Virtual CDFI Symposium – Capitalizing CDFIs
June 3rd, 2020
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Ask your question Live.

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This event is hosted by the following organizations.
Community Development

The mission of the Federal Reserve’s community development function is to promote the economic resilience and mobility of low- to moderate-income and underserved individuals and communities.
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The information, analyses, and conclusion set forth are those of the presenters and do not necessarily indicate concurrence by the Board of Governors of the Federal Reserve System, The Federal Reserve Banks, or members of their staffs.
Welcome

Agenda for this webinar

Overview of Webinar Series → MOEs Access to Capital from CDFIs → Just how risky? → Audience Q&A

Emily Wavering Corcoran
FRB Richmond

Joyce Klein
Aspen Institute

Maude Toussaint-Comeau
FRB Chicago

Jessel Amin
Capital Impact Partners

Eric Hangen
University of New Hampshire
Addressing the Capitalization and Financial Constraints of CDFI Microlenders

Joyce Klein
Addressing the Capitalization and Financial Constraints of CDFI Microlenders

Joyce Klein, the Aspen Institute Business Ownership Initiative
Co-authors Brett Simmons and Jonathan Brereton, Revolve
Presentation to the CDFI Symposium, June 3, 2020
Research design

• Not a traditional research project
• A market research, financial modeling and product/solution design project
• Goal: Identify best strategies for solving the capitalization and financial challenges facing growth-oriented CDFI microlenders and move to implement them.
Research partners and participants

• Aspen Institute Business Ownership Initiative – long history of convening and supporting microlenders around issues of practice and research
• Revolve – for-profit firm created by former colleagues at Accion Chicago to address CDFI financial challenges
• Microfinance Impact Collaborative – six of the largest CDFI microlenders; all with a strategic focus on growing their microloan portfolios.
Microfinance Impact Collaborative

Collectively make more than 8,500 loans, totaling $175M, each year.

* Accion East and Accion Chicago
Importance of scaling CDFI microlending

Most entrepreneurs of color and women are seeking less than $100K in financing:

- 76% of Black-owned firms
- 63% of Hispanic-owned firms
- 67% of Women-owned firms

* Source: Federal Reserve Small Business Credit Survey.
Financial constraints limit growth

1. **Net Assets**: National creditors want 4:1 leverage. CDFIs must raise $0.25 in net assets for each additional $1 in debt.

2. **Debt/Lending Liquidity**: Costs to borrow typically increase as they access larger pools of unsecured capital and become more leveraged.

3. **Operating Subsidy**: Earned income of CDFI lenders with a focus on microloans covers less than 60% of operating expenses.
New strategies explored by MIC members

- Securitization
- Institutional loan sales
Institutional loan sales

• Lender sells a 90-100% nonrecourse stake in an individual loan
• Purchaser receives the principal, interest, and some fees
• Lender retains servicing and the customer relationship, receives servicing fee
• Can address all three financial constraints
CDFI experience with loan sales

• Five MIC members have sold loans:
  • Opportunity Fund
  • LiftFund
  • Accion Chicago
  • Justine PETERSEN
  • Accion East

• Committed transactions in multiple markets:
  • Chicago
  • Kansas City
  • San Diego
  • Minneapolis
  • San Francisco Bay Area
  • St. Louis
  • Texas
  • Denver
Motivations for loan sales/purchases

Return/lending liquidity:
Higher volume, lower price

Premium/lending test credit:
Lower volume, higher price
Financial benefits of loan participation sales

- CDFI A generates a 7% return on a portfolio with these characteristics. There are 200 loans in this purchase.

<table>
<thead>
<tr>
<th>CDFI A</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio Participated ($)</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Average Loan Amount ($)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Average Interest Rate</td>
<td>13.0%</td>
</tr>
<tr>
<td>Avg Contract Loan Term (Months)</td>
<td>36</td>
</tr>
<tr>
<td>Avg Actual Loan Tenure (Months)</td>
<td>25</td>
</tr>
<tr>
<td>Monthly Servicing Fee (Per Loan)</td>
<td>$15</td>
</tr>
<tr>
<td>Average Long-Term Default Rate</td>
<td>7.0%</td>
</tr>
<tr>
<td>Average Cost of Capital</td>
<td>3.0%</td>
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</tbody>
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- CDFI B generates a .11% return on a portfolio with these characteristics. There are 500 loans in this purchase.

