

Connecting Communities

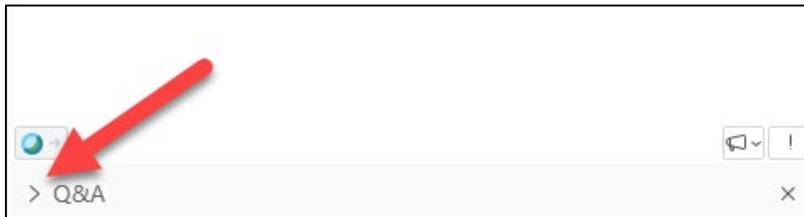


Virtual CDFI Symposium – Capitalizing CDFIs

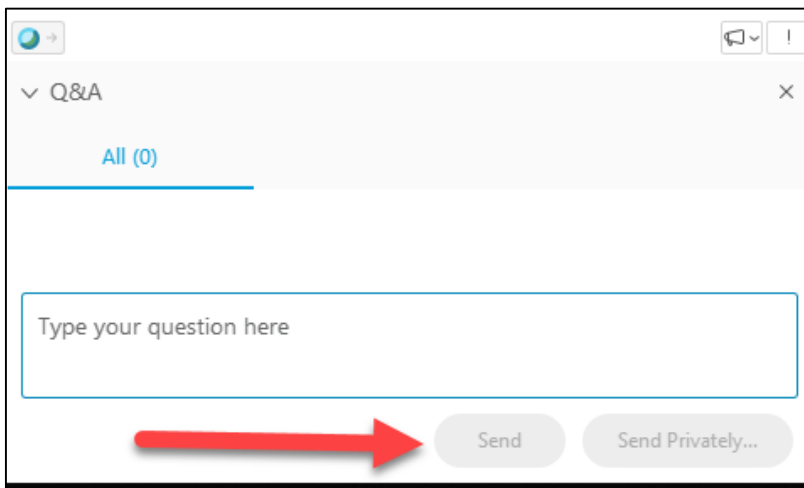
June 3rd, 2020

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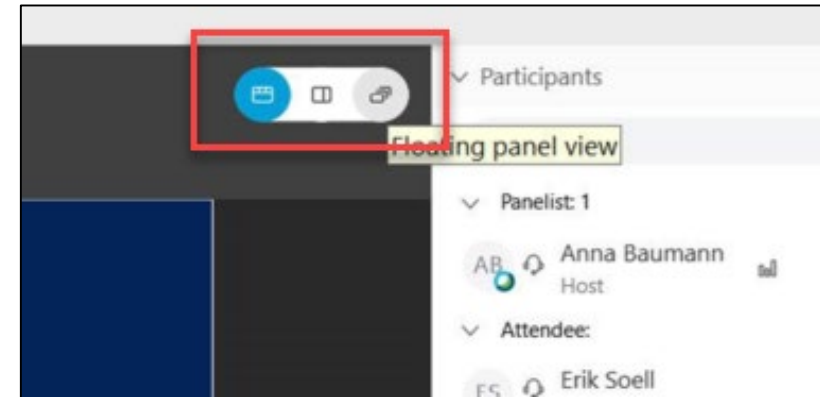


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Click **Unmute my microphone**  when you are called on to speak.

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.



Legal Notices and Disclaimer



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



**Emily Wavering
Corcoran**
FRB Richmond



Joyce Klein
Aspen Institute



**Maude
Toussaint-Comeau**
FRB Chicago

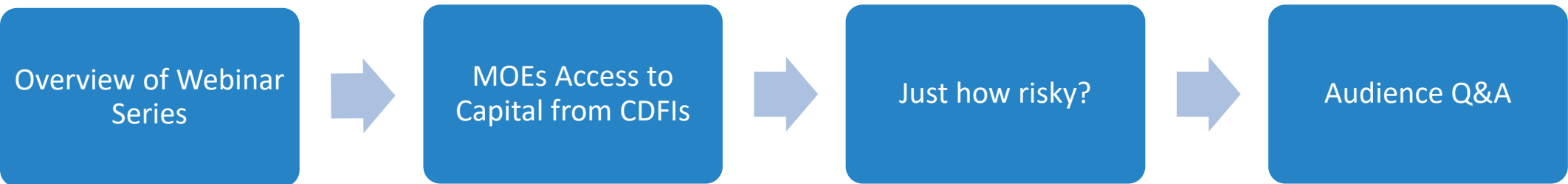


Jessel Amin
Capital Impact
Partners



Eric Hangen
University of
New Hampshire

Agenda for this webinar



Addressing the Capitalization and Financial Constraints of CDFI Microlenders



Joyce Klein





**BUSINESS
OWNERSHIP
INITIATIVE**

 THE ASPEN INSTITUTE

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

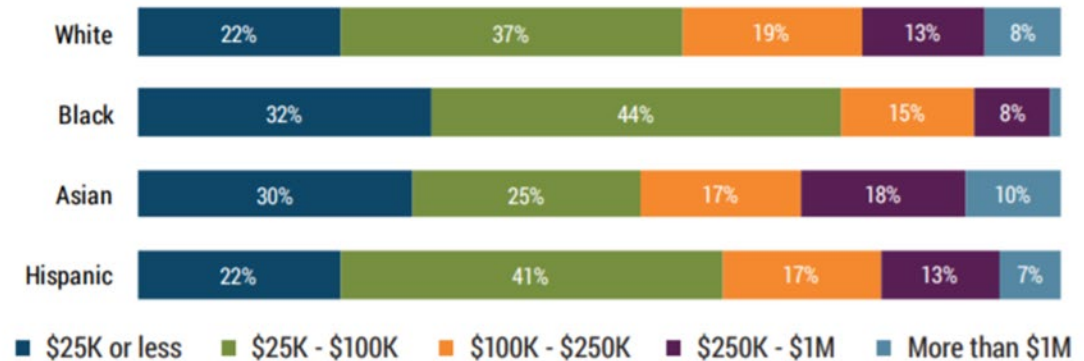
Importance of scaling CDFI microlending

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
- * Source: Federal Reserve Small Business Credit Survey.

