFIs would not have survived balance sheet decline without those high levels of equity.

2. Freedom from regulatory limitations: Many of the non-depository CDFIs were advantaged by not having a regulator force them to write off assets completely or stop making loans. Self-regulation—within the context of investor covenants—gave them more flexibility. Many CDFIs temporarily renegotiated loss reserves, impaired loans, and leverage covenants, and had enough regulatory flexibility to continue operating.

3. Borrower relationships: The CDFI industry has always excelled at working with struggling borrowers that require loan restructuring and patient capital. As long as CDFIs did not have a liquidity problem, they had the local knowledge and freedom to restructure loans without losing control of their balance sheet, eventually recovering much of the capital.

4. Counter-cyclical policy: Counter-cyclical stimulus and social safety net programs aided some CDFIs, particularly nonprofit CDFIs, during the Great Recession. While an analysis of the extent and impact of that assistance does not exist, the capacity model we present in the next section seems to bear this out or, at the very least, suggests a substantial policy impact on CDFI capacity during this time period.

⁵ It should also be noted that the CDFI Fund represented a radical change in how federal programs work. Instead of providing funding for specific projects, the CDFI Fund invested in skilled intermediaries that, in turn, invested in specific projects as they saw fit. No federal program had done this before the CDFI Fund.

⁶ BBC Research and Consulting, "20 Years of Opportunity Finance, 1994-2013: An Analysis of Trends and Growth" (Opportunity Finance Network, 2015), Figure III-3.

The BBC report notes the spiking of net charge-offs and delinquency rates during the recessions at levels slightly higher than FDIC-insured institutions.⁷ Those rapid increases have come down from their high point in 2010 and were only slightly higher than the FDIC-insured institution average in 2013.

The Carsey Institute study for the CDFI Fund makes the point that some CDFIs paid a financial price for increasing their lending activity during the 2008 recession as they *stepped into the breach* of declining conventional activity.⁸ That study used community development credit union and community development banking data to show that many depository CDFIs grew their lending activity at a faster rate than non-CDFI depositories during this period, but incurred higher losses.

Political Appeal

CDFI appeal to both Democrats and Republicans has been one of the most important policy accomplishments of the past two decades. While Democrats have been the most consistent supporters among White House and Capitol Hill officials, many congressional Republicans have also embraced CDFIs as social interventions with more market-orientation than traditional social programs.

One of the interviewees reminded us that during the administration of President George W. Bush, Jr. the CDFI Fund was zeroed out of appropriations and that many practitioners assumed the CDFI Fund would close down. The political capacity of CDFIs to rally congressional leaders from both parties was decisive.

One strategy to accelerate capitalization during the steady growth period was the creation of a specialized rating agency. Initially formed by OFN and now independent, Aeris (formerly CARS) was developed at the inflection point between the proof of concept stage and the steady growth period. It began rating CDFIs in 2004 and since then has issued ratings on more than 100 CDFIs and sold its services to 65 investors. It is also a significant source of CDFI data that can be converted to use for capitalization efforts in the future.

The steady growth stage is also when CDFIs first made regular use of structured finance pools and secondary market mechanisms. The former were created through the use of CDFI, public, and/or foundation assets in a junior security position with concessionary rates, and senior bank notes at more market-based pricing (e.g. OFN Member ROC USA's manufactured home lending program). The latter were created through bank consortia and special entities created either by individual CDFIs or CDFI networks (e.g. IFF's investor consortia and The Community Development Trust, both OFN Members).

Structured finance allowed for increased lending, as CDFIs could now use the capital of conventional lenders who might purchase the senior tranche of a security comprised of CDFI loans with the CDFI maintaining a servicing role. In this way, CDFIs incur origination costs for the investors and de-risk their capital. In the process, they move into a more sophisticated capital markets role: shaping a security with multiple risk and cash flow attributes, and functioning as a partner in a niche financial market.

⁷ –Ibid., Figure III-12.

⁸ Swack, Hangen, Northrup, "CDFIs Stepping into The Breach: An Impact Evaluation Summary Report" (Carsey School of Public Policy: University of New Hampshire, 2014).

During the steady growth period, the architecture of CDFIs became more complex in response to the practical growth requirements of capitalization and functional diversity, including: 1) the need to appeal to different investor classes; 2) the need to segment product strategies; 3) the need to shield or limit liability from one balance sheet to another; and 4) an allowance for semi-autonomous organizational cultures suitable for varied activities.

In every stage of growth there are acknowledged industry leaders whose size and strategy brand the industry. Industry leaders during this period included both depository and non-depository institutions. Shore Bank and the Institute for Community Economics played that role during the early proof of concept period. Interestingly, neither of those institutions is in existence today.

The value of industry leaders over and beyond their own lending impact is the role they play in opening up new capitalization, borrower, and public policy opportunities. They have industry-wide impact through demonstration, strategy, and relationship diffusion.

While industry leaders are often comprised of large organizations with balance sheets and lending activity that can produce a greater scale of activity, size is not the only basis for leadership. There are examples of smaller organizations whose role in serving a particular sector or market denotes leadership. A variety of microfinance, rural housing, and tribal lending CDFIs whose efforts are relatively modest from a capital standpoint have nonetheless demonstrated broad industry impact and are viewed as leaders.

One portfolio theme of non-depository CDFI leadership organizations in the steady growth period has been a specialization in financing public receivables (or capitalizing the flow of public revenue) in support of the social infrastructure of community revitalization: affordable housing, childcare centers, charter schools, healthcare centers, arts organizations, and service institutions.

Many CDFIs involved in this financing sector also became specialists at marrying philanthropic, public sector, and banking resources, often with the CDFI functioning as a lead aggregator and systems director. Two prominent national CDFIs—Local Initiatives Support Corporation and Enterprise Community Partners—were particularly effective in this integration, based on their use of the Low Income Housing Tax Credit. Other CDFIs have followed suit in areas other than low-income rental housing and have become important to social policy in their respective areas.

Three of the characteristics that define many of the highest growth *non-depository* CDFIs today are: a dominant role in financing public receivables, particularly related to real estate development; an expanded voice in domestic policy aligned with their financing strategy; and the ability to manage increasingly complex organizational systems that bridge distinct investor and product requirements. Small business and consumer lending, critical to the mission of credit flow in low-income communities, has generally been carried out by non-depository CDFIs whose growth rates are more modest.

Measuring CDFI Capacity

During the period of steady growth, how have CDFIs performed? From the perspective of total asset growth, the answer is clear. The industry expanded dramatically, based on the infusion of new capital and increased policy influence. With increased capital there was a substantial increase in social outcomes measured by housing units, jobs, business growth, community facilities, and so forth. From the perspective of financial strength, the data on nonperforming assets and charge-offs demonstrates a story not too different from that of conventional financial institutions.

We also wondered about the industry's capacity: how sustainable and effective it was during the steady growth period. Capacity is a somewhat normative term that means something more than asset growth and financial strength—it also implies the ability to carry out mission.

We were interested in building a capacity measure precisely because growth, in and of itself, can be deceptive. A high-growth firm can have declining profits, which may eventually lead to problems. And a nonprofit can grow in absolute service terms, but decline with respect to key financial and operating metrics and, thus, its reputation among public and private funders may erode.

Asset and balance sheet quality by itself can also be deceptive. A CDFI can have a great net assets (net worth) ratio and strong portfolio, but show limited ability to increase its deployment of assets around its primary mission. It may be financially strong but increasingly disconnected from its market and, hence, have limited impact.

We were interested in exploring whether combining measures of growth, effectiveness, impact, and financial performance could provide a useful measure of *CDFI capacity*. We looked to the OFN longitudinal Member database to identify proxy measures. As the table indicates, we were not able to identify a separate impact variable that could be used in this exercise, so we ran the capacity analysis with three variables instead of four.

Indicator	Proxy OFN Longitudinal Member Database Variable
Performance	Operating Loss/Gain
Effectiveness	Deployment Ratio
Growth	Change in Capital Available for Lending from Previous Year
Impact	Not available ⁹

We used a statistical technique called factor analysis to explore the correlations between Member CDFIs' annual (2003–2013) proxy variables listed above. Not included in the analysis was data from a CDFI's first five years of existence.¹⁰ The analysis included 173 unique CDFIs and a combined 1,168 years of data. Since each year for each CDFI represented a unit of analysis, our sample size was 1,168.

⁹We found that there was no data that allowed us to differentiate social impact productivity loan-by-loan or organization-by-organization. OFN and the CDFI Fund collect impact data and Aeris analyzes social impact for their ratings, but there was no reliable way to use that data in this analysis. Thus, a major caveat in the capacity analysis is that it assumes one dollar of deployment by organization x is as impactful as a dollar by organization y. Until we are able to reliably differentiate dollar-to-dollar impact, it is not possible to use social impact data in this kind of analysis, but only to assume that increased deployment translates into increased impact in a comparable manner. We recognize the limits of this assumption.

¹⁰During those first four years, startup effects create variations in performance that lack useful comparison. We viewed the wide variation or noise of the first four years as somewhat confirmatory of the model, in that it demonstrated a normative operating path once a CDFI leaves its startup phase. We tested this theory by running the factor analysis five times, each time removing another of the first five years from the analysis. The factor structure provided strong evidence supporting a CDFI Capacity factor starting in year five.

Analysis results indicate whether the variables overlap in a way that reveals a collective measure of CDFI capacity. The level of overlap defines the weighted contribution of each variable to the *CDFI Capacity Score™*. (See Appendix C, Factor Analysis for a more detailed explanation and summary of the results.)

The factor analysis' results suggest that these three variables hold promise for collectively measuring a CDFI's capacity over time. As a result, we used the model to calculate a CDFI Capacity Score for each CDFI for each year. With this data, we are able to use the average score per year to assess overall industry capacity trends, as well as trends within industry subgroups (e.g. by geographic coverage, years of operation, total asset size). We can also use an individual CDFI's annual factor scores to quantify its performance over time and compare it to the industry average.

Figures 2, 3, and 4 below show median annual values for each factor analysis variable. We can see that if we chose one of these variables as a measure of capacity we would get three different stories. The steadiest of the three variables was the deployment ratio, while operating gains/losses show heavy volatility in the three-year period from 2009 until 2011, and change in capital available for lending shows the most volatility over the entire time period.

Figure 2: Median Deployment Ratio

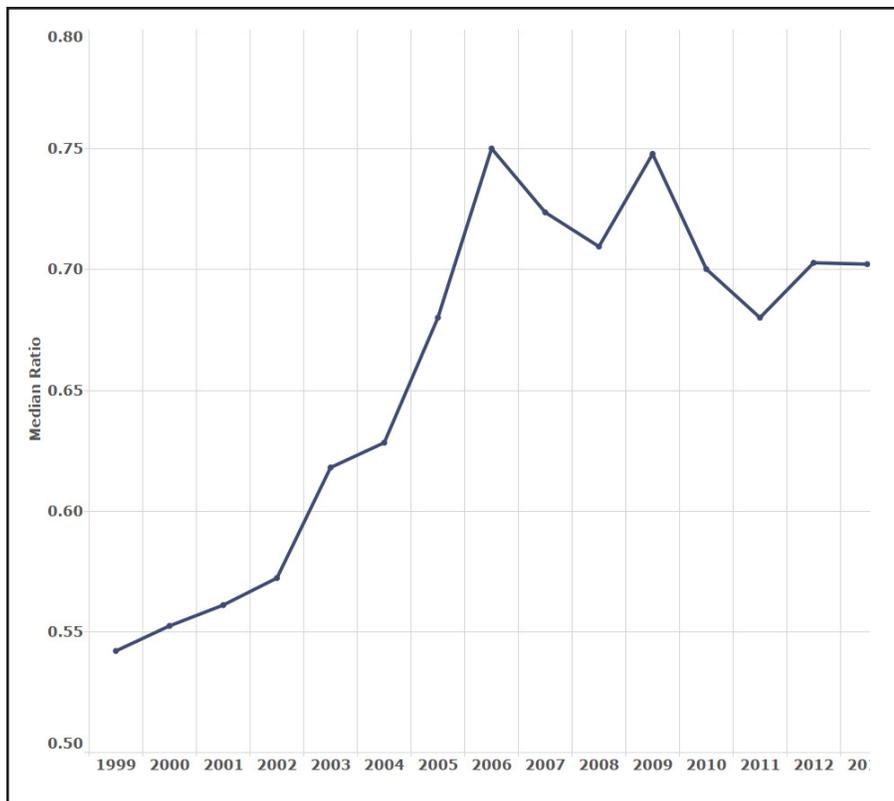
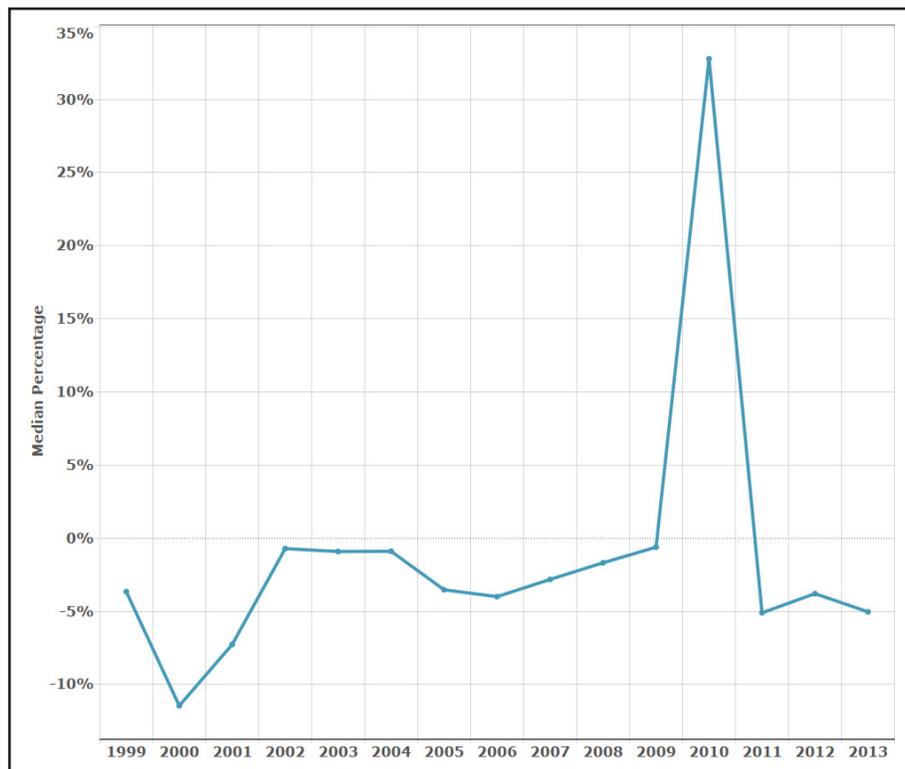


Figure 3: Median Percent Change in Capital Available for Lending from Previous Year



Figure 4: Median Percent Operating Gain/Loss



Figures 5 and 6 below depict the median *CDFI Capacity Score*, resulting in a single story told by the three correlated variables. Again, these are industry trends that reflect median factor scores for all CDFIs in the OFN membership database.