<table>
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CDFI A needs a higher premium to warrant selling. It should demand a premium for “CRA units” and for income given to the buyer.
Financial benefits of loan participation sales

CDFI B could sell with no premium and improve its outcomes but has more “CRA units” and should demand a premium for them.

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Factors for CDFIs to consider

• Scale of capital relative to existing strategies
• Scale of portfolio – harder with fewer than 100 outstanding microloans; for SBA microloans
• Addressing concerns and information needs of purchasers
  • Institution risk – does the have CDFI underwriting, servicing capacities and financial strength over the term of the loans purchased?
  • CRA knowledge – demonstrating the value of the purchases from a CRA perspective
  • Transaction risk – getting past the due-diligence and sales process on a specific set of loans

There is always a cost in terms of capacity and bandwidth to implement a new strategy
Scaling loan sales over the long term

Key factors from our research:

• Third-party risk rating
• Servicing support
• Market-maker function
What makes sense in today’s context?

• Deteriorating portfolio quality and loan deferments strain net asset ratios, lending and operating liquidity.

• Demand for CRA-motivated purchases (and loan sales more broadly) is uncertain.

• Strategy shifts – address current liquidity needs through near-term strategy to sell pre-COVID loans to entities that can help absorb risk while restructuring to provide borrower relief; build market for CRA-motivated purchases over long term:
  • Entrepreneur-Backed Assets Fund
  • Federal Reserve liquidity facility
Raising Capital When the Going Gets Tough: Channels of Adjustment for Depository CDFIs

Maude Toussaint-Comeau

Federal Reserve Bank of Chicago
RAISING CAPITAL WHEN THE GOING GETS TOUGH

Channels of Adjustment for Depository CDFIs

MAUDE TOUSSAINT-COMEAU
ROBIN NEWBERGER
FEDERAL RESERVE BANK OF CHICAGO

Presenter: Maude Toussaint-Comeau
CDFI Research Symposium Webinar
June 3, 2020

The views expressed are the authors’ and do not represent the views of the Federal Reserve Bank of Chicago or the Board of Governors of the Federal Reserve System.
MOTIVATION

• Capital was a fundamental issue for banks during the last 2008-2010 financial crisis, particularly from the standpoint of survival

• The most recent COVID-19 era creates a new set of challenges in 2020.
FOCUS OF THE STUDY

• Examine the data to understand the sources of equity capital growth for CDFIs.

• Examine the relationship between growth in bank equity capital and growth of different categories of assets, including gross loans.

• Conduct an analysis to identify the factors that are most reliably or (statistically) significant in determining equity capital for depository CDFIs, compared to other community banks.
DATA SOURCES

- Call Reports via FDIC Statistics for Depository Institutions (SDI)
- CDFI Fund and National Community Investment Fund (NCIF)
- FDIC List of Minority Depositories

- Covers 2006 to 2019 time period
- Some analyses go further back to 1996
- Depository institutions: CDFIs, minority and non-minority CDFIs, community banks (according to FDIC definition)
RESULTS
TRENDS IN EQUITY CAPITAL

Total Equity Capital ($000)

- MDI-CDFI
- NON-MDI-CDFI
- COMMUNITY BANKS (right axis)
RESULTS
TRENDS IN EQUITY CAPITAL RATIOS

Minority CDFI

Non-Minority CDFIs

Community Banks

CAPital/Assets
CAP/Risk Weighted Assets
SOURCES OF INCREASES IN BANK EQUITY CAPITAL
NORMALISED TO PERCENTAGE POINTS CHANGE OF END-OF-YEAR RISK-WEIGHTED ASSETS

\[ \text{CAP}_{1} - \text{CAP}_{0} = \text{CAP}_{1}^N + (\text{NI}_{1} - \text{DIV}_{1}) \]