TOTAL AMOUNT OF FINANCING SOUGHT^{1,2}

(% of applicants)



Financial constraints limit growth

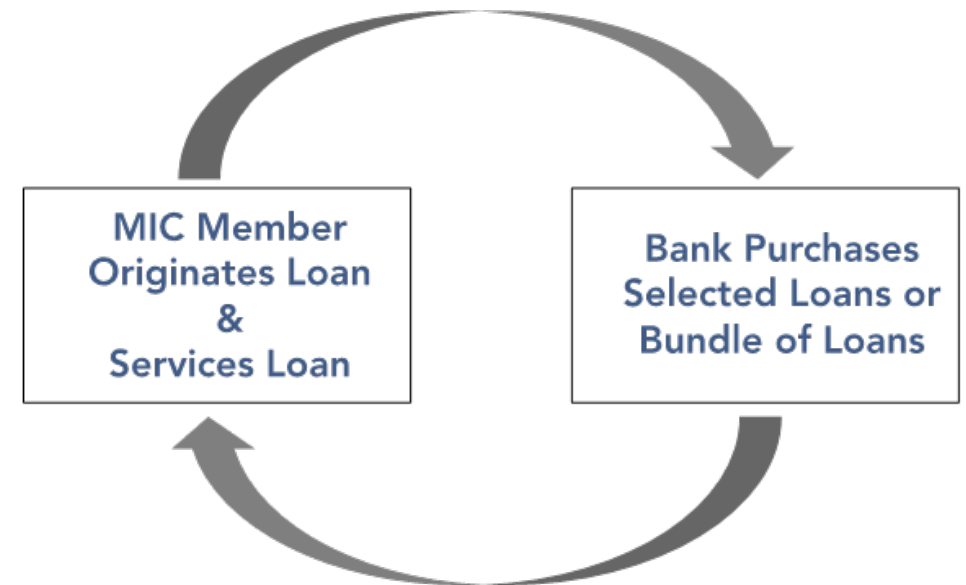
- 1. Net Assets:** National creditors want 4:1 leverage. CDFIs must raise \$0.25 in net assets for each additional \$1 in debt
- 2. Debt/Lending Liquidity:** Costs to borrow typically increase as they access larger pools of unsecured capital and become more leveraged
- 3. Operating Subsidy:** Earned 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	
Portfolio Participated (\$)	\$5,000,000
Average Loan Amount (\$)	\$25,000
Average Interest Rate	13.0%
Avg Contract Loan Term (Months)	36
Avg Actual Loan Tenure (Months)	25
Monthly Servicing Fee (Per Loan)	\$15
Average Long-Term Default Rate	7.0%
Average Cost of Capital	3.0%

CDFI B	
Portfolio Participated (\$)	\$5,000,000
Average Loan Amount (\$)	\$10,000
Average Interest Rate	13.0%
Avg Contract Loan Term (Months)	36
Avg Actual Loan Tenure (Months)	25
Monthly Servicing Fee (Per Loan)	\$15
Average Long-Term Default Rate	13.0%
Average Cost of Capital	3.0%

- CDFI A generates a 7% return on a portfolio with these characteristics. There are 200 loans in this purchase.
- CDFI B generates a .11% return on a portfolio with these characteristics. There are 500 loans in this purchase.

Financial benefits of loan participation sales

CDFI A needs a higher premium to warrant selling. It should demand a premium for “CRA units” and for income given to the buyer.