Figure 5: Median CDFI Capacity Score

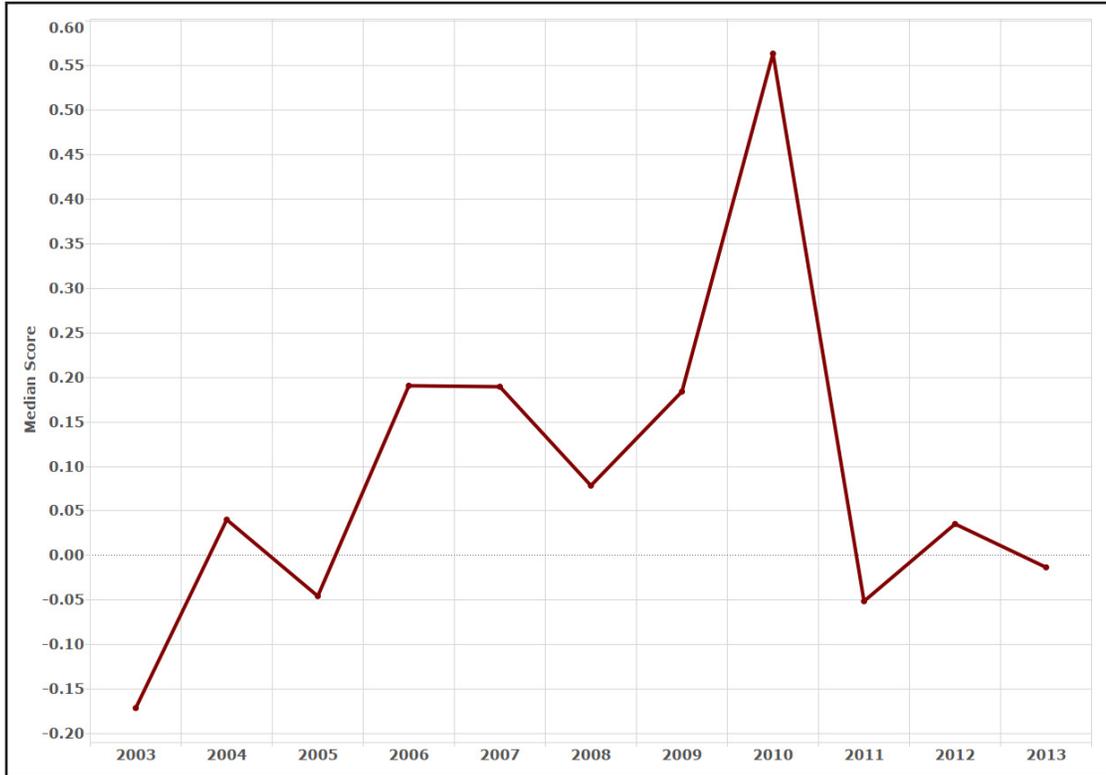


Figure 6: Three Year Moving Average of Median CDFI Capacity Score

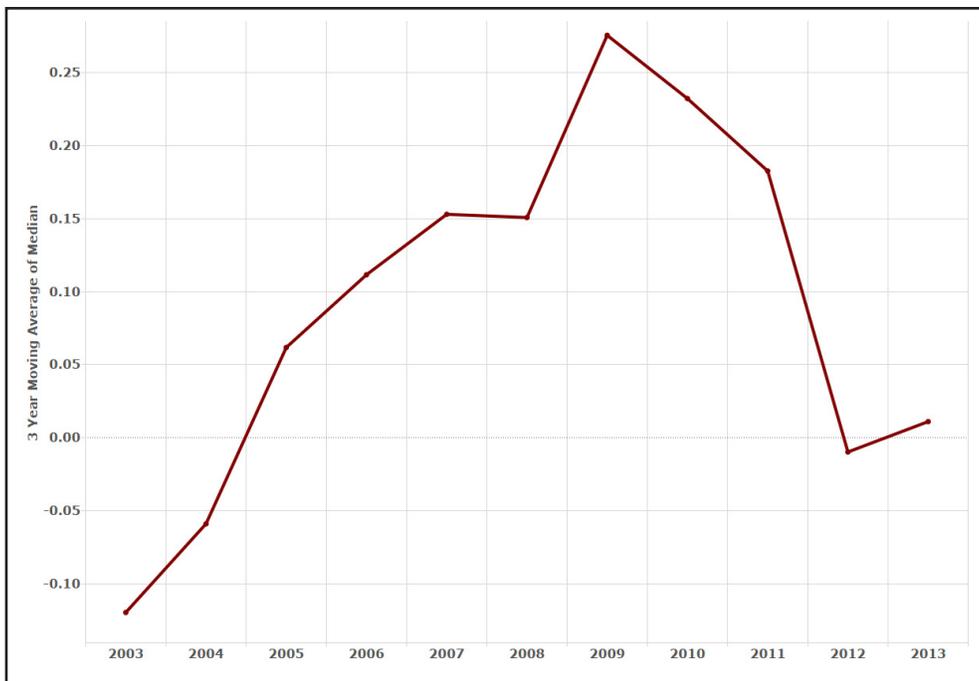


Figure 5 shows the industry-wide median CDFI capacity from 2003 through 2013. Figure 6 is a moving average version of Figure 5, where each year is represented by the average of the year prior, the actual year, and the year after's median factor scores. The moving average technique smooths year-by-year variation, allowing for a clearer picture of the overall trend.

Looking at the moving average (Figure 6), it is interesting to note the industry's relatively steady, upward capacity trajectory from 2003 until 2007, with a brief leveling off around 2008, and then a dramatic spike upward and downward during 2009 and 2010. The industry capacity level then declines until 2012, at which time it levels off.

The obvious question is what does this mean? One observation is that the timing of the declining capacity scores may have to do with the timing of charge-offs by some CDFIs. It could be that many non-regulated CDFIs maintained non-performing assets longer than conventional regulated financial institutions were able to, and hence, the impact of charge-offs was shown several years after the recession peak. That scenario would explain some of the timing of the downward slope.

But this hypothesis does not explain the overall picture. Our larger working hypothesis is that during the earliest part of the recession, the industry anticipated portfolio problems that were ameliorated by two factors: the temporary decline of conventional bank competition and the entry of additional public subsidy through the federal stimulus programs. New forms of public subsidy were most likely driving up operating profits for several years.¹¹ For a brief time, CDFIs had new capital to deploy, the necessary working capital, and demand to choose from as the banking industry stalled.

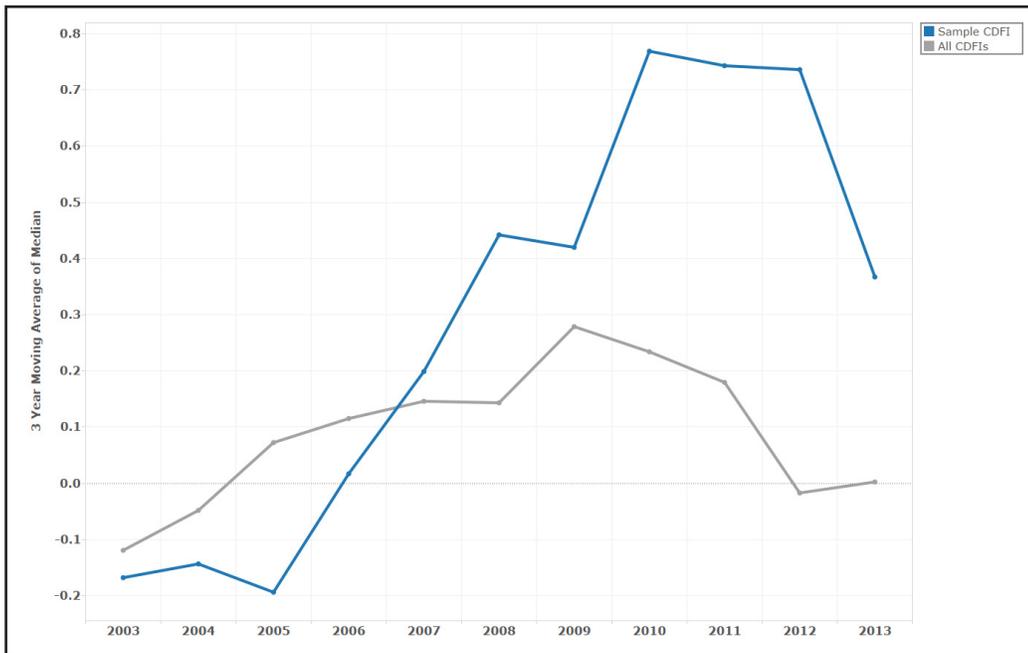
In 2010, as the impact of the federal stimulus receded and credit markets began to return, CDFIs—particularly those involved with housing finance—may have rapidly moved from a position of high subsidy and lower competition to one of lower subsidy and more competitive lending markets. This happened over a relatively brief period of time. Moreover, as CDFIs wrote off some of the loans they had previously assumed they could salvage, the impact on profit and loss statements was more pronounced. There were now less operating profits and more recognized loan losses. Hence, operating ratios weakened from 2010 to 2011.

This is only a hypothesis, and the rapid movement upward and downward is subject to other explanations. And while some CDFI leaders confirmed this hypothesis during our interviews, it is not indicative of the experience or trajectory of every organization or everyone's sense of what was happening at the time.

Providing a capacity score for every CDFI allows us to compare an individual CDFI with the industry average. Figure 7 is the comparison of a randomly selected CDFI's capacity trend to the overall industry capacity trend (represented by the smoothed (three-year average) median strength score per year). You can see that the individual CDFI followed similar trends, but scored higher than the industry average from 2007 onwards. In 2013, the industry as a whole had a capacity score similar to the 2005 period, whereas the selected CDFI tracked at a higher level, close to its 2009 levels.

¹¹ The American Recovery and Reinvestment Act of 2009 included, for example, an additional \$90 million in funding for CDFI Fund awards.

Figure 7: Three Year Moving Average of Median CDFI Capacity Score (Sample vs. All CDFIs)



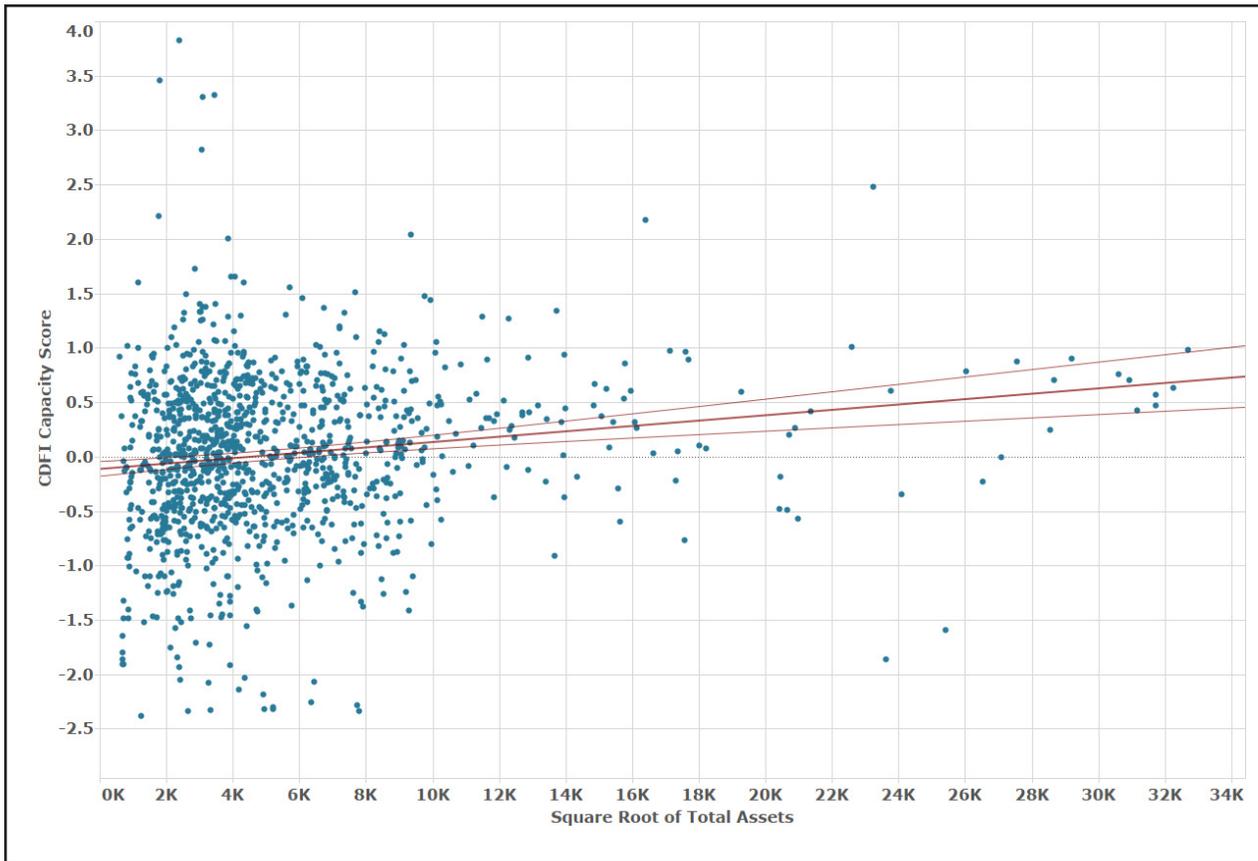
In 2013, the CDFI industry’s overall capacity score finished at a pre-2007 recession level after a roller coaster ride along a complex economic and public policy track. So did CDFI industry capacity grow as assets grew? Yes, but with the caveat that the Great Recession and policy impacts from that period created substantial upward and downward movement in the capacity measure, which then re-tracked to a pre-Recession pace in 2013.

One of the issues we were curious about when developing the capacity score was the issue of the relationship between overall asset size and capacity. The CDFI industry is stratified by asset size, with a small number of CDFIs making up a disproportionately large amount of total assets. Using 2013 data from OFN’s database of 209 Members, 36% of all CDFI assets were contained within the 10 largest CDFIs (or about 5% of the total). These 10 CDFIs had median assets of \$316 million in 2013.

This bifurcation is something investors and practitioners brought up repeatedly, and there is some conventional wisdom among investors regarding the capacity gulf between the largest—and perhaps best-known CDFIs—and the rest of the pack.

We explored the hypothesis that larger CDFIs, as measured by total assets, were more likely to exhibit higher CDFI Capacity Scores. To test this hypothesis, we created a scatter plot of CDFI Capacity Scores and total assets (see Figure 8 below). The square root of total assets was used as a method of minimizing the effect of outliers on the scatterplot. The linear best-fit line serves as a quantitative measure of the relationship between the two variables. The R-squared value of the best-fit line was .02. This means total assets can explain only 2% of the CDFI Capacity Score variance. This very low value indicates that CDFI Capacity Scores are independent of CDFI size.