Community Banks

CDFI

- Retained Earnings
- New CAP
- Change in CAP

0 0.5 1 1.5 2 2.5 3 3.5


SOURCES OF INCREASES IN BANK EQUITY CAPITAL
NORMALISED TO PERCENTAGE POINTS CHANGE OF END-OF-YEAR RISK-WEIGHTED ASSETS

Non-Minority CDFI

Minority CDFI

- Retained Earnings
- New CAP
- Change in CAP
CHANGES IN THE COMPONENTS OF BANK INCOME

\[ N_t = NI_t + NOI_t - OE_t \]

Net Interest Income/assets

Non-Interest Income/assets

Operating Expenses/assets
DIVIDEND PAYOUT AND ROE

**Dividend Payout**

- **Community banks**
- **Non-Minority CDFI**
- **Minority CDFI**

**Return on equity (ROE)**

- **Community banks**
- **Non-Minority CDFI**
- **Minority CDFI**
ASSET AND LOAN GROWTH

- Community banks
- CDFIs
- Non-minority CDFIs
- Minority CDFIs

Assets: orange bars
Cash and interbank holdings: blue bars
Gross loans: brown bars
Other assets: green bars
Trading securities: gray bars
## Relationship Between Bank Equity Capital Growth, Profitability and Asset Growth Strategy

(OLS Regression Estimates)

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Risk-Weighted Assets</th>
<th>Gross Loans</th>
<th>Securities</th>
<th>Cash and Interbank</th>
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<td>Coef. t-stat</td>
<td>Coef. t-stat</td>
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<td>Coef. t-stat</td>
<td>Coef. t-stat</td>
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<td>CDFI_MDI</td>
<td>9.91</td>
<td>3.17</td>
<td>7.30</td>
<td>1.81</td>
<td>9.02</td>
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<tr>
<td>CDFI_NON_MDI</td>
<td>-2.10</td>
<td>-0.5</td>
<td>-2.08</td>
<td>-0.52</td>
<td>-1.74</td>
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<td>Equity Ratio 2016</td>
<td>-1.22</td>
<td>-2.9</td>
<td>-1.46</td>
<td>-3.2</td>
<td>-1.88</td>
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<tr>
<td>CDFI_MDI*Equity Ratio in 2016</td>
<td>-1.75</td>
<td>-0.9</td>
<td>-2.74</td>
<td>-1.16</td>
<td>-1.65</td>
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<td>CDFI_nonMDI*Equity Ratio in 2016</td>
<td>1.07</td>
<td>0.56</td>
<td>1.37</td>
<td>0.72</td>
<td>1.22</td>
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<tr>
<td>Change in Equity Ratio</td>
<td>0.07</td>
<td>0.78</td>
<td>0.02</td>
<td>0.24</td>
<td>0.06</td>
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<tr>
<td>CDFI_MDI*Change in Equity Ratio</td>
<td>0.30</td>
<td>1.99</td>
<td>0.34</td>
<td>2.14</td>
<td>0.36</td>
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<tr>
<td>CDFI_nonMDI*Change in Equity Ratio</td>
<td>0.25</td>
<td>0.77</td>
<td>0.21</td>
<td>0.67</td>
<td>0.16</td>
</tr>
<tr>
<td>Net income/assets</td>
<td>0.36</td>
<td>2.24</td>
<td>0.28</td>
<td>1.83</td>
<td>0.30</td>
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<tr>
<td>CDFI_MDI*Net Income/Assets</td>
<td>2.52</td>
<td>3.15</td>
<td>2.27</td>
<td>1.56</td>
<td>2.17</td>
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<tr>
<td>CDFI_nonMDI*Net Income/Assets</td>
<td>-1.07</td>
<td>-1.6</td>
<td>-1.13</td>
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<td>-0.98</td>
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<td>Intercept</td>
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<td>8.91</td>
<td>10.48</td>
<td>7.57</td>
<td>9.88</td>
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<tr>
<td>Number of obs</td>
<td>2,499</td>
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<td>2,365</td>
<td></td>
<td>2,457</td>
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<td>R-squared</td>
<td>0.043</td>
<td></td>
<td>0.0544</td>
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<td>0.079</td>
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STANDARDIZED COEFFICIENT FIXED EFFECTS ESTIMATES OF THE EFFECTS OF DETERMINANTS OF EQUITY CAPITAL, UP TO 2018