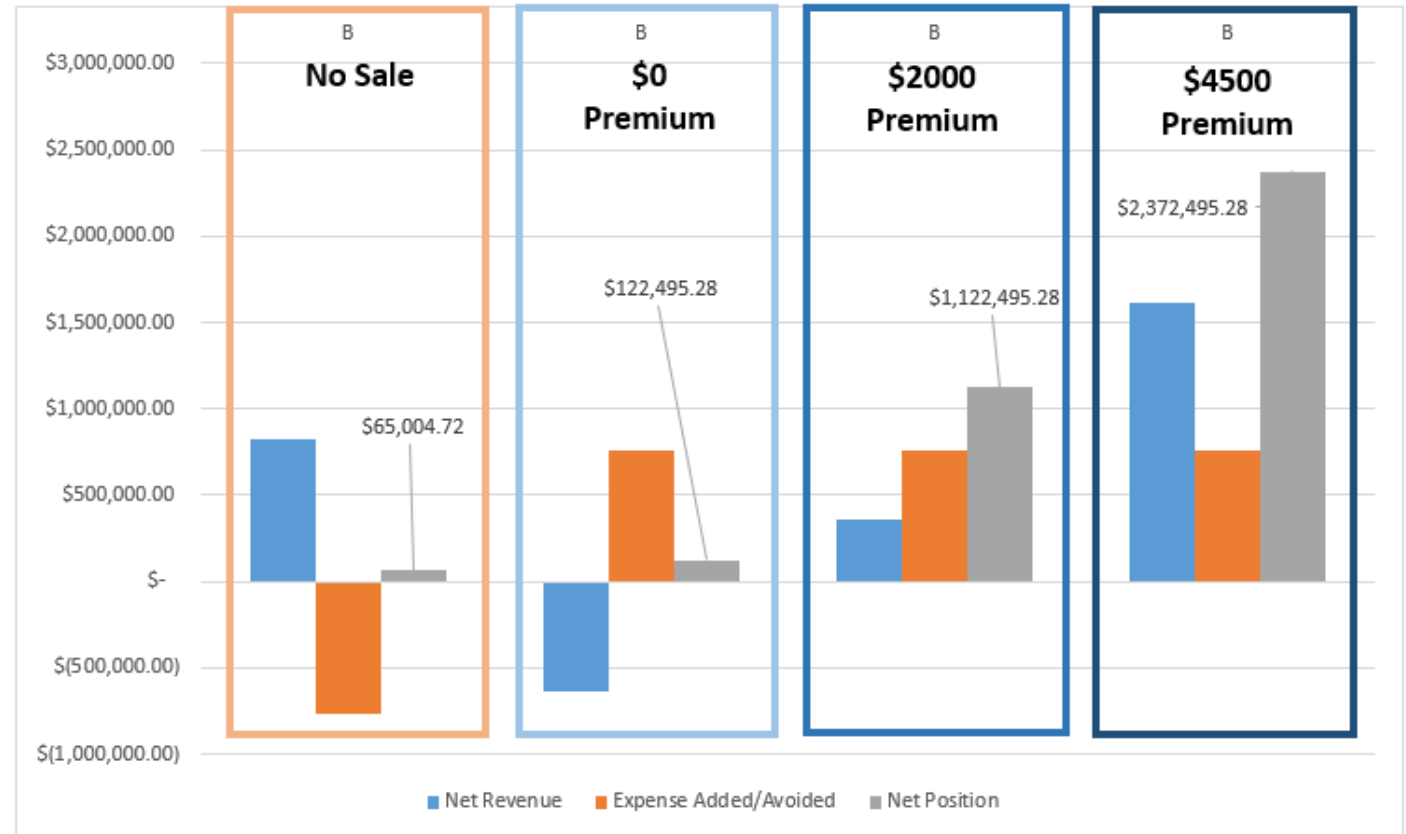
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Financial benefits of loan participation sales

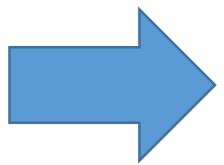
CDFI B could sell with no premium and improve its outcomes but has more “CRA units” and should demand a premium for them.

CDFI B	
Portfolio Participated (\$)	\$5,000,000
Average Loan Amount (\$)	\$10,000
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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

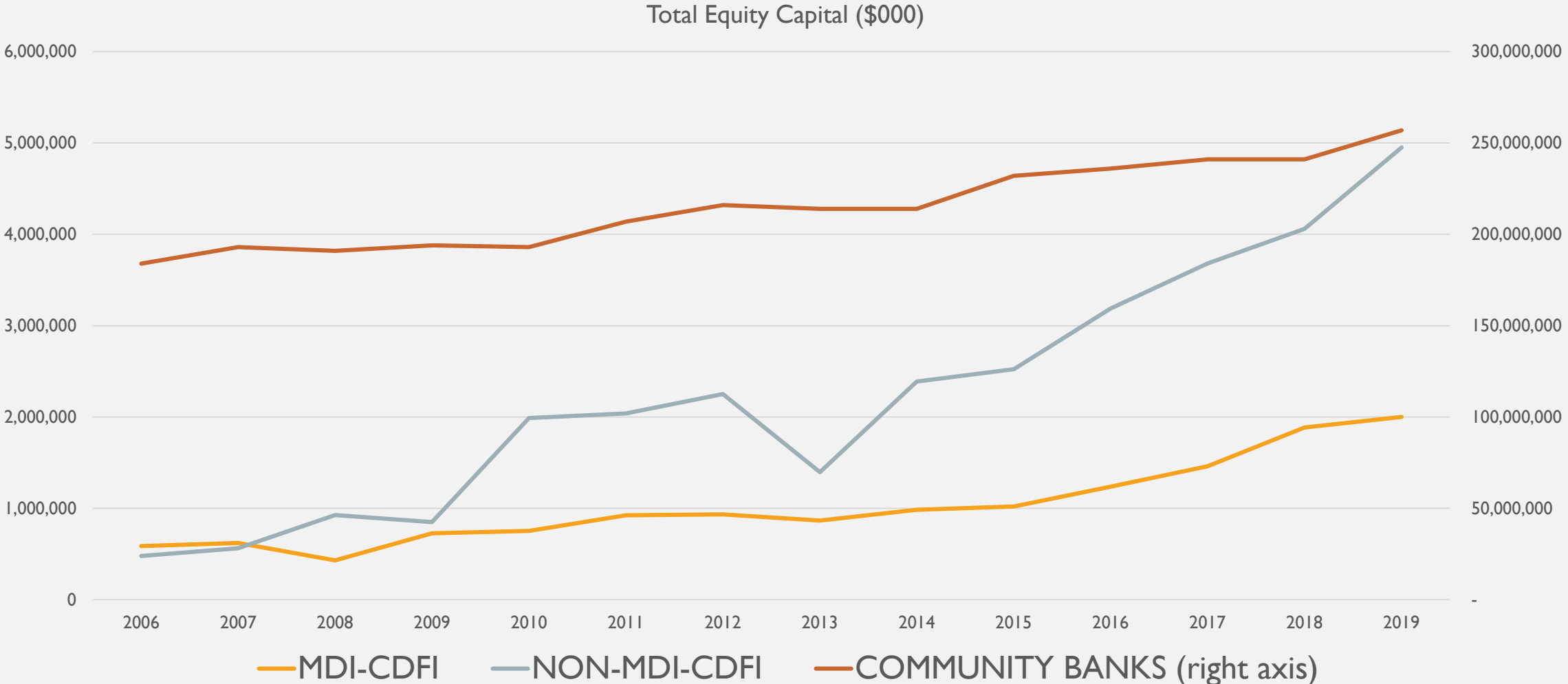
- Examine the data to understand the sources of equity capital growth for CDFIs.
- Examine the relationship between growth in bank equity capital and growth of different categories of assets, including gross loans.
- Conduct an analysis to identify the factors that are most reliably or (statistically) 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)