Figure 8: Scatter Plot of CDFI Capacity Scores and Total Assets



This finding is important because it shows that there are a wide range of CDFIs that, while modest in size, are capable in terms of the CDFI Capacity Score's three components. Thus, while stratified by asset size, the field comprises a significant number of organizations of various sizes whose CDFI Capacity Scores are relatively equal.

The Disassembly of Product and Place

One change during the steady growth period is the geographic expansion of some CDFIs from local and statewide organizations to multi-state and national institutions. This represents an adaptation from a period when CDFIs defined themselves as more connected to a singular place. While the size of the place varied (citywide, metropolitan, statewide, large rural region, tribal boundaries), an identity with place was a standard theme of early CDFI development.

Over the past 15 years there has been some shift in emphasis towards product-level breadth over place-based depth. This follows a transformation from a local service orientation, as with many place-based nonprofits, to one more rooted in financial intermediation. Today the growth of some of the largest CDFIs has less to do with place and more to do with the portability of loan products and New Markets Tax Credit investments.

There are a variety of reasons that CDFIs expand their lending geography:

1. Investor incentives: Many large-scale CDFI investors, including national banks, want the strongest CDFIs to cover as much of their CRA target area as possible. Moreover, there are public sector programs, such as NMTC, that incent larger geographies and, hence, enable a division within many CDFIs between local lending and national New Markets Tax Credit allocation.

2. Expansion of strong borrowers: As with other lenders, CDFIs sometimes follow strong borrowers who take on projects in other locales. This happens in a variety of service, housing, and business sectors. Lenders grow based on borrower ambition.

3. Product specialization: CDFIs have become expert at product types, which have common characteristics from place to place; therefore, geographic expansion reflects the capacity to apply expertise developed in one market to others. We see this with such products as manufactured housing, charter schools, supermarkets, and health centers.

4. Deal-sourcing pressure: CDFIs have to *do deals* to keep revenue flowing and manage operations. In some cases, geographic expansion is linked to the need to manage the negative effects of liquidity, including negative arbitrage and loss of revenue.

5. Diversification of markets and civic environments: Financial institutions seek diversification as a way to mitigate risk. Too constrained a geography subjects lenders to concentration risk. It also means being dependent on the local dynamics of particular business, civic, and public actors, where lending opportunities can be constrained.

We spoke with CDFIs that expanded geographically by establishing new offices, building local partnerships with other CDFIs, consolidating with other CDFIs or mission-focused lenders, and by using technology to diminish the need for physical proximity. All of these strategies are in play today at various rates of change.

OFN's Member data draw a complex picture of geographic expansion. The bar charts below divide all OFN Members into one of four geographies: local (anything from a neighborhood to a metropolitan region or a multi-county site); statewide, multi-state, and national.

Figure 9: Percent Change in Number of CDFIs Compared to 2001

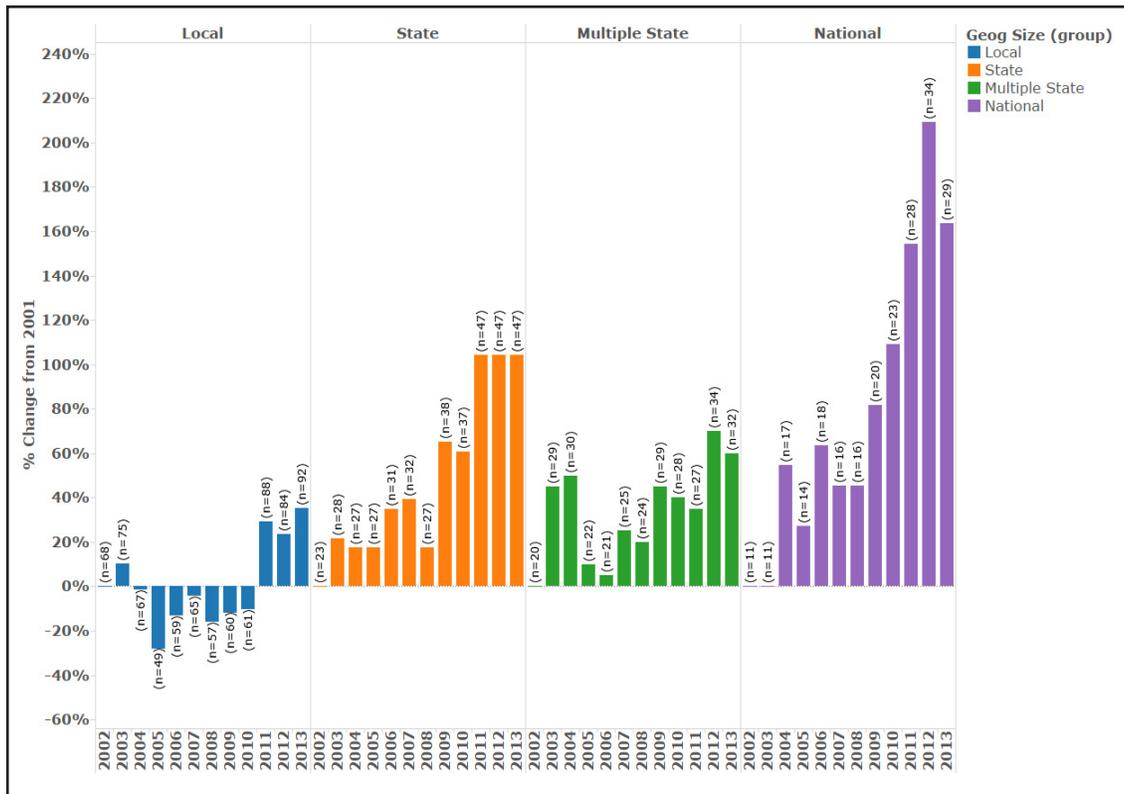


Figure 10: Share of OFN Member CDFIs by Geographic Size

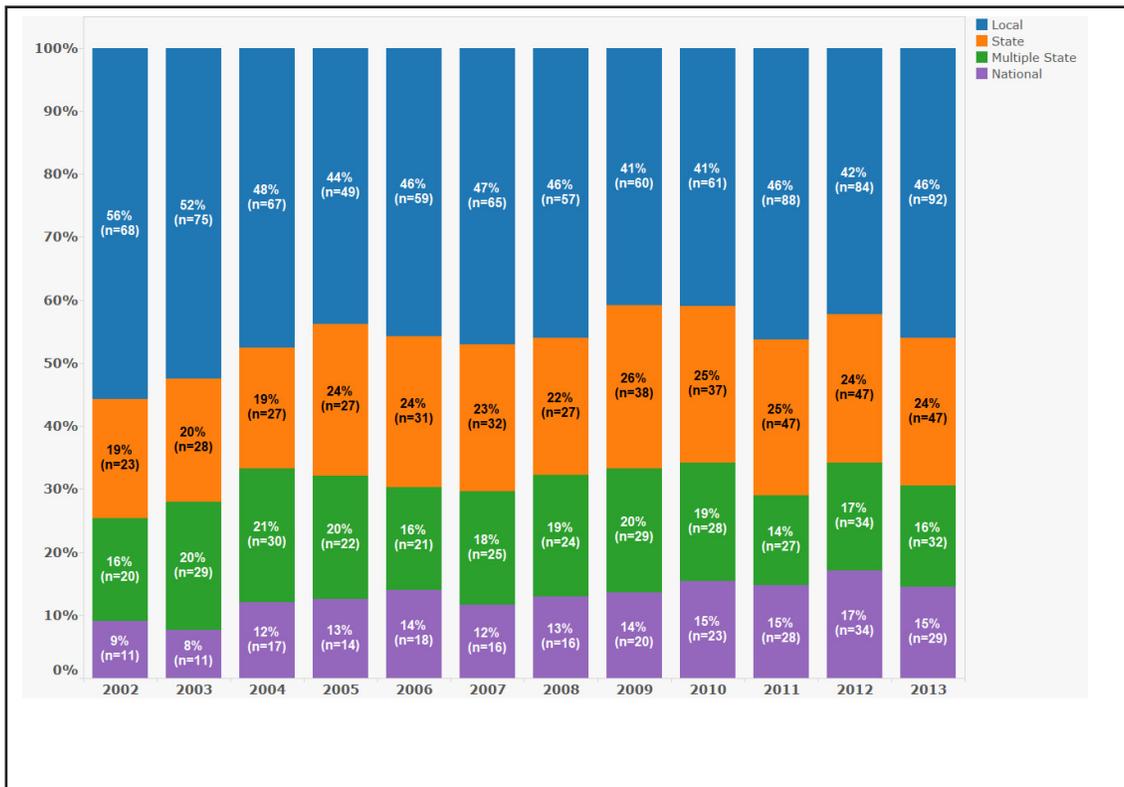
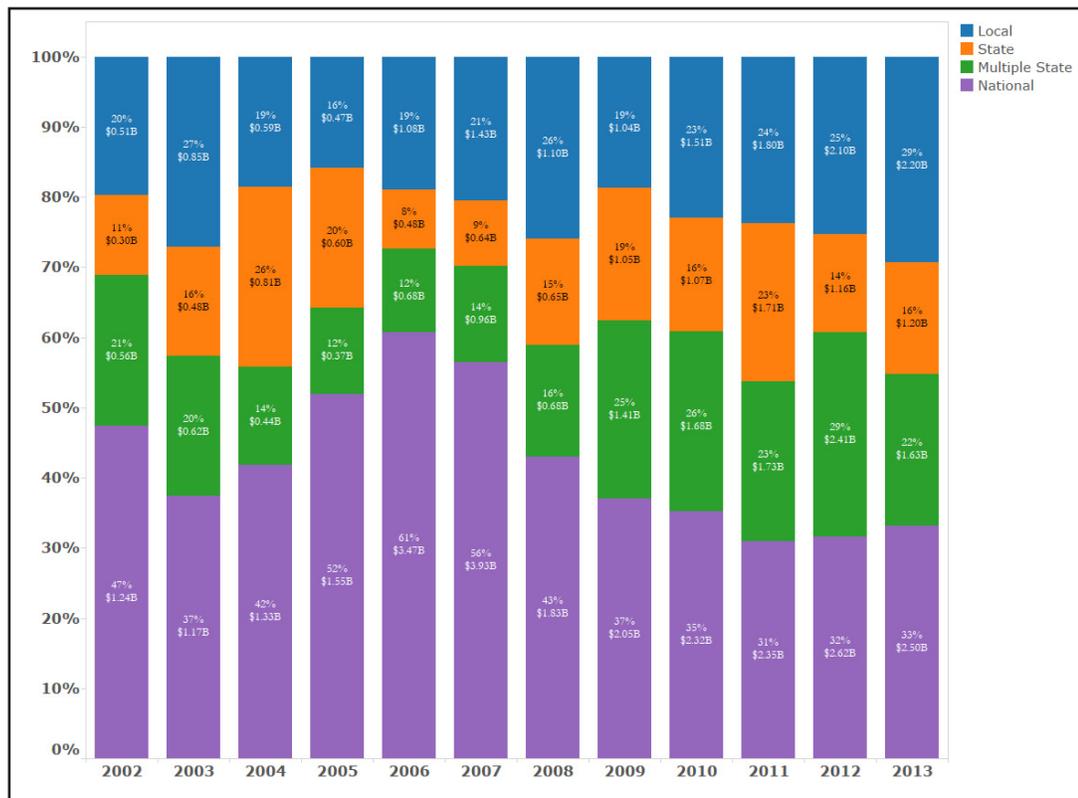


Figure 11: Share of CDFI Capital by Geographic Size



The first bar chart (Figure 9) shows that the greatest growth on a percentage basis over the past 12 years has been as follows: national, state, multi-state, and local. We do not know enough about the drivers of this change, although between 2003 and 2010 when there were declines in the total number of local funds, it is likely that many local funds were taking on larger geographies. This period corresponds to rising capacity for the industry, meaning there was both working capital and loan capital available for expansion.

The second chart (Figure 10) demonstrates that from the perspective of OFN’s overall membership, local funds are still dominant, despite decreasing from 56% to 46% of overall composition over 12 years. The third chart (Figure 11) is an asset composition chart, which shows that local funds represent 29% of Member assets, which is an increase from the 2002 level of 20%.

Based on the OFN Member database it is fair to note that the CDFI industry is still dominated by local (below state-level) funds. There are, however, some growth trends away from local strategies, something interviewees noted.

In discussions with CDFI practitioners, we asked whether there was a downside to geographic expansion in terms of increased levels of risk, loss of relationships, or the over-extension of working capital. No CDFI practitioners with whom we spoke viewed geographic expansion as an issue in terms of increased risk *as long as they had a local partner (including another CDFI) or local office*. There was, however, some caution regarding the ability to choose the right local partners and to understand the startup costs of geographic expansion, including the cost of consolidation with other CDFIs.

Some CDFI practitioners viewed expansion as a way to build efficiency, given the existence of many small CDFIs they viewed as not sustainable. In the discussion around geographic expansion, the issue of consolidation was raised. Some large CDFIs expressed the sentiment that more, not less, consolidation has to happen, and that there ought to be better mechanisms for enabling consolidation. They were concerned about organizational inefficiency with small organizations that may be over-reliant on public grants.

At the same time, many smaller funds worried that the wrong kind of consolidation would leave areas without a CDFI because smaller CDFIs may specialize in particular places or particular products (e.g. microlending). One smaller CDFI noted that banks say they cover their CRA obligations by investing in multi-state or national CDFIs; yet this smaller CDFI does not believe that multi-state and national CDFIs are attentive enough to local CDFIs' areas or product focus, especially in rural communities and with small business credit.

Several interviewees made the point that asset growth is not always the same thing as impact, if you use a place orientation. From one perspective, the more assets a CDFI has and the more loans it makes, the more impact it has. But from another perspective, similar to main street community banks, smaller CDFIs sized appropriately to their market thought they have greater place-based impact than national or multi-state funds due to their concentrated investment focus.

Many smaller funds wanted to enter into **networked lending opportunities** with larger funds to take advantage of their capital capacity.