-0.3 -0.2 -0.1 0 0.1 0.2 0.3 0.4 0.5 0.6
Net income/asset
Log of assets

Core deposits/assets
Intangibles/asset
Loan concentration
U.S Treasury securities/asset
Loans to individuals/asset
Interest income/asset
Construction and development...
Loans to individuals/asset
Herfindahl index of bank...
Multi-family residential...
State unemployment...
Non-performing loans/total loans
(Core deposits/assets)2

-0.25 -0.2 -0.15 -0.1 -0.05 0 0.05 0.1 0.15 0.2 0.25

non-MDI CDFI MDI CDFI
<table>
<thead>
<tr>
<th>Variable</th>
<th>non-MDI CDFI</th>
<th>MDI CDFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangibles/asset</td>
<td>-0.05</td>
<td>0.05</td>
</tr>
<tr>
<td>Loans to individuals/asset</td>
<td>-0.15</td>
<td>-0.05</td>
</tr>
<tr>
<td>Core deposits/assets</td>
<td>-0.1</td>
<td>0</td>
</tr>
<tr>
<td>Construction and...</td>
<td>-0.05</td>
<td>0</td>
</tr>
<tr>
<td>Commercial and...</td>
<td>-0.05</td>
<td>0</td>
</tr>
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<td>Multi-family residential...</td>
<td>-0.05</td>
<td>0</td>
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<td>0</td>
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<td>Herfindahl index of bank...</td>
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<td>0</td>
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<tr>
<td>U.S Treasury...</td>
<td>-0.15</td>
<td>0</td>
</tr>
<tr>
<td>Interest income/asset</td>
<td>-0.2</td>
<td>0.1</td>
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<tr>
<td>(Core deposits/assets)^2</td>
<td>-0.25</td>
<td>0.15</td>
</tr>
<tr>
<td>Non-performing...</td>
<td>-0.25</td>
<td>0.2</td>
</tr>
<tr>
<td>Loan concentration</td>
<td>-0.25</td>
<td>0.2</td>
</tr>
</tbody>
</table>

**Net income/asset***

**Log of assets***

STANDARDIZED COEFFICIENT FIXED EFFECTS ESTIMATES OF THE EFFECTS OF DETERMINANTS OF EQUITY CAPITAL, AFTER 2018
CONCLUSIONS

• The CDFIs in recent years have grown their equity capital.

• The result points to the benefit of equity capital for growing in size and expanding lending.

• Adverse macroeconomic shocks (unemployment) negatively affect the equity capital of banks.

IMPLICATIONS:

• Research suggests that banks’ profitability and strong capital position prior to a crisis can help mitigate the effects of economic shocks during the crisis.
CONCLUSIONS

• The current COVID-19 pandemic has brought unprecedented challenges.

• There is (potentially temporary) reprieve to borrowers (and thus banks) given by government relief funds.

• 399 MDIs and/or CDFIs participated in the PPP program, 28 of which were MDIs and CDFIs. This represented 78 percent of MDI CDFIs.
Discussants

Jessel Amin
Capital Impact Partners

Eric Hangen
University of New Hampshire
Question & Answer

Emily Wavering Corcoran
FRB Richmond
Participate during the Q&A.

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Q&A

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Next Steps

• All session materials are available on our web site and in the next few days we will post an audio file of today’s session.

• Information about future sessions will be posted on our website along with archived materials from past sessions: https://bsr.stlouisfed.org/connectingcommunities

• The forth installment of the Virtual CDFI Symposium is next Wednesday, June 10th at 3 pm ET. It will focus on research pertaining to CDFIs and Native American Communities. Registration is now open at stlouisfed.org/events/cd