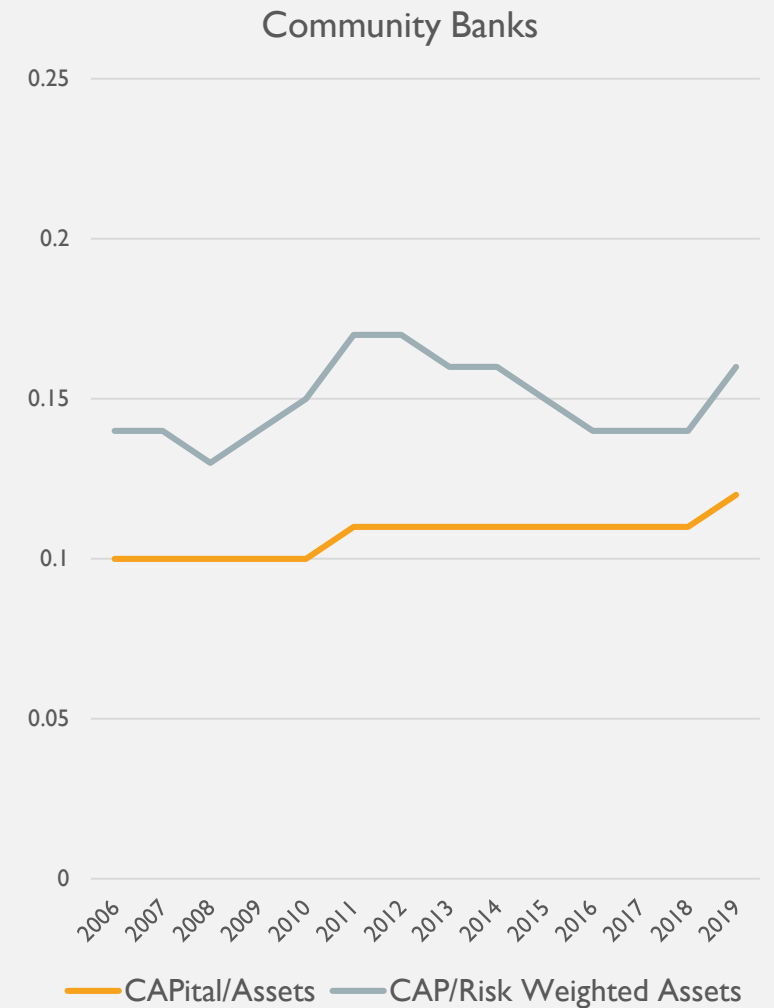
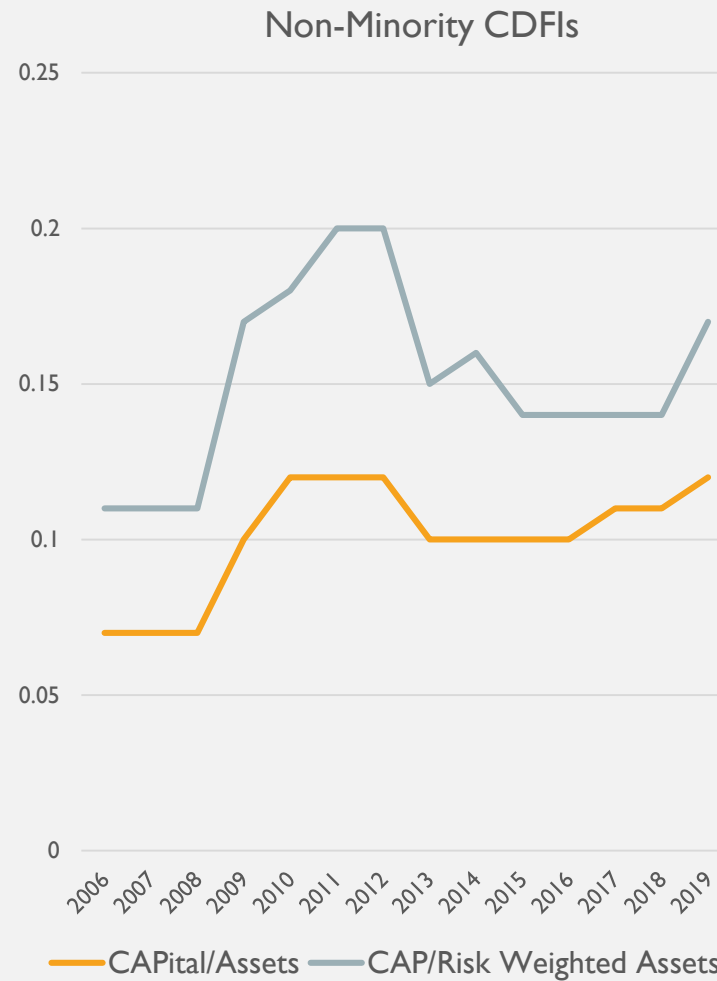
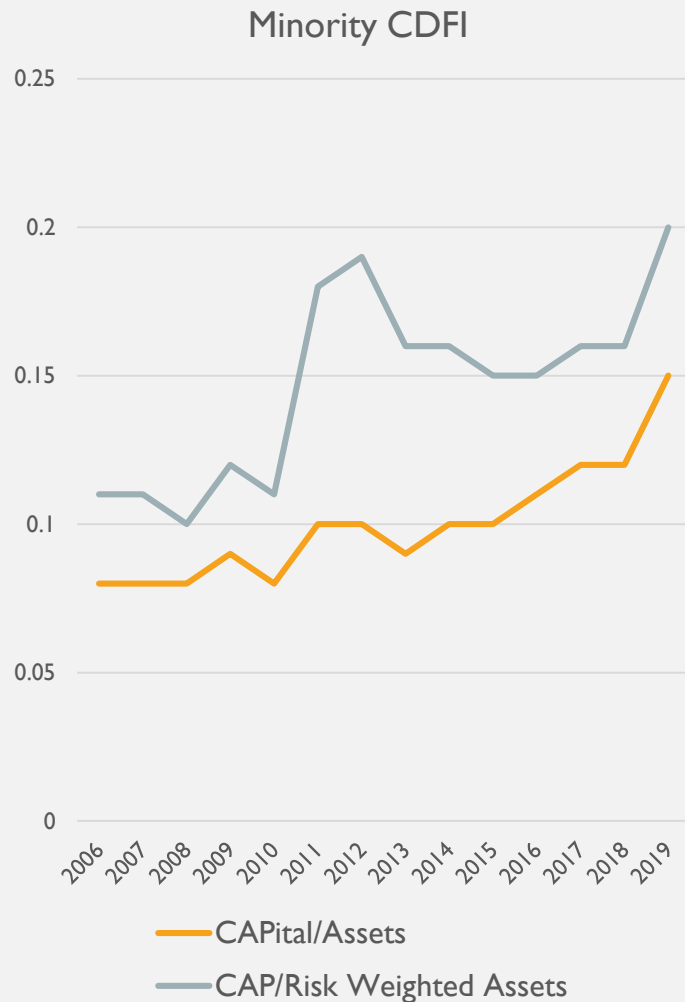
RESULTS