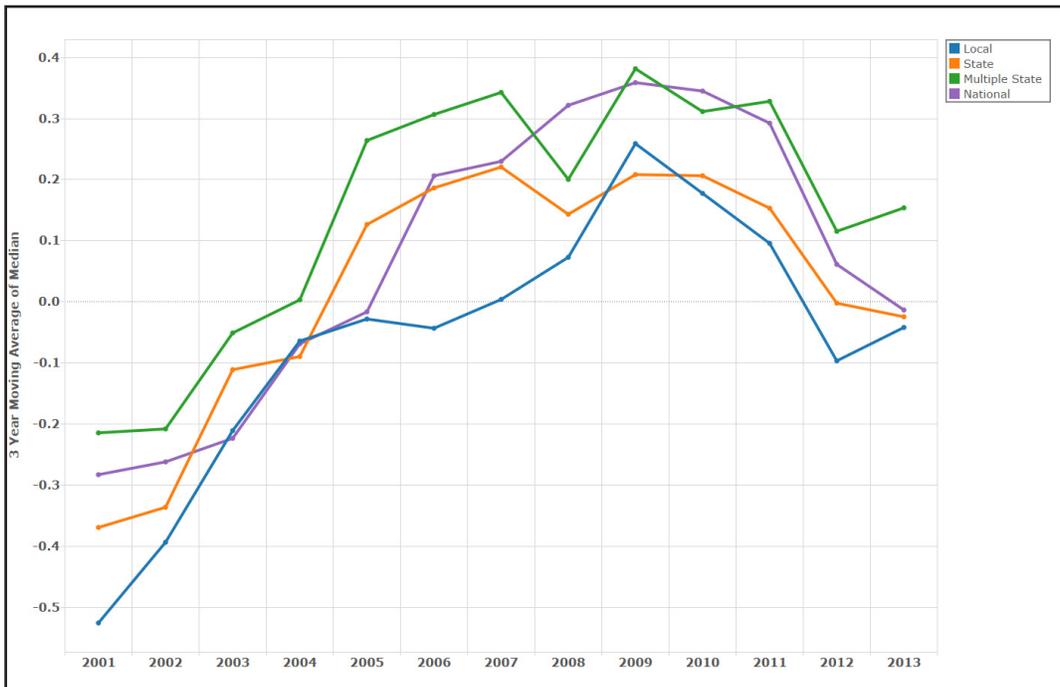
The conversation around larger and smaller CDFIs with overlapping boundaries brought up the issue of whether more productive, inter-fund networks could be formed. Many smaller funds wanted to enter into networked lending opportunities with larger funds to take advantage of their capital capacity. Some of that is clearly happening but there is demand for more of it, at least according to several CDFIs we interviewed as well as one major CDFI investor.

Given the problems with credit access in rural America and the fact that large rural states have significant political standing, such inter-fund networks could help brand CDFIs as more of a national movement. Moreover, the finding that there is no relationship between asset size and CDFI Capacity Score (see Figure 9 above) demonstrates the potential productivity of these connections. A growth opportunity for the field requires additional lending and capitalization networks, including those with CDFIs of relatively small stature.

No existing data support the notion that CDFI geographic expansion has increased portfolio risk. This may be worth looking at in the future as more refined data are collected. Today, a number of CDFIs are expanding on the basis of products and services that they view as portable and they do not think it is changing the risk profile of their balance sheet.

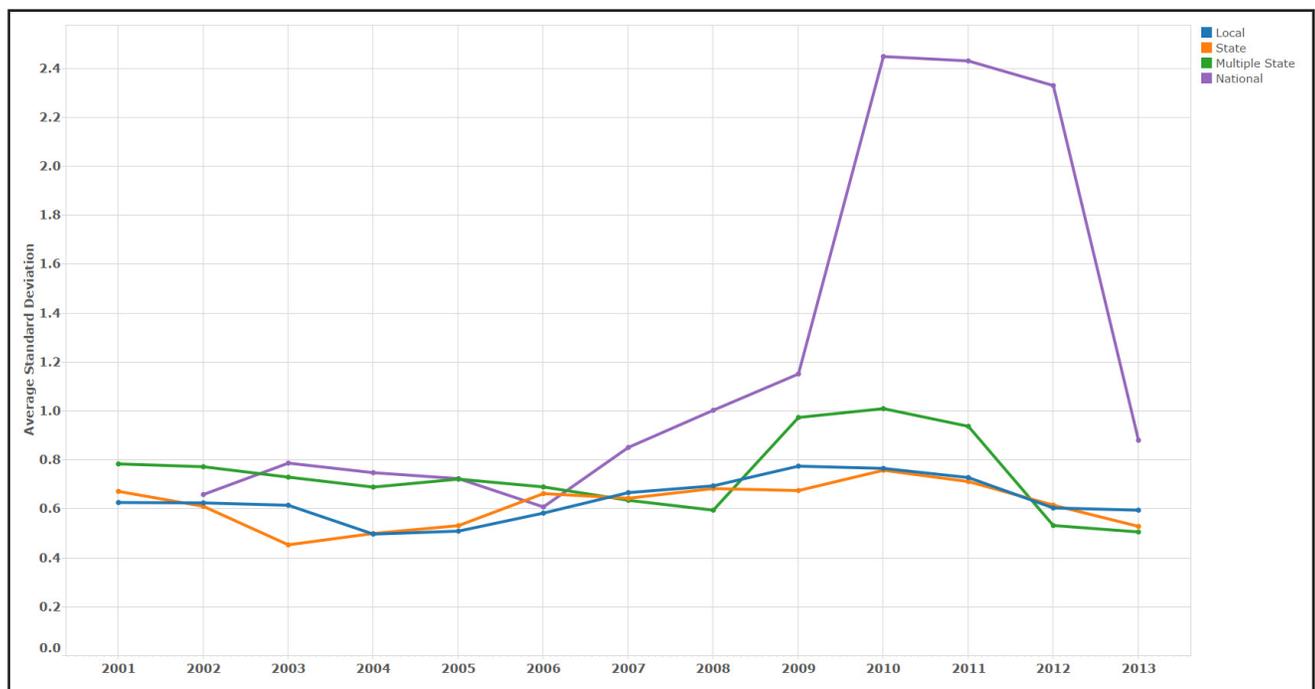
When we applied the capacity model to the four geographic types, the multi-state funds seem to do best and the local funds trail the pack. See Figure 12. But from the perspective of our capacity model, it is not possible to note any major distinction based on geographic strategy.

Figure 12: Three Year Moving Average of Median CDFI Capacity Score



We were interested in further exploring the variation in capacity among the geographic types. Accordingly, we ran an analysis that showed the moving average of the standard deviation of CDFI Capacity Scores for each cohort, as illustrated in Figure 13 below. That analysis seems to suggest that the variability in capacity among organizations that define themselves as national is more pronounced than among the other groups where variability is negligible.

Figure 13: Average Standard Deviation of CDFI Capacity Score by Geographic Size



It is hard to know why this variability is so. It may be that there is a lag time between aggregating more capital for national uses and deploying that capital. Several practitioners to whom we spoke noted that this might be an issue. Because the sample of national organizations is small, it is also true that a few outliers can create this variation.

The high touch nature of CDFI lending did lead some investors, especially bankers, to wonder about risk and portfolio quality in situations where the CDFI does not have adequate local knowledge, or the right partners or sponsors in the area. But the pervasive view was that geographic expansion was a natural byproduct and driver of scalability, and the issue had much more to do with operational risk (working capital) and defining local purpose (civic credibility).

One depository CDFI practitioner that is expanding by buying other depository CDFIs warned of the costs of doing so and the need to find mission-based investors to help incur those costs. Another practitioner, this one a non-depository CDFI, spoke eloquently about anchoring locally and then determining the appropriate products to provide, rather than going from city to city with pre-defined products in the absence of a local presence.

One of the organizing principles of early CDFIs was to create permanent institutions connected to place that would adapt capacity and products based on those places. Can individual CDFIs build multiple geographic nodes of civic credibility and market relevance without losing a center of gravity in their earlier home offices, which are still generally the places where they have the most loan and civic exposure? Is it possible that CDFIs will lose their earlier *civic reason for being* as they expand? After all, you can argue that this is an industry that emerged with a critique of modern finance as disconnecting capital from place. Are we retreating from that critique?

Most practitioners did not think that expanding CDFIs would face a local credibility problem. They saw themselves as having expertise in a sector where that knowledge and its corresponding products made them valuable to other places. They did not see this as being in contradiction with maintaining primary markets of interest; rather, they thought they could do both as a way of building long-term sustainability.

There was at least one practitioner who was more skeptical and thought that abandoning a place-based identity might pose a long-term risk to the industry, both because CDFIs could lose civic support and because they would increasingly adopt a more industrial model of growth. By an industrial model, the practitioner referred to the inability to respond to more boutique projects. That practitioner took pride in pointing to a community where intensive levels of investment over time generated change and where they provided a wide variety of loan types in support of revitalization.

There were also practitioners that pushed back against the place-oriented emphasis of the past. They noted the importance of an efficient product-oriented perspective or a people-oriented lens (e.g. low-income homeowners) that could affect place without being reduced to it. CDFIs have their roots in both place-oriented community movements and in the Civil Rights movement, which was fundamentally a people-based rights strategy.

Besides using particular financial products such as New Markets Tax Credits, there were a variety of other points of entry into new geographies for CDFIs. Some have had their expansions underwritten by foundations with a place orientation that wanted to promote more CDFI capacity in their market. Others have utilized research and policy work to build relationships and market knowledge prior to entering with financial products. And still others have entered by partnering with local CDFIs that welcomed increased capacity.¹²

If CDFIs once felt a sense of local franchise as with community development corporations in neighborhoods, the notion of holding on to a local franchise is less common, particularly among many large CDFIs. CDFIs are finding product niches in multiple geographies side by side with other CDFIs. Whereas this may have seemed awkward or unusual 15 years ago, when the industry had a more place-based identity, it is much less of an issue today.

Conversations with CDFI practitioners made it clear that geographic expansion by CDFIs has the attributes you would expect of a growing financial institution: market exploration and portable (selective) product expertise. But CDFI expansions are also sometimes incited by social sector capital, including public and philanthropic programs. Some interviewees wondered about the long-term sustainability of geographic expansions fostered by a temporary external pull rather than a longer term, self-generated strategy.

An important issue related to geographic expansion is the requirements of new management systems and skills. The co-existence of *product and place* is a management issue as much as a strategy or mission issue. The management between sites and lines of business that cross those sites will be among the most important challenges for the CDFI industry over the next decade. High quality organizations become adept at managing the tension between centralized and decentralized properties. CDFIs will not be an exception.

¹²For more on the topic of CDFIs partnering with each other, see “CDFI Collaborations: Keys to Success” (Opportunity Finance Network, 2016).

FinTech and CDFIs

Banking and finance have undergone continuous change during the past several decades, driven by deregulation but more fundamentally a byproduct of new communications and information technology. Lending has a long history of transforming face-to-face relationships into more generic commodities: from the early credit exchanges established by department stores a century ago, to credit and debit cards, to increasingly sophisticated mass marketing systems.

Today the most talked about change in banking is FinTech, or the integration of finance and technology. FinTech refers to software-driven financial services and lending platforms whose purpose is to disrupt conventional banking and lending through more cost-efficient customer connections.

FinTech should be considered a *wake-up call* for CDFIs.

FinTech is the logical outgrowth of increasingly sophisticated uses of information and data to make loans. It also represents the latest technological disruption of conventional businesses from retail services to education. Is FinTech to banking what Amazon is to local retail or what Uber is to the taxi industry? We will find out in the next few years.

There are multiple market segments within financial services that FinTech companies are pursuing: wealth management, payment services, lending products, and financial management. The amount of venture capital flowing into the sector has expanded rapidly, reaching more than \$12 billion in 2015. Common equity investors into FinTech include hedge funds, pension funds, and other institutional investors.

FinTech uses big data, technology, and algorithmic risk models to outpace conventional financial intermediaries in identifying customers, deploying capital, managing costs (and setting prices), and providing a satisfying customer interface.

When Quicken Loans announces that they can now process your mortgage and give you a decision while you are waiting in a line at Starbucks, they are not simply creating a good sound bite. They are conveying that their ability to use data (including social media, credit bureau, tax return, and real estate analytics) is so well integrated through algorithms they trust, they can indeed do just that.

If you think that FinTech will be the new banking model, it is because you view existing banking architecture as slow and inefficient and not able to keep up with customer expectations in a rapidly changing web-based retail world. You also think that a generational threshold has been passed in consumer behavior regarding financial exchange and electronic platforms.

If you think that FinTech will not supplant more conventional banking and other physical lending outlets so quickly it is because you are skeptical of untested algorithms, assume that trust requires a higher touch, that data mining and technology can be purchased and used by the incumbent banking systems, and that the regulatory barriers for FinTech are much higher than they anticipate.

The FinTech models in lending include increasingly well-known names like Kabbage, On Deck, and SoFi; and peer-to-peer markets like Lending Club and Prosper. The industry has emerged rapidly and competitors are fighting over market penetration and the ability to provide returns and liquidity to investors. There will be consolidations, losers, and winners over the next few years.

An important attribute of FinTech is its integration with retail channels for customer acquisition. That part of the FinTech story is often overlooked. It is not just technical processing platforms but the ability to use marketing channels to find customers, from mailing lists to software subscriptions to retail transactions.

How will FinTech affect CDFIs? It would seem, based on conversations with practitioners, that one part of the CDFI world will be largely immune from these changes, but one part will be affected. At the same time, the increased integration of finance and technology is something all CDFIs have to be cognizant of to build market presence. As it is for parts of the banking industry, FinTech should be considered a *wake-up call* for CDFIs.

Those CDFIs involved in financing complex residential and commercial real estate projects that require multiple financing sources, including public subsidies, will largely be immune from FinTech lending (at least as we know it today). It is hard to turn high touch deal-making with multiple parties into a simpler commodity. This means that for many of the large CDFIs with multi-state and national practices, largely around capitalizing public receivables and using tax credits, there should not be that much of a direct impact from FinTech lenders.

But for the part of the CDFI market that makes small business and consumer loans, the picture may be different. Some practitioners interviewed (microlenders, small and medium enterprise lenders, and depositories that provide consumer and small business credit) recognized the potential implications.

Nobody really knows the extent to which FinTech lenders might cut into the customer base of CDFIs because we lack substantive data on FinTech customers, let alone the ability to measure the potential overlap between those customers and small business and consumer CDFI customers. Moreover, we cannot predict whether some of these platforms will fail or not, as with so many sub-prime mortgage lenders just a decade ago.

Several practitioners thought that the line between predatory and non-predatory practices for a number of FinTech lenders was thin, based on their pricing models and business practices (marketing). Small businesses certainly report that many online lenders offer loans at higher costs than common factoring credit. And there are many FinTech companies whose marketing materials convey some of the *too good to be true* sensibility of the sub-prime mortgage industry prior to 2007.

Clearly, however, not all FinTech lenders are predatory. Some appear to be serving their market in ways that work well for customers in terms of pricing and convenience. The Federal Reserve and the U.S. Department of the Treasury are only now trying to understand the impact and character of these companies, including relevant regulatory standards.

CDFI interaction with FinTech has the potential to play out in one of a variety of ways. CDFIs can:

1. Ignore the whole phenomenon and assume that their markets are boutique enough that they will not be affected
2. Build their own technology platform to deepen the customer base, automate customer underwriting, and expand distribution channels
3. Private label existing FinTech platforms, thereby functioning as a distributor for the FinTech firm

Several CDFIs are building or using platforms for lending that have a FinTech character in terms of the ability to automate the transformation of credit scores, tax returns, and company financials into a rapid loan decision. These CDFIs include Accion in several areas of the U.S. and Intersect Fund in New Jersey.