TRENDS IN EQUITY CAPITAL



RESULTS

TRENDS IN EQUITY CAPITAL RATIOS

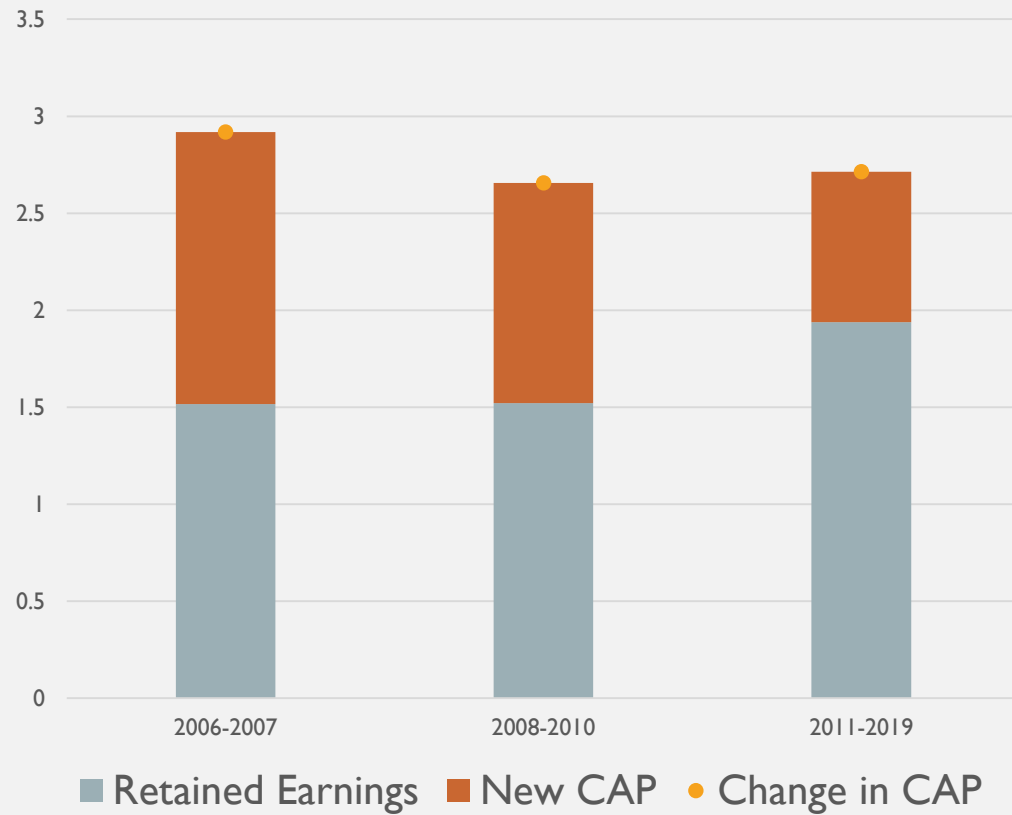


SOURCES OF INCREASES IN BANK EQUITY CAPITAL

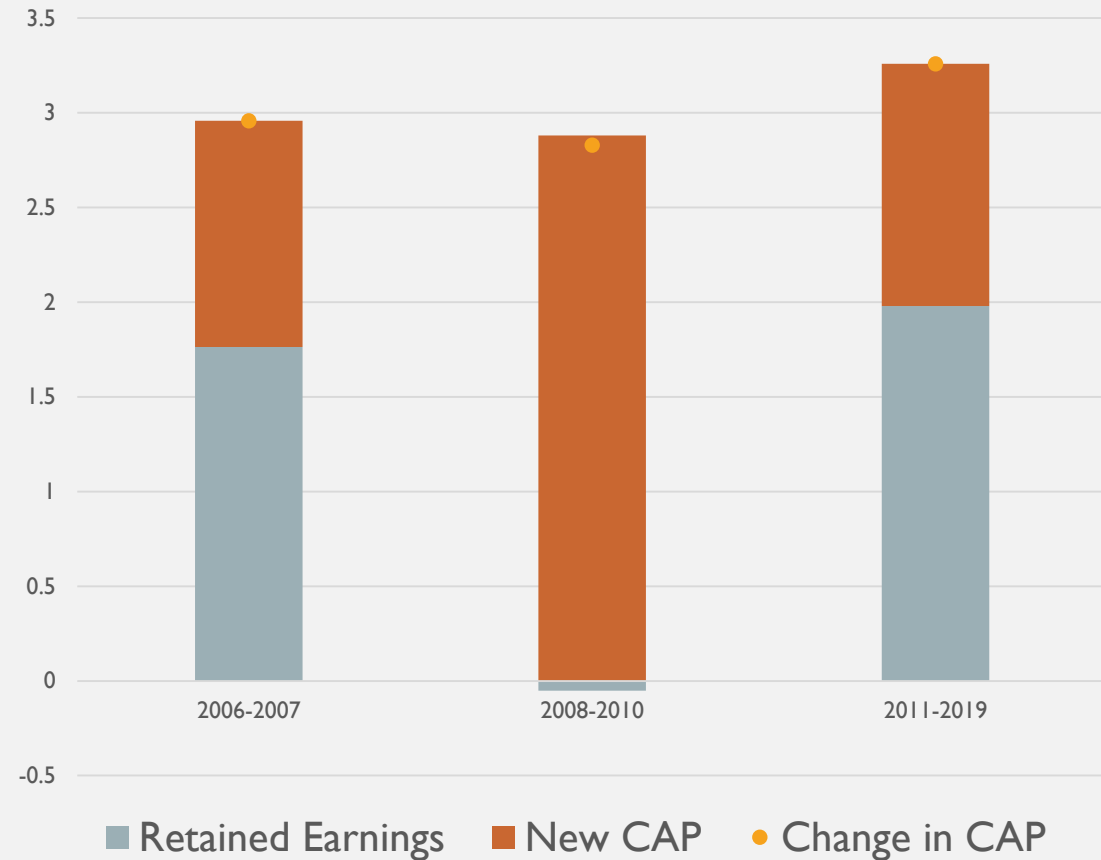
NORMALISED TO PERCENTAGE POINTS CHANGE OF END-OF-YEAR RISK-WEIGHTED ASSETS

$$CAPI_1 - CAP_0 = CAPI_1^N + (NI_1 - DIV_1)$$

Community Banks



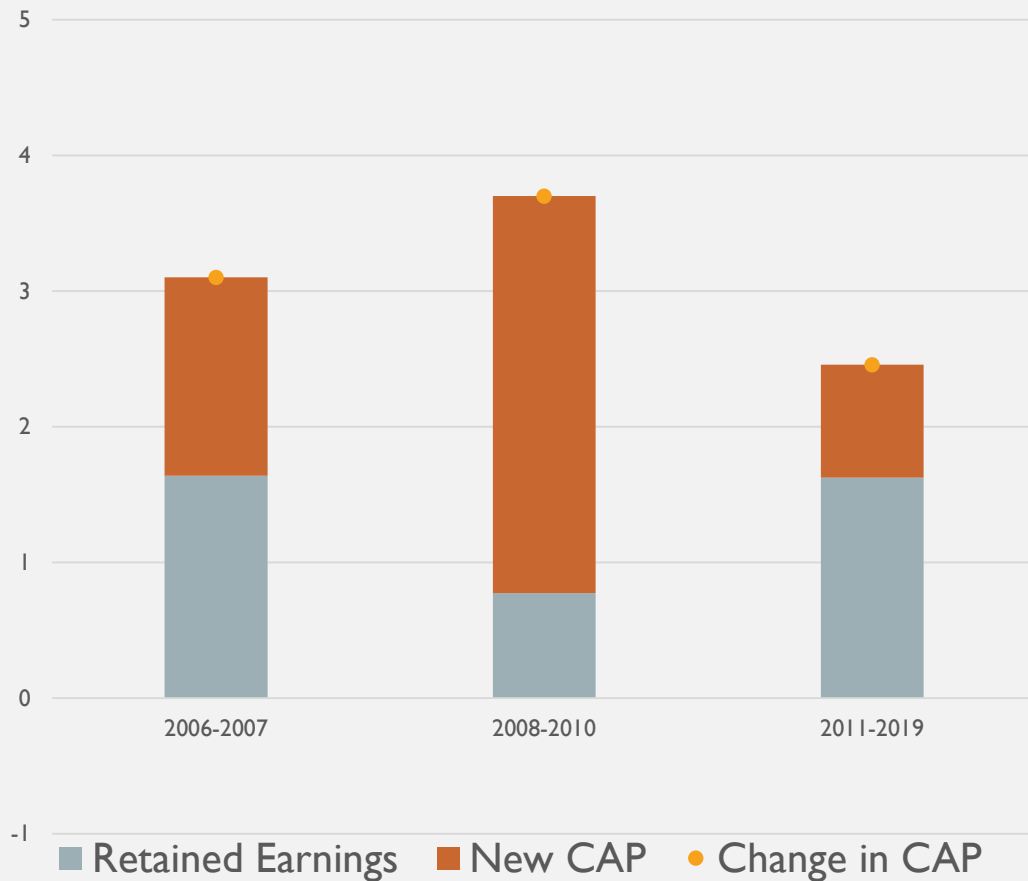
CDFI



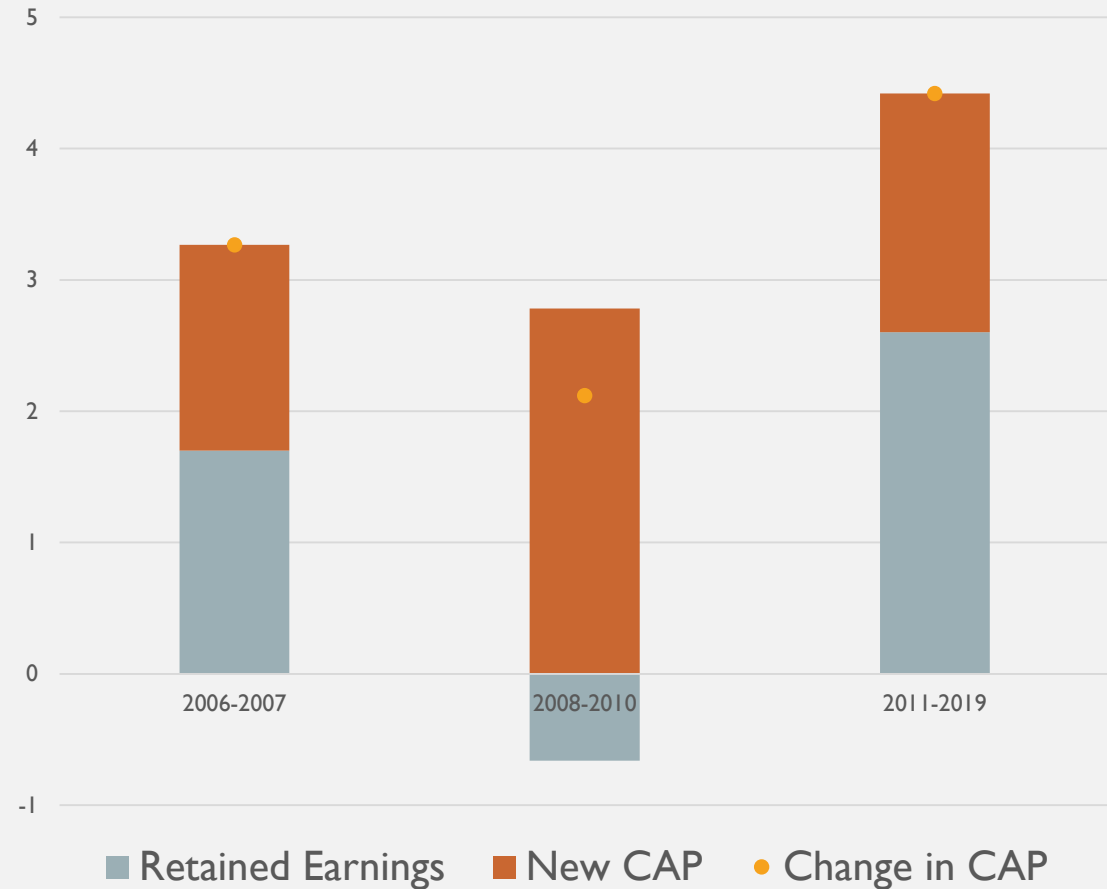
SOURCES OF INCREASES IN BANK EQUITY CAPITAL