Opportunity Fund is entering into a partnership with Lending Club, a well-known FinTech company, and several other CDFIs with whom we spoke are exploring similar partnerships. One of the best-known new microlenders, Kiva, uses an online lending platform to connect investors and borrowers in the manner of peer-to-peer market lenders.

Oportun, formerly known as Progreso Financiero, has one foot in the for-profit FinTech world and one foot in the CDFI world. It is a certified CDFI that focuses on financially-underserved Hispanics and uses technology and a national retail distribution to acquire and process loans. Oportun has raised a significant amount of private equity.

Several interviewees noted that the growing Hispanic consumer and business population in the United States is a particularly important focus for small dollar lending that can be captured by either *bad money* (predatory payday lenders, car title lenders, pawn shop lending) or *good money* civic actors (credit unions, community banks, microfinance institutions). In that market, FinTech is going to play an important role, particularly if it can utilize trusted community channels.

It is worth noting that periods of high immigration into the United States have always resulted in the development of new formal and informal credit institutions that serve communities with limited connection to the formal banking system. In another era of U.S. history, the postal system was used as a savings vehicle and had that same effect. While created largely as part of a national legislative reaction to the Panic of 1907, it helped acculturate millions of new European immigrants to formal savings societies.¹³

CDFIs that are FinTech-lite still rely on the knowledge of places and sectors to acquire loans, but use technology to rapidly process them. Unlike Oportun, most do not have the working capital to ramp up operations rapidly although some of them have the ambition.

The impact of FinTech on CDFIs that are small business lenders may also have to do with the ambition of the CDFIs themselves. If a CDFI wants to maintain a very limited lending market—a small fund in a local geography—then there may not be much of an issue at stake. The bigger question is for the small business lending CDFI that seeks significant growth.

Stepping back from FinTech as a new Silicon Valley phenomenon, it is important to note the valuable role technology plays in reaching underserved consumers and small businesses. A recent report from the World Economic Forum noted that FinTech holds great promise in providing financing for small- and medium-sized enterprises in a sustainable way.¹⁴ And mobile banking in the developing world has had significant wealth-building impact for low-income people, as Bill Gates recently noted.¹⁵

At a time when a good deal of conventional bank financing has left the small business lending market, competition within FinTech for small business credit is a good thing, as long as there are consumer safeguards. Better technology and information management can support financial products that are place-agnostic which ought to provide enormous benefit to lower income people, if done right. Thus the FinTech phenomenon can be seen as a challenge to CDFIs to increase technology skills and data access in pursuit of mission.

¹³ Mehra Baradaran, "A Short History of Postal Banking," *Slate* (August, 2014).

¹⁴ The World Economic Forum, "The Future of FinTech: A Paradigm Shift in Small Business Finance" (October, 2015).

¹⁵ Bill Gates, "Mobile Banking Will Help the Poor," *GatesNotes* (2015 Gates Annual Letter).

There was a strong sense among practitioners and investors that either because of working capital constraints or organizational culture, CDFIs were not as tech-oriented as they needed to be. Some saw this in generational terms: the first generation of CDFI leaders—many of whom are just now retiring--had a non-tech orientation. Others viewed it as a result of the fact that CDFIs do not compete for customers (to the same extent as for-profit lenders), are subsidized, and, therefore, not driven to cost efficiency.

Many interviewees thought CDFIs still largely viewed technology in the manner of most nonprofit organizations: as the background utility for programs and services. There was perhaps less understanding of the ways in which technology could shape a program or product in terms of transaction costs for the originators and borrowers, as well as identifying new customers.

Along with technology, the other part of the FinTech challenge has to do with partnerships with non-lending customer channels. It is no accident that accounting software companies or retail establishments are entering national lending markets: they have customer data, subscription information, and point of sale trend analysis. Can CDFIs build lending markets through relationships with non-lending institutions? A number of CDFIs are experimenting with this. Craft3 in the Northwest, for example, has pioneered utility company relationships to make energy efficiency consumer loans.

For CDFIs pursuing expansion through technology, there are two dimensions to the work: 1) the technological interface and underwriting analytics and 2) the customer acquisition channel. These go hand in hand, with the former being useful only when the latter generates sufficient volume. There has been very limited attempt at data mining for customers in the CDFI industry. CDFIs use data analytics to understand market gaps and potential demand, but that is a step removed from customer acquisition.

There was a strong sense among practitioners and investors that either because of working capital constraints or organizational culture, CDFIs were not as tech-oriented as they needed to be.

Chasing the Impact Investor Brand

During the past ten years *impact investing* has emerged as the most widely used language within the social investment industry. Impact investments are today a very recognizable brand. The term covers a broad range of activity, at least based on the definition offered by the Global Impact Investing Network (GIIN) which defines it as “*any investment into a fund, firm, or organization that seeks a social or environmental impact, as well as a financial return.*”¹⁶

You can argue with a definition that is so broad, but it may be that the very breadth and simplicity of the concept has given it significant brand power.

The interest by wealth holders (corporations, family offices, individuals) in identifying ways to balance social and economic returns is part of today’s *Weltanschauung*. It has many historical sources, including the maturing of the corporate social responsibility movement, the emergence of climate change as a global concern, the popularity of microfinance as a tool in the developing world, and the more generic interest in social entrepreneurship.

Impact investing has quickly gained extraordinary global coverage in financial and mainstream media. It is hard to think of a major financial major financial news source from the Wall Street Journal to Forbes to the Economist that has not covered it.

Impact investing draws some of its U.S. narrative from the track record of CDFIs. A recent study on domestic opportunities for impact investors sponsored by the GIIN notes the prominence of CDFIs as a high-impact opportunity for U.S. impact investors.¹⁷

CDFIs view themselves as the affirmative practitioners within the social investment world, the *in the trenches* dealmakers who actualize the values of social investment outside mainstream capital markets and mainstream companies.

Yet there is a practical gulf between the impact investor movement and the CDFI industry, something recognized by everyone we interviewed. CDFI practitioners could not point to significant new CDFI capital that identified itself as affected by the new impact investor efforts. CDFI investors working in institutions that make CDFI and impact investments spoke to the cultural gap that exists between the two industries. Conversations with both investors and practitioners identified five areas of difference:

- 1. Market versus concessionary expectations:** Many impact investment proponents do not believe that you have to take a concessionary perspective regarding rates of returns. This is generally not the way CDFIs view their practice. CDFIs largely seek capital at concessionary rates, with the exception of investments incited by tax policy.
- 2. Equity versus debt structures:** Many impact investment proponents are interested in equity investments rather than debt instruments. CDFI equity is much less prevalent than simpler debt products. CDFIs largely offer fixed income products with lower levels of liquidity than comparable debt instruments. Moreover, many of the studies on impact investment returns have been based on a narrow selection of equity funds.¹⁸

¹⁶ “What You Need to Know about Impact Investing” (Global Impact and Investing Network <https://thegiin.org/impact-investing/need-to-know/#s1>).

¹⁷ Swack and Hangen, “Scaling U.S. Community Investing” (GIIN and Carsey School of Public Policy, October, 2015).

¹⁸ See for example the recent report from the Wharton School, University of Pennsylvania, “Mission Preservation and Financial Performance, *Wharton Social Impact* (October, 2015)

3. Private versus public sector orientation: The impact investment movement self-identifies as more enterprise-focused than social or public sector-oriented. It has limited connection to the layering of public subsidies with private investments and it does not have a connection to the tradition of social reform embedded within many CDFIs. By contrast, CDFIs have a brand with a strong public sector focus. CDFIs may not think of themselves as having a public sector brand, but to many outside of the field, their identity is bound to the CDFI Fund and New Markets Tax Credits; hence, they appear as part of government.

4. Environmental versus community development focus: Much of the impact investors' focus is global and environmental. While many CDFIs are involved in environmental projects it is not a well-marketed aspect of the CDFI industry. There are other aspects of impact investment that line up well with CDFIs in terms of poverty and education but often the mechanisms for change are different. Community development does not translate as well with family office investors as it does with banks, foundations, and religious community investors.

5. Disintermediation versus grassroots bankers: Some of the nation's new wealth held by individuals interested in impact investing has been created through disruptive technologies whose processes and products upend existing institutions and businesses. These individuals have built wealth through the disintermediation of incumbent companies, and CDFI practices may not appear as a disruptive enough model of change. The CDFI industry's culture is practitioner-focused, built on incremental transactions and institution building. The impact investor world is organized around big social impact bets.

There are also significant points of convergence, including the fact that both groups care about social metrics and share poverty reduction goals. Moreover, some of the same institutions that finance CDFIs are also involved in the non-CDFI impact investment industry.

The impact investment field represents both a challenge and an opportunity for the CDFI world. Can it produce capital for CDFIs? Will it marginalize CDFIs as an inferior impact option? How do CDFIs best market and develop investment products that appeal to the impact investment industry? Answering these questions may be critical to the next stage of CDFI industry growth.

While some of the CDFIs we interviewed dismiss impact investing as just a new type of marketing, impact-motivated investing represents positive demand from wealthy individuals and institutions with endowments to identify new ways to invest capital.

The language of impact investing is especially resonant with family offices that manage wealth. And given the dramatic intergenerational transfer of wealth over the next several decades, this is an increasingly important issue.¹⁹

In conversations with CDFI practitioners there was some pessimism that the world of impact investments and the CDFI world could better connect. After all, from the CDFI perspective the social investment world of screened stocks and bonds has meant virtually nothing to CDFI portfolios. Why would this be different, especially since there appears to be a mismatch of pricing and terms, and the relationships are just not there? That said, many practitioners noted that early skepticism was waning and there was increased interest in figuring out how to connect the two worlds.

¹⁹ See for example Liz Skinner, "The great wealth transfer is coming, putting advisors at risk," *Investment News* (July, 2015). Boston College's Center for Wealth and Philanthropy produces quality research on this topic.

CDFI investors, including foundations and banks, were more optimistic. Many bank investors see the impact investment field creating new touch points for CDFI-like work within their institutions, particularly through wealth management and trust divisions. During the course of preparing this report, Goldman Sachs completed its purchase of Imprint Capital, a well-known impact capital advisory group and asset manager. Clearly something new is in the works.

How do CDFIs best market and develop investment products that appeal to the impact investment industry?

Many foundations view impact investing as a way to frame additional work across their institutions that will increase the flow of social investment capital. It has helped some foundations reinvigorate internal conversations around how they use their non-grant portfolio for social returns. Recent announcements at several major national foundations regarding increasing their impact investment portfolios reflect that perspective.

The Heron Foundation has actively pursued the notion that the entire corpus of their foundation ought to be viewed in terms of social impact, as a singular portfolio with the ability to invest affirmatively over different asset classes. In this way the distinction between grant making and conventional portfolio investing is at least conceptually diminished through the broader category of social change. It is likely no accident that Heron's CEO is an early pioneer of the CDFI industry.

The MacArthur Foundation, one of the largest philanthropy-based investors in CDFIs over the past three decades, actively works on mediating the divide between impact investors and CDFIs. They are engaging in transactions that unlock capital from donor advised funds and high net worth individuals in ways that are useful to CDFIs, as well as other social enterprises. To do so, they use their balance sheet to provide liquidity and credit enhancements for the investors. The goal is to build a practice that somewhat *disrupts* the impact investment field, bringing its capital into closer alignment with social enterprise capital needs.

MacArthur's work assumes there is a gap between the risk and liquidity needs of many potential impact investors and the kind of capital CDFIs find useful. They see the role of the foundation as building a transactional bridge (through products and platforms) that connects the supply and demand for social enterprise capital.

Conversations with investors and practitioners lead to the conclusion that the CDFI world, along with its strong, mission-aligned investment supporters, has to take a focused approach to connecting its practice with the impact investor appetite. There are many dimensions to that approach, but four stand out:

1. Simplify and market: CDFIs have a brand that is too complex and requires too much explanation. The impact investment industry uses a language that is accessible. CDFIs have to market themselves as a proven domestic social impact vehicle and make their story simple.

2. Challenge profit maximization: The CDFI industry has to represent itself through a theory of its practice that includes a rationale behind certain forms of subsidy and the value of being profitable without being profit-maximizing. Those themes have to be articulated and marketed in affirmative ways.

3. Innovate around products and platforms: The work of the MacArthur Foundation with high net worth individuals—and investor platforms like the ones developed by Calvert and the new ImpactUS Marketplace—are the beginning of cross-CDFI financial product innovation. This product innovation should be actively supported by the industry.

4. Cultivate new relationships: The industry needs to create bridges to the new philanthropy linked to money that was made through technology and finance over the past two decades. Those relationships exist for a few CDFIs and for some traditional CDFI investors, but they have not translated into a high level of industry recognition or understanding.

The CDFI world, along with its strong, mission-aligned investment supporters, has to **take a focused approach to connecting its practice with the impact investor appetite.**

Another way of thinking about the impact investment industry and CDFIs is to place the issue within the historical framework of social enterprise in general. CDFIs were early social enterprises (before the term was widely used) but since the emergence of the CDFI field, social entrepreneurship has accelerated and new models of private philanthropy have emerged to support it.

To many in the social enterprise world, CDFIs are not prominent actors, despite the fact that a great deal of debt financing for social enterprises (from charter schools to fresh food alternatives to the new *Pay for Success* impact bonds) has a CDFI connection.

Given the heightened nationwide interest in issues of income inequality, poverty, and racial justice, this is an important moment for CDFIs to reinvigorate their profile within the broader impact investment world and social enterprise field. But it will not happen without intentional efforts to do so.

Is There a Diversification Problem?

The discussion about impact investments and FinTech is germane to the overall question of CDFI growth. Those movements are signals of change: one from a social impact perspective and another from a market vantage point. They point out how a shift in technology and narrative can lead to business disruptions or new civic and market opportunities.

The ability of CDFIs to take advantage of new technologies and new investor opportunities speaks to the issue of adaptability. When change appears, it is common to ask whether an industry is too dependent on a certain way of looking at their work to adapt to change. And if so, to what extent is that dependence a byproduct of how it is capitalized and who its customers are? These are important questions for the CDFI industry today.

Is the CDFI industry stuck, based on the operating logic of its investors and borrowers? This is a question that any business or social sector enterprise is wise to ask in an ongoing way. It's one of the cornerstone questions of Clay Christensen's work on disruptive innovation: the ways in which unexpected change can dramatically impact successful incumbent companies.²⁰

Both CDFI practitioners and investors wonder whether CDFIs are too dependent on the two principal sources of financial support that defined their growth over the past 15 years: the public sector and banks. While access to this funding is a marker of CDFI success, is the springboard for growth also a constraint to change in that it shaped a way of thinking about the present and the future? And if so, how can CDFIs best use their grant-funded balance sheets and banking relationships to diversify more effectively?

The utilization of awards from the CDFI Fund is only one part of the public sector diversification issue. Another aspect of CDFI public dependence has to do with the New Markets Tax Credit program. Since 2001, New Markets has allocated \$35 billion in credits, including a substantial amount through CDFIs. Again, a significant marker of CDFI success.