NORMALISED TO PERCENTAGE POINTS CHANGE OF END-OF-YEAR RISK-WEIGHTED ASSETS

Non-Minority CDFI



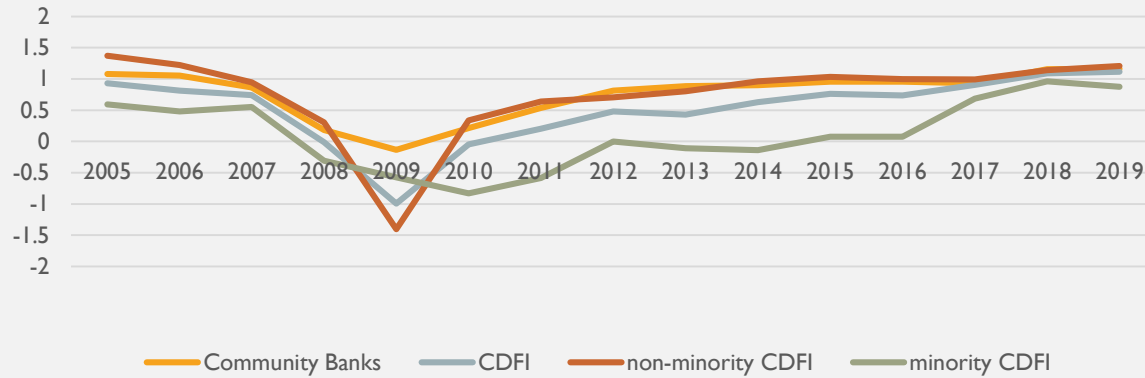
Minority CDFI



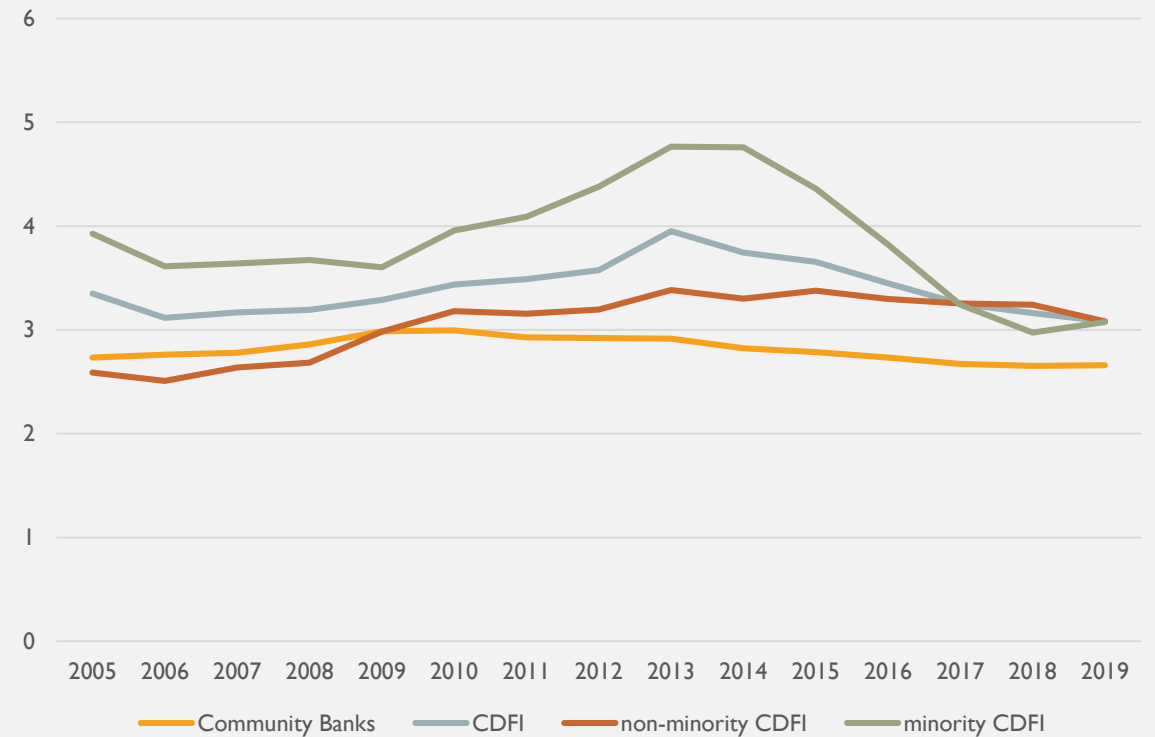
CHANGES IN THE COMPONENTS OF BANK INCOME