New Markets Tax Credits have provided many CDFIs with a stream of revenue, particularly during the period of the Great Recession when revenue from interest rate spread was diminished and charge-offs and delinquency rates elevated. The recent longer term extension of this tax credit program will ensure that stream of revenue for at least another five years, and likely much longer.

The dependence on public sources may have two downsides:

1. Policy risk: The obvious issue has to do with public policy risk. As one interviewee said, *what if the spigot turns off or the programs change character, can CDFIs adapt?* The policy concerns also relate to banks in terms of CRA. In the absence of CRA or if the incentives of CRA change, what would it mean for CDFIs?

2. Masking inefficiencies: Subsidies can mask cost or operating inefficiencies that eventually may have to be faced. Many practitioners and investors were nervous about too many CDFIs using CDFI Fund Financial Assistance grants for operating expenses. Others asked whether New Markets Tax Credit revenue has made it harder for CDFIs to come to terms with operating inefficiencies in their lending programs.

²⁰ Clay Christensen, *The Innovators Dilemma*, (New York: Harper, 1997).

The investor support from depositories is driven by CRA. While bank investments are private, they are shaped by a public mandate. For two decades, CRA-motivated capital has been a near perfect systems match between a rapidly consolidating banking industry and the emergence of a CDFI industry interested in markets that overlap with banks' trade areas, but within which banks are less likely to make certain types of loans.

CDFIs offer banks a low transaction cost partnership opportunity to cover CRA obligations. While the CRA strategies of banks vary, the growth of the largest banks during the first decade of the 21st century has been an opportunity for the larger CDFIs and the industry as a whole.

It is hard to know how bank consolidations will change these relationships in the future. The changing asset concentration of the banking industry—the four largest banks now hold more than 50% of total bank assets—may place CDFIs at an advantage (a larger market opportunity for lending and more bank incentives for CDFI investments) or a disadvantage (fewer large institutions supplying debt to CDFIs).

Conversations with bankers and practitioners pointed out a few warning signs in future CDFI-bank relationships:

- 1. Concentration risk:** As with any lender, banks have to manage their concentration in particular CDFIs and in a few cases they are now oversubscribed. One practitioner not only spoke about the issue of reaching concentration limits but also noted that geographic expansion had the added benefit of opening relationships with new banks.
- 2. Regulatory costs:** Many banks are passing on transaction costs to their borrowers in the form of heavier documentation and due diligence in the post-2008 regulatory context.
- 3. CRA issues:** Several large banks currently have less CRA incentive because they are not buying banks; and they are less able to get an outstanding rating since the housing crisis.
- 4. Underwriting concerns:** Some banks are looking more carefully at CDFI operations and balance sheets as they deploy more bank assets through CDFIs. Banks are focused on several issues of concern, including:
 - *The nature of CDFI unrestricted net assets and capital and whether the industry has a handle on their grant and government contracts regarding restrictions or recapture.* One banker thought we needed to be able to categorize net assets as something akin to tier one capital and tier two capital, as with banks.
 - *Concern that there is still not enough standardization among CDFIs, particularly at the level of financial auditing standards.* Many investors noted that they would like AERIS reviews to drive more standardization and wonder whether the Standard and Poor's (S&P) ratings will have that effect.
 - *How the use of certain government programs (CDFI Bond Guarantee Program and Federal Home Loan Banks) is making it harder to secure their investments due to preferential security.*
 - *As bank lending standards change and the amount of capital loaned to CDFIs increases, banks are less apt to make general recourse investments and instead want to take security on their investments.*

Bank incentives to work with CDFIs are context- and bank sector-specific. There are a good number of smaller banks that are struggling: they have trouble managing new regulatory costs, non-bank lending competition is significant, they cannot raise new equity in the capital markets, and they do not have enough non-lending products to profitably cross-sell. Those banks will not be able to play a role with CDFIs. Moreover, the general movement in the United States continues to favor a significant reduction in the number of banks. When CDFIs were first emerging, there were 15,000 banks in the United States; today that number is around 6,500.

The larger regional and national banks right below the four largest mega-banks may have the most incentive to work with CDFIs, as many of them are strong financially and still involved in potential mergers. This group includes the approximately 30 banks in the \$50 billion to \$400 billion asset level.²¹

The four largest U.S. banks – Citi, Wells Fargo, Bank of America, and JPMorgan Chase – will continue to be active CDFI investors. While several have risk concentration issues with large CDFIs, they are nonetheless attentive to their community investment portfolios. They will continue to look for ways to buy or securitize CDFI paper, invest in off-balance sheet funds that benefit CDFIs, and use their corporate foundations to innovate with CDFIs. Similarly, the large, full-service investment banks, such as Goldman Sachs and Morgan Stanley, will maintain active community investment programs.

Banks and other financial institutions have formed the backbone of the syndicated debt, tax credit, and structured finance funds that have benefited CDFIs in targeted products and places. The structured finance funds have generally had banks in the senior position of a financial stack, with CDFIs, foundations, and public sector capital in a junior or subordinated position.

Substantial investments from the *largest banks* are still concentrated in what are viewed as the top 10 to 20 CDFIs. The general perspective from banks is that there is a significant drop in capacity from the top tier to the second tier. Again, our review of the data from the perspective of what we called CDFI Capacity Score might challenge that conclusion. It could be that there are a number of CDFIs that do not have the size or sophisticated systems to deal with large bank investors, but are nonetheless capable and could play important roles in CDFI lending networks, which would undoubtedly have bank lines of credit involved.

The existence of the CDFI Fund and other funders providing grants to strengthen CDFI balance sheets has been central to CDFI growth, but by defining the net worth strategy for the industry it may have had unintended consequences regarding the diversity of operating models and assumptions. At the heart of the capital diversification issue is whether there are ways to generate net assets over and above the public (and sometimes private) grant strategies that CDFIs currently use.

Logically, a CDFI can build net worth in one of four ways: 1) through retained earnings based on the profitability of operations, 2) through direct public or private grants specified for net assets, 3) by obtaining heavily subordinated debt (Equity Equivalent (EQ2)) that assumes perpetuity, and 4) by using a financial structure that issues partnership shares or some form of common and preferred stock.

CDFIs use all four strategies but the overwhelming majority of net assets arrive as grants, with the CDFI Fund being decisive for many organizations. There are also examples of very large grants from state government to CDFIs (e.g. Self-Help, Reinvestment Fund).

²¹ FDIC, "Largest 50 Institutions by Consolidated Banking Assets" (2015). Data as of 3Q, 2015.

The CDFI industry's net asset strategies resemble nonprofit endowment giving more than the financial services business, with the key donor being the public sector. Large philanthropies and major bank foundations have also made targeted *endowment-like* net worth grants into CDFIs (Ford, MacArthur, JPMorgan Chase, Kresge, Gates, Walton) usually directed toward particular program outcomes, including such things as energy conservation, charter schools, supermarkets, childcare centers, and affordable housing development.

As CDFIs' expertise, lending activity, and net worth have increased, many have reached higher self-sufficiency ratios. Yet few have been able to generate a level of retained earnings from operations that can self-fund significant levels of new growth. This means that with the present models, reliance on public and private sector grants for asset growth is critical.

If grant-based net worth were not available to the industry, CDFI growth would require one or more of the following strategies:

1. More profitability through operations
2. Less balance sheet lending and a shift to a finance company model of high-volume loan sales
3. An asset manager fee role with off-balance sheet funds, including impact investor assets and bank CRA portfolios
4. Increased leverage by making the case to investors that historical loss records and the quality of the present portfolios allow for it

CDFIs are experimenting with all four of those approaches. Several practitioners thought that CDFI profitability was not enough of a concern in the industry, perhaps due to the nature of the market roles that CDFIs play, the nature of the funding environment (too much short-term, relatively expensive debt and zero-cost grant equity), or the culture of mission-based or nonprofit operations.

Whatever the reason, several practitioners and investors thought it was the right time for the industry to pose questions about operating margins and profitability, including: Are there forms of CDFI growth that make it too difficult to be profitable? What would CDFIs give up or gain if they had to focus more explicitly on profit margins? In the absence of reliable CDFI Fund or other grantor equity, what would it take to create higher levels of self-funded growth and still meet a high mission threshold?

A thought experiment from one interviewee was as follows: Use a simple matrix with one axis standing for profitability and another for social impact. Practitioners want to have their assets occupy as much of the high impact, high profitability box as possible, and as little of the low profitability, low impact box as possible. Most practitioners would like to say their assets are in the mid-zones.

But few organizations understand their costs and profit per product, especially in relationship to impact per product, well enough to fill in the matrix and plot growth strategies on that basis. The obvious *sweet spot* for a CDFI ought to be where impact and profitability are best aligned. But in the absence of understanding enough about the relationships between costs/profitability on the one hand and impact on the other hand, many CDFIs continue to grow like social service organizations, identifying social needs and building programs to meet those needs.

A service model of growth can certainly be socially effective, but it assumes continued soft money for operations and an endowment contribution model of net worth for ongoing growth. Some CDFI grantors and investors may unwittingly promote a notion of growth that may not be sustainable in the long run, to the extent they direct CDFIs to the highest need functions, without understanding the compensating cost requirements or even the limits of debt financing as a social change tool.

While practitioners may want to drive growth by aligning high impact and high margin investments, what if most of the highest impact investments have lower margins (or lose money)? In this scenario, how do you limit the role of external subsidy as the driving force of program continuity?

One option is a cross-subsidy strategy where a CDFI has one or more lines of business that are mission-lite, but more profitable, and are able to generate more returns for the organization to support higher cost, higher impact projects.

The concept of mission-lite in the CDFI field generally has to do with income impact. Most CDFIs concentrate on places and people that are low and moderate income. The mission focus is the industry's key differentiator and what makes its work attractive to social investors. But it may also be true that the inability to construct a more mixed-income portfolio makes it harder to scale institutions without government and philanthropic subsidies. Experiments in cross-subsidy ought to be encouraged as a way to support new growth models.

Moreover, CDFIs working with environmental and physical infrastructure projects cannot always track their work precisely through the lens of income, at least in a direct way. This is an important issue for the industry to come to terms with, especially given impact investors' interest in the environment, and emerging interest in private investment in public infrastructure.

Today, CDFI cross-subsidy largely comes through fees from the Low Income Housing Tax Credit and New Markets Tax Credit programs. Many CDFIs have separate affiliates that specialize in those areas and can often up-stream profits to the core CDFI balance sheet.

Substantial investments from the largest banks are still concentrated in what are viewed as the top 10 to 20 CDFIs. The general perspective from banks is that there is a significant drop in capacity from the top tier to the second tier. Again, our review of the data from the perspective of what we called **CDFI Capacity Score** might challenge that conclusion.

While tax credit fees are a good example of mission-focused cross-subsidy, they have also demonstrated one of the downsides of cross-subsidy: the internal competition for resources that can emerge within a CDFI, between the organization's more cost-intensive mission component and the capital markets component. Conversations with several practitioners pointed out the complexity of integrating mission and margin when there is internally generated subsidy whose use has to be negotiated.

Internally generated subsidy has the potential to be more disciplined than external subsidy; it is earned and not directed by a third party, so the competition for its use can potentially lead to greater productivity or impact. The negotiated use of self-generated earnings forces an organization to come to terms with competing visions of short and long-term operating priorities.

A central issue related to CDFI profitability is the availability of long term capital. Virtually every practitioner made note of this issue. The ability to make long-term loans that do not have heavy servicing requirements

allows a CDFI to obtain a predictable interest rate spread against their cost of funds. This annuity model of profitability is an important strategy for CDFIs, as long as interest rate risk and liquidity can be managed via asset-liability matching models and access to emergency liquidity channels.

Organizational ownership and capital structure is another vantage point through which the net assets question can be analyzed. There are presently too few for-profit CDFI experiments (apart from CDFI banks) where equity is raised from investors who expect dividends. Clearinghouse CDFI, the Housing Partnership REIT, the Community Development Trust, and a handful of community development venture capital organizations are examples of equity or equity-like corporate structures. But in general, the CDFI world is a debt-driven business where the ownership structure is overwhelmingly nonprofit or mutual.

Based on our conversations with investors and practitioners, it would be fair to say there are widespread diversification concerns within the industry. Public sector equity and bank debt have underwritten the growth of the industry, but many question whether this same system of capitalization can continue to underwrite growth rates such as those that we saw over the past 10 years. That kind of growth may require a broader range of investment products, stronger levels of CDFI profitability, a different relationship with the public sector, and increased capacity to use data and technology to obtain customers.

A Capital Transformation Phase

The central purpose of this report is to explore the present inflection point for the CDFI industry. Our conversations defined this moment through reference to one or more of the following topics: 1) current CDFI operating challenges, 2) the changing banking environment; 3) the new impact investment practice, and 4) new CDFI successes individually, through networks, and in terms of public policy.

The least optimistic perspectives on the industry often emphasized current challenges, particularly capital diversification. The most optimistic points of view focused on new successes in the industry, including those that have the potential to traverse capital diversification barriers. Observations of the changing banking and social investment environment were stated more as facts, rather than as cause for optimism or pessimism.

Today's inflection point is not rooted in one issue or the other, but the overall web of issues concerning CDFI operations and external possibilities. There is a general sense that one phase of industry growth may be playing itself out, while new practices are emerging, at least among a group of institutions. But beyond that sense of limits and successes, all else is a matter of informed speculation.

The operating challenges and changing environment for CDFIs were already covered in other parts of this report. What about breakthrough successes in the industry and what they might mean for the future? Practitioners pointed to two public policy developments that have aided CDFIs: CDFI access to the Federal Home Loan Bank system and CDFI Bond Guarantee programs. Both have their limitations due to collateral requirements and access. But both are important because they provide long-term capital and more fundamentally denote CDFIs as a part of the financial system.

The criticism of Federal Home Loan Bank access was that its rules of entry were uneven from bank to bank. The criticism of the CDFI Bond Guarantee Program was its collateral requirements and the fact that the Office of Management and Budget treats every transaction through an individual project financing framework, rather than underwriting an organization and giving them more discretion when managing project-level risks.

Many conversations regarding the changing possibilities within the industry focused on individual CDFI successes: Boston Community Capital's mortgage foreclosure refinance program, the work of New Hampshire Community Loan Fund with manufactured housing, Reinvestment Fund's supermarket programs, Community Reinvestment Fund's Spark Platform, the work of Capital Impact Partners in Detroit, and CDFI efforts in New Orleans. The list is long and impressive.

As a CDFI founder who has been outside the industry for four years²², it is easy to become re-impressed by the breadth of work in the field and the willingness to continually tackle new issues. Among the organizations interviewed, three emerging practices were especially noteworthy as they related to future options within the field.

- *Clearinghouse CDFI* received investment grade ratings from S&P, with other CDFIs following
- *Self-Help Credit Union* has orchestrated dramatic roll-ups of faltering credit unions in Chicago and California
- *Sunrise Banks* is building a successful depository CDFI that is now marketing a national technology platform in support of small dollar loans

²²The author was the founding CEO of Reinvestment Fund and led the organization from 1986 to 2011.

The conventional credit rating strategy is an important moment for the industry. It adds new legitimacy to the CDFIs being rated, the CDFI rating system (Aeris) that helped pave the way, and the industry itself. It sends a signal to investors that have not been able to invest in CDFI paper, because it was not investment grade, that the door is open. This could have significance for pension funds and insurance companies. It also should help market CDFI paper to impact investors.

Rated CDFIs (Clearinghouse, Housing Trust Silicon Valley, and Reinvestment Fund) are now investment-grade credits that provide fixed-income rates of return, with clear market comparability. S&P is a stamp of legitimacy, familiarity, and clarity.

For sheer scale of community investment and engagement, North Carolina-based Self-Help Credit Union's expansion into Chicago and California, where they currently have more than 80,000 members and \$600 million in assets, represents a dramatic point of change. Using low interest social investments, Self-Help re-capitalized struggling credit unions and expanded their footprint. In doing so, they are building the largest CDFI that is aggregating savings from lower-income households.

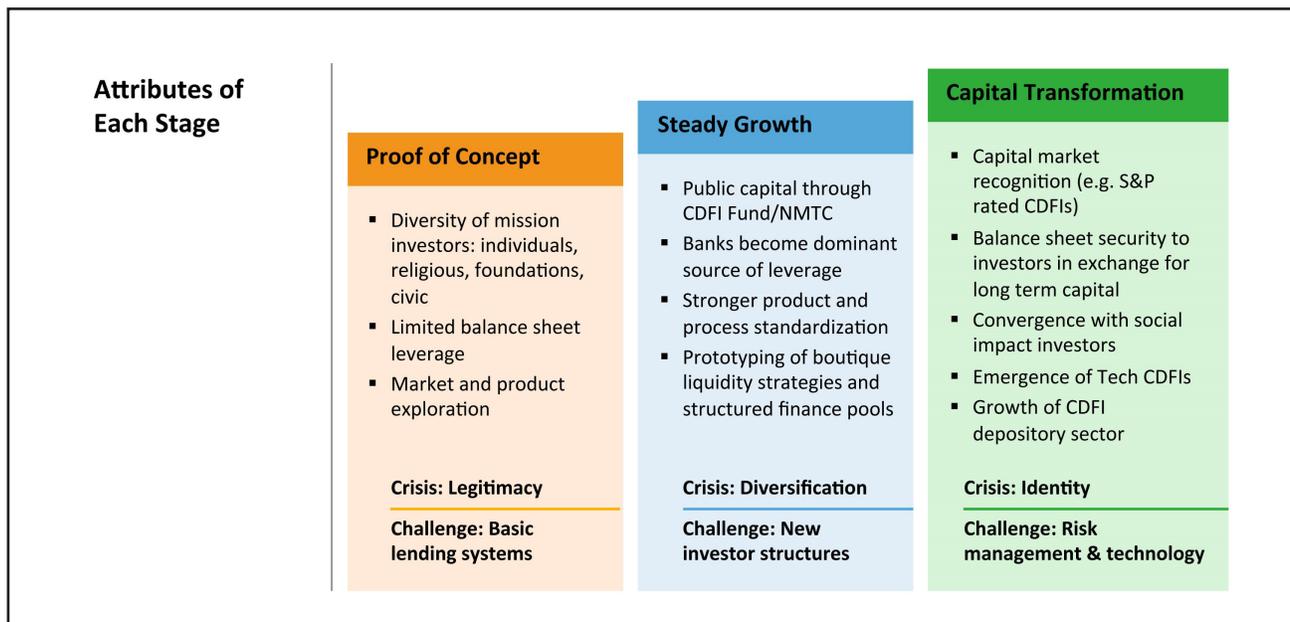
Another depository CDFI, Sunrise Banks, has partnered with employers and employee benefits firms to develop a small dollar loan product for moderate-income workers. They have figured out an effective way to provide non-predatory pay day liquidity as an employee benefit, which has helped reduce the use of 401(k) withdrawals as expensive loans for employees, something benefits companies support. Sunrise Banks has been at the forefront of building a national technology platform and may be demonstrating how to best balance old-fashioned, main street banking with national, web-based products. This balance may be the only way for community banks to survive in the long term.

Capital market participation, aggregating savings on a mass scale along with more traditional community investments, and building technology platforms with retail channels are ways to soften the dependence on traditional CDFI investors. The ability to market these and other breakthroughs to a broader impact investor constituency will advance this work dramatically, which is why it is so important for the CDFI story to travel outside its traditional investor base.

Based on these successes and others like them, it is possible that parts of the CDFI industry are *in transition* to a new type of growth that eclipses the operating model of the past 15 years. I call this third stage *capital transformation* because it represents a shift in identity from an industry whose primary organizing logic is as a social sector institution to one increasingly defined as a new kind of financial institution.

Moreover, it could represent a transition in CDFIs' scale and operating capacity, just as the shift from proof of concept to the steady growth period did. The chart below provides a framework for three stages of growth, noting the key attributes and challenges for each, as well as the points of tension or crisis that can drive the industry from one stage to the other.

Figure 14: Attributes of CDFI Transition Stages



In the capital transformation stage, there are three organizational forms that might allow for significant departure from stage two:

1. Non-depository development agencies: These include the CDFIs that are on their way to becoming more robust capital markets participants with rated paper, able to float bonds and tackle increasingly higher levels of social infrastructure financing. They are the organizations that largely grew through financing partnerships with public sector subsidy and have been able to expand geographically by following public sector programs. Examples include Clearinghouse CDFI and Reinvestment Fund.

2. FinTech CDFIs: These include small business lenders that are experimenting with new technology and data systems, and are going to build models that increase market share and profitability. It is likely there will be break-through examples of small business lending organizations that are quite small today relative to the larger CDFIs. In addition, well-known and larger CDFIs financing small businesses are becoming more technologically adept. These organizations will become increasingly virtual and software-driven.

3. Depositories: These include a number of existing CDFI banks and credit unions that can take advantage of a CDFI designation through access to capital and potential safe harbors from regulations, use depository infrastructure to perform asset transformation (changing short-term deposits into long-term loans), and avoid the problems of overly-localized community banks through national networks and platforms. Both Sunrise and Self-Help, in different ways, represent an adaptation of the local credit union and local community bank model. Additional adaptations (some through small bank consolidation) will follow.

These three organizational forms are not mutually exclusive structures, as we know from existing practices, but highlight three operating strategies. Some organizations able to grow dramatically will use aspects of each operating strategy. Every organization able to move into this stage will not do so in the same way, or at the same growth rate, but for those that do there will be two major shifts: 1) a reduction in the reliance on conventional bank and public funding sources and 2) an increased ability to use internally-generated profits to grow.

More importantly, as with previous stages, the growth of a number of industry leaders will facilitate a diffusion of opportunities to a broader range of groups by opening up capital sources and sharing techniques.

By 2025, the industry may comprise as many as 20 organizations with assets of \$1 billion or more and net assets or equity of more than \$250 million. Several organizations are already approaching or exceeding those numbers. That kind of growth will challenge and enable the domestic impact investment field. There will be significant new, and relatively easy, choices for impact investors.

The majority of CDFIs will remain small due to choices they make, markets they cover, and/or their own management capacity. They will continue to play important roles in their environment and civic context, and offer retail network opportunities for larger CDFIs. The best scenario for the field is that the smaller CDFIs become networked through larger CDFIs to assist with deal sourcing, loan participations, and market development. From the perspective of our CDFI Capacity Score, there is no reason why those efforts cannot be developed further.

As the scale and complexity of the largest CDFIs proceed, they will have new management challenges, including how to attract and incent talent that can build the organizations' technological and financial management capacity. *The CDFI industry's chief financial and technology positions will undergo the most stress in an effort to sustain profitable growth.*

Finance and technology roles will move from control or utility functions to strategic leadership roles. This, in turn, will create a need for CDFIs to sustain healthy management teams that co-navigate direction and growth. A new level of corporate business skills will be required to ensure success.

The industry's transition into this phase depends on two enabling shifts already noted: 1) the creation of platforms that make it easier for new impact investment capital to flow into CDFIs without CDFIs having to constantly construct new funds of their own; and 2) the capacity of CDFIs to obtain higher levels of operating profitability. The internal operating capacity and external enabling environment reinforce each other.

To accomplish these transitions, there will be a need for working capital to promote more coherent strategies and better operating models. One of the questions we asked during all of the conversations had to do with industry and organization innovation. Most respondents viewed CDFIs as innovators in the social sector, but many questioned whether there were adequate resources or incentives to help CDFIs manage fundamental change.

Innovation is assisted among profit-maximizing businesses by four attributes that CDFIs do not generally possess: 1) an equity model of investment to fund growth, working capital, and R&D, 2) a drive toward profitability to beat out the competition; 3) an incentive system for shareholder income and wealth; and 4) the existence of working capital that allows for R&D investment.

Of course, not all businesses have all of these attributes. And many businesses, generally smaller family-owned businesses or so-called lifestyle companies, get by with low levels of growth and modest levels of profitability. They can indeed survive in a relatively narrow operating lane. But if there is going to be profound industry or sector change, it will occur because these four attributes are present.

The transition to the capital transformation stage will be made more effective and widespread if there is increased investment in CDFI innovation, such that it simulates one or more of those business attributes. The enterprise or business development field has a variety of public and private models to support change, including the following:

1. Accelerators where startup company management teams compete for entry and are given mentorship and investments based on rigorous training.²³
2. Prize philanthropy that rewards promising applied research with access to significant awards designed to accelerate change.²⁴
3. Equity-like staged investments based on progress along a continuum of milestones, including market acceptance of a product or service.²⁵
4. Open-source data platforms that provide multiple participants access to business modeling and market data that supports their growth.²⁶

Today, many CDFIs conflate innovation with linear growth in assets, loans, and geography, in part because there is virtually no innovation funding designed to reconfigure the field.

Moreover, the assumption regarding how change is made organizationally should not be limited to existing CDFI staff or organizations. CDFIs can often best be aided by partnering with talented professionals in technology, strategy, and finance when redesigning or rethinking operations. That is the value of the accelerator model: it assumes talent outside the existing company is utilized to influence a growth path.

These efforts have to be pursued on a sustained basis through philanthropy, banks, the CDFI Fund, OFN, and others. Today they are being done in relatively idiosyncratic ways, and the results are not shared across the industry systematically.

The Center for Financial Services Innovation has developed a variety of innovation tools that, while not directly related to CDFIs, involve the same issues about which CDFIs care: low-income communities and financial services. There is a great deal that can be learned from their work, much of which is expected to be applicable to the CDFI field.

R&D funding that supports organization-specific and industry-wide change in three areas is particularly critical: 1) financial profitability modeling; 2) impact investment product development; and 3) new technologies for lending and customer acquisition.

While a few individual CDFIs may have the working capital to pursue systems change and product development, external investments with the right kind of expertise and industry-wide prestige can effect more significant transitions.

²³For a list of strong accelerators see Brian Solomon, "The Best Start-up Accelerators of 2015," Forbes Magazine (March, 2015). Y-Combinator is generally viewed as the leading accelerator due to its long-time Silicon Valley relationships but the field has diffused significantly during the past decade since the 2005 opening of Y-Combinator.

²⁴The McKinsey Study of Prize Philanthropy provides a great overview of the field. See "And the Winner Is: Capturing the Promise of Prize Philanthropy" (McKinsey, 2009).

²⁵The Stage-Gate Innovation Model is a common industry process for birthing new initiatives through incumbent companies.

²⁶These are increasingly common in government, education, and the tech sector. Perhaps its greatest application has been in the scientific sector, where professionals and amateurs have combined to problem-solve.

CDFI Identity and Social Reform

Along with the addition of innovation financing to a transition into a new phase of growth, CDFIs require deliberation on their broader social reform role. Today, that role largely reflects advocacy around CDFI funding programs, but there is a need for a bigger picture perspective, based on what CDFIs have learned during the past several decades.

The importance of reflecting more deeply about the policy ramifications of CDFIs is made more important as the industry has more success. Every stage of development brings with it points of crisis, and it is likely that the crisis for CDFIs in the capital transformation stage will have to do with social identity. What do CDFIs stand for as it relates to economic policy and development questions?

It is instructive to remember that the language and concept of a CDFI was negotiated as part of creating a public policy support system. Community development banks (principally Shore Bank in Chicago), community development credit unions, and a variety of non-depository loan funds searched for a common language to describe what they did and why they emerged (in the absence of public support).

In searching for a common language, the organizations referred to a common social change legacy linked to post-1960s anti-poverty efforts. CDFI organization-building reflected three of the period's social change themes: 1) the application of civil rights to economic issues; 2) a recognition of the civil society role in social change; and 3) a focus on market mechanisms in support of a public purpose.

Those themes, important to the industry's early development, are alive today. Most CDFI practitioners view their work through the lens of social inclusion and civil society, and as a bridge between capital markets and social mobility. Yet there is some concern that the box within which social change and CDFIs are discussed is being increasingly narrowed. And more importantly, that the deeper meaning of those themes needs to be articulated based on 30 years of work.

In our conversations, CDFI social reform issues were raised in four contexts: 1) generational change, 2) policy tensions with conventional financial institutions, 3) the downside of the CDFI public sector brand, and 4) the role of CDFIs as permanent institutions versus change catalysts.

Generational Shift

Interviewees pointed out that a number of founder CDFI leaders have left or will soon retire and new people coming into the industry have different perspectives regarding the industry's social reform role. There have been numerous successful transitions among early CDFIs such as LIIF, IFF, NFF, Reinvestment Fund, Lakota Fund, and others. Within a decade, all of the founders of the first wave of organizations will retire or be replaced.

Does the generational shift represent a potential political shift? The first generation of CDFI leaders had more direct connections to the civil rights or community organizing aspects of CDFI origins. They also may have viewed capitalization as challenging holders of capital more than creating products that align with the requirements of capital. Even so, there is no evidence that new CDFI leaders lack a strong social change focus, at least based on these conversations. The language may have changed, but the intent remains.

In fact, current social movements around race and inequality are giving rise to a new generation of strongly political CDFI entrants. In several cases, small CDFIs have recently developed within university dorms, just as do tech business startups. Those college students are building institutions and bringing strong business and technology skills to their enterprises.

Nothing in these conversations led us to think that becoming more technically sophisticated means losing a connection to the animating social movements that gave rise to the industry in the first place. The preservation of this social change history within the institutions has more to do with the intentionality of individual CDFIs and the CDFI movement as a whole: how it talks about itself, how it educates new leaders, and the public issues with which it grapples.

For many individual CDFIs, it also has a lot to do with governance, especially the perspectives of board members that drive long-range planning and are guardians of organizational mission. In the early development of CDFIs, organizational boards were supposed to integrate three interests and capacities: investors, borrowers (or consumers), and technical know-how. There is no reason to think that this balance cannot continue as long as the intentionality is present to make that integration a reality. The institutions' rising complexity and financial risk management tasks may make it even more important to seek the right balance.