- $NI_t = NII_t + NOI_t - OE_t$

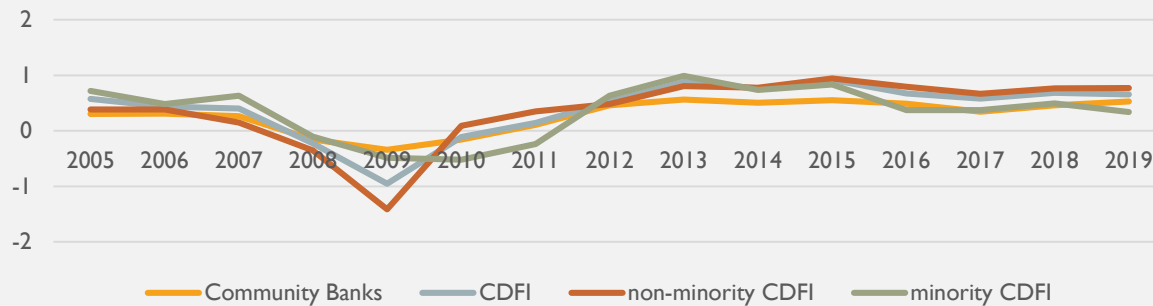
Net Interest Income/assets



Operating Expenses/assets

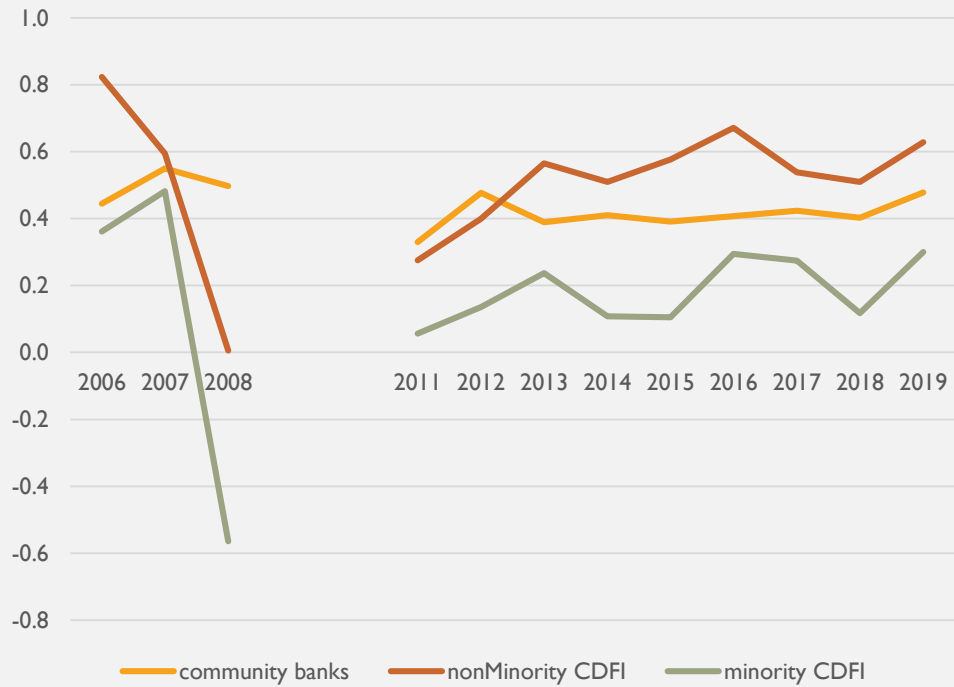


Non-Interest Income/assets