Banking Relationships

CDFIs emerged as critics of conventional finance, but are now overwhelmingly capitalized by the banking industry. Several practitioners discussed being capitalized by banking institutions, while still reserving the right to criticize certain banking practices. The dilemma of being both *partner and critic* reached its sharpest point during the run up to the Great Recession when many CDFI leaders criticized the practices of subprime lending, including the role of those banks that enabled it.

CDFIs were vocal critics of subprime lending and the decreasing equity in their target communities. A significant number produced studies and policy analyses of those practices. A few CDFIs took policy leadership during this period in state and federal legislative battles; something that continues today.

One interviewee thought the industry as a whole did not offer a coherent enough critique of subprime lending, in part due to CDFIs' complex relationships, in part because of the industry's practitioner orientation, and in part because the industry's policy focus was elsewhere.

Outsourced Government

In the section on diversification, we discussed the ways public sector equity and tax credits have come to define the CDFI industry as increasingly government-reliant for growth (equity grants) and revenue (tax credit programs). There were practitioners who wondered whether public sector equity could limit the CDFI reform agenda. The fear was that the more CDFIs are anchored to public programs, the more they become integrated into the logic and culture of those programs, becoming the outsourced arm of government. In this instance, policy becomes reduced to negotiating program rules more than challenging the financial system.

This fear was often expressed in conversations about new and emerging CDFIs who may see the industry more as a government program than as an independent and organically created social practice. Pre-1990s CDFIs and post-CDFI Fund CDFIs may have different cultures because of assumptions about the role of government.

Several practitioners noted that as more politicians, entrepreneurs, and financial advisors learn about the CDFI sector through New Markets Tax Credits, the more likely it is that CDFIs are viewed as de facto government agencies (the “CDE-ification” of the industry) in the public narrative. Thus the autonomous political space, through which the industry was created, might contract.

Permanent Institutions Versus Change Catalysts

One practitioner noted, bluntly, “*I did not get into this work because I thought lending would in and of itself change things, but rather to build a platform that would allow me to push for the changes we need in finance and banking.*”

That practitioner was reflecting an important subtext of the overall CDFI enterprise: the tension between building permanent, scalable organizations with a recognizable function in the financial system versus being a change agent with respect to mainstream finance (through the platform of the CDFI). This balance between functioning as a demonstration institution pioneering new markets, while critiquing conventional financial systems *and* focusing on building a permanent institution, may be one of the creative tensions that define the industry.

It may be that two decades of public sector CDFI programs have partially obscured the broader arc of CDFIs as social change institutions. Yet the field emerged outside of federal support; it was a civic and private project that responded to market gaps, community needs, and new institution-building possibilities. Can it sustain this broader identity?

The CDFI field can maintain a long-term perspective on social reform in two ways: 1) by grounding itself not only in its immediate CDFI history, but in issues of financial reform woven throughout American history and 2) by using its practice to build ideas and strategies that contribute to the important economic growth and social mobility issues of American society.

Finance and Social Reform Examples

Indeed, in every important economic transition in American history, expanding access to credit and banking has been part of the social reform conversation: whether it was savings banks among 19th century artisans, the creation of the Freedman’s Bank during Reconstruction,²⁷ the battles of rural sharecroppers and farmers to escape debt-servitude,²⁸ or urban reform movements seeking to remove high priced moneylenders from their communities.²⁹

The results of credit access struggles have been far ranging, from a tradition of African-American owned banks in the South, to a state-owned bank in North Dakota, to a populist reform movement that almost elected a U.S. president, to policy support for creating government-sponsored enterprises in the 20th century.³⁰

The tension between institution building and social advocacy, which is part of the CDFI narrative today, has played out historically through myriad examples in American history. The early savings banks and building and loan associations, for example, were created as quasi-charitable, self-help institutions during the first few decades of the 19th century and then expanded significantly throughout the 19th and much of the 20th century.

²⁷ Carl R. Osthaus, *Freedmen, Philanthropy and Fraud: A History of the Freedmen’s Savings Bank*, Urbana, Illinois: University of Illinois Press (1976).

²⁸ The best history on this period was written by Lawrence Goodwyn, *The Populist Moment: A Short History of the Agrarian Revolt in America*, Oxford University Press (1978)

²⁹ A history of these movements in the 19th and early 20th centuries is captured in Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit*, Princeton: Princeton University Press (1999).

³⁰ The early records of 18th century savings banks are instructive in this regard. See for example, James Willcox, *A History of The Philadelphia Savings Fund Society: 1816-1916*, Philadelphia: Lippincott (1916). The minutes and discussions reflect the attempts at building a social purpose bank.

The mutual CDFI-like mission of many of these institutions evaporated in the second half of the 20th century due to regulatory and competitive pressures and the expansion of other banking options. They were assimilated into the mainstream financial system, often by acquisition.

Among credit institutions with roots in mutual ownership structures, credit unions continue to prosper and grow. A century ago, North American credit unions had strong support from the Catholic Church as part of immigrant churches' parallel institution building efforts. But throughout the 20th century, credit unions spread more through unions and employee associations. Today, the United States has more than 6,000 credit unions with more than 100 million members, holding assets of more than \$1.1 trillion.

But today, with the exception of mission-driven community development credit unions, most credit unions do not think of themselves as part of a social change movement linked to historical struggles over credit access. They uphold their cooperative structures and battle the banking industry over claims they have an unfair tax advantage; they serve their members and manage their portfolios. But they rarely take on the social justice issues that many CDFIs view as part of their identity.

If we want to examine CDFI-like organizations that most actively pursued both targeted low-income lending (*the good money strategy*) and strong policy advocacy (*getting rid of bad money*), the best example would be the *charitable* lenders that organized themselves within the National Federation of Remedial Loan Associations in a few dozen cities during the first three decades of the 20th century. Some were organized as charitable pawnshops and others as direct small dollar moneylenders.³¹

The Remedial Loan Association members and their supporters debated the relative merits of *good money* institution-building versus driving *bad money* from the system through legislation and regulation. They did some of both and, along with many political and civic supporters (including small dollar moneylenders that sought to evade being branded as bad actors), they passed legislation in state after state around pricing and other consumer regulations.

Ultimately, the remedial loan associations and most (not all) of the charitable pawnshops closed down, but not until they had a significant impact on lending practices during their time.

The historical examples point out the potential for taking two radically distinct directions, neither of which CDFIs are looking to emulate: 1) full commercial assimilation and loss of social purpose or 2) closing up shop based on the success of policy victories that effect the behavior of other lenders.

If CDFIs want to grow commercially and still be true to their social reform origins, they need to define a policy agenda that better describes what they stand for and how they see themselves within the context of the American financial system. Without doing so, they can easily devolve into one more public sector constituency or into second-tier financial service institutions. History is filled with examples of reform efforts playing themselves out based on shifting social contexts, including changing market requirements and technologies.

³¹ The proceedings of the Remedial Loan Association meetings can be found on the Internet <http://www.russellsage.org/proceedings-national-federation-remedial-loan-associations> and are preserved by the Russell Sage Foundation and the American Academy of Political Science, which published extensively on the subject 100 years ago. The subject of the Remedial Loan Associations is covered extensively in Caldor, *op.cit* and in John Caskey, *Fringe Banking*, Russell Sage Foundation (1994).]

The CDFI Contribution

The most prominent public policy strategy adopted by CDFIs is the trade group and network strategy around advocating for the preservation of existing public resources and supporting new public sector capital options. CDFIs have been remarkably successful in that policy lane: the CDFI Fund, New Markets Tax Credits, the CDFI Bond Guarantee Program, and capital support within other federal departments for activity related to education, supermarkets, housing, and small businesses.

But while CDFIs have been good at policy preservation and expansion, they have not authored policy perspectives that focus on broader economic or organizational systems issues, apart from program and legislative issues that affect their work. They have not more explicitly proffered a world-view regarding the kind of institutions and capital required to increase social mobility and decrease inequality. Yet they are well positioned to do so precisely because of the richness of their practice.

CDFIs are practitioners who know the limits of markets (not just its power) and the limits of government regulation (not only when it is necessary), and hence can speak with credibility in a nation so polarized around the role of markets and government. CDFI leaders are often the radical pragmatists in the policy conversation.

Moreover, CDFI leaders know that their own role as debt financing institutions is significantly limited in the overall issue of social change. During one of our conversations, an interviewee reflecting on mortgage foreclosure issues noted that the problem for their clients was inadequate income and that perhaps pushing for a minimum wage increase would be the best thing a CDFI leader could do for their portfolio in the long term.

As we talked about what affects their CDFI borrowers, outside of access to capital, the practitioner noted the issue of high-quality public goods: education, healthcare, transportation systems, and housing. In the absence of these things, people were too often borrowing money that was hard to repay. In the run-up to the Great Recession, American household debt increased at a remarkable rate, and it was clear that debt had increasingly become a substitute for income and/or compensation for the degradation of those public goods.

The CDFI industry was birthed during a period of limited and unequal capital access in the 1970s and 1980s. That was a time of very high interest rates, when pricing was a barrier for most Americans and discrimination was more blatant than today. The industry grew up during a period when capital access was no longer such an issue for many consumers, but increasingly price and terms became the newest form of discrimination against low-income and minority consumers.

CDFIs have been practical witnesses, in the communities where they work, to both the effects of limited investment and the effects of the wrong kind of investment; to the prospect of no-debt financing and to inappropriately priced and structured debt allocation.

They also know both the necessity of government support and the sometimes ineffective ways in which government functions. They know the power of markets, but know that markets cannot be the answer to every social problem.

This experience and positioning ought to provide an opening for a CDFI economic policy perspective that can speak to issues larger than our own capital support systems. Most of those issues would fall within the category of the role of capital in social mobility: what kind of circumstances—in terms of capital, public, and institutional supports—favor social mobility, and how can the CDFI industry generate a vision of mobility that corresponds to its own practice?

To support the next phase of CDFI growth, the industry will need to reach back to its own experience, and to the broader questions of capital access in American history, to formulate perspectives and debate on these broader themes. As hybrid institutions with the credibility of functioning portfolios, there is an opportunity to use the CDFI platform to answer questions such as:

1. How can debt financing best be used to accelerate the social mobility of households and communities?
2. How can the wrong use of finance, including financial innovation, function as a destructive force to those very households and communities?
3. What is the role of hybrid institutions like CDFIs (neither fully market nor fully public) in helping to shape a vision and practice around the financing of social mobility?
4. What are the public infrastructure (social and physical) investments that have to exist to support the work of CDFIs, and without which the role of CDFIs remains limited?
5. Are there income-oriented policies (e.g. the minimum wage) that CDFIs ought to support as part of their overall policy efforts?

These issues are not abstractions in a nation that keeps rehashing stale ideological arguments about the role of markets and government. Points of view on these issues will help sustain CDFIs' identity as social change organizations beyond their current role in government-aided public policy. And, in doing so, CDFIs will make a bigger contribution to American society.

Conclusion

The CDFI industry is at a pivotal time of change. The research and ideas presented in this report are meant to stimulate reflection, conversation, and action. CDFIs need to take this opportunity to shape our future so that others don't.

This paper lays out eight major findings, each of which is a conversation in and of itself. Our conclusion that the next phase of CDFI growth requires increased innovation infrastructure, a more networked approach to CDFI growth, and greater clarity around a CDFI social reform identity should help drive the discussions around some of the most compelling themes.

Appendix A. List of Interviews

1. Priscilla Almodovar, Managing Director, JPMorgan Chase
2. John Berdes, President & CEO, Craft3
3. Tom Bledsoe, President, Housing Partnership Network
4. Doug Bystry, President, Clearinghouse CDFI
5. Elyse Cherry, CEO, Boston Community Capital
6. Kimberlee Cornett, Director of Innovative Capital, The Kresge Foundation
7. Raj Date, Managing Partner, Fenway Summer, LLC
8. Andy Ditton, Managing Director, Citi Community Capital, and Director of Center for Community Development, Citigroup
9. Annie Donovan, Director, CDFI Fund, US Department of the Treasury
10. Julie Eades, President, New Hampshire Community Loan Fund
11. Martin Eakes, Co-founder & CEO, Self-Help and the Center for Responsible Lending
12. Dan Letendre, CDFI Lending & Investing Executive, Bank of America
13. Christine Looney, Senior Program Investment Officer, Inclusive Economies, Ford Foundation
14. Rohan Matthew, Executive Director, The Intersect Fund
15. Clara Miller, President, F. B. Heron Foundation
16. Joe Neri, CEO, IFF
17. Dan Nissenbaum, Managing Director, Goldman Sachs
18. Alex Payne, Co-founder, Simple
19. David Reiling, President, Sunrise Community Banks
20. Joe Reilly, President & CEO, Community Development Trust
21. Deborah Schwartz, Managing Director, Impact Investments, The John D. & Catherine T. MacArthur Foundation
22. Shaolee Sen, Executive Vice President, Accion U.S. Network
23. Liz Sessler, Client Advocate, Impact US
24. Charlie Spies, Managing Director, CEI Capital Management, LLC
25. Jennifer Tescher from CFS Innovation

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Appendix C. Factor Analysis

What is factor analysis?

Factor analysis is a statistical tool for investigating complex relationships among variables. The key concept of factor analysis is that multiple observed variables will show similar patterns if they are associated with a latent (i.e., not directly measured) variable. The analysis explores the correlation among the observed variables in an attempt to identify the latent variable. The latent variable can then be calculated using a weighted combination of the observed variables.

What is an example of a practical application of factor analysis?

Perhaps the most well-known example of factor analysis is the intelligence quotient (IQ). In this example, intelligence is our latent variable, but it cannot be directly measured. Instead, observable variables measuring ability in math, language, and logic are used to measure the IQ's construct of "intelligence."

How did you use factor analysis to determine that Deployment Ratio, Change in Capital Available for Lending from Previous Year, and Operating Loss/Gain hold promise for collectively measuring CDFI Capacity Score over time?

In factor analysis, the relationship of each observable variable to the latent variable is expressed by its factor loading. By convention, factor loadings above .40 are considered strong contributors to the latent variable's hypothesized construct. The table below shows that all three observable variables have factor loadings above .50.

Squaring the factor loading produces what is known as the overlapping variance percentage. The overlapping variance is the portion of CDFI Capacity Score that can be explained by each variable. We look for percentages that are above 20% (variables are making a substantial contribution to defining the latent variable) and below 70% (one variable is not doing the majority of the work to define the factor). The results below show that each observable variable is contributing an acceptable amount of information to define CDFI Capacity Score, with Deployment Ratio contributing the most information, followed by Change in Capital Available for Lending from Previous Year, and Operating Loss/Gain.

Observable Variable	Observable Variable is a Measure of	Factor Loading	Overlapping Variance between the Observable Variable and the new Latent Variable CDFI Capacity Score
Operating Loss/Gain	Operational excellence	.52	27%
Deployment Ratio	Practical understanding of the market	.70	49%
Change in Capital Available for Lending from Previous Year	Mission-focused growth	.58	34%



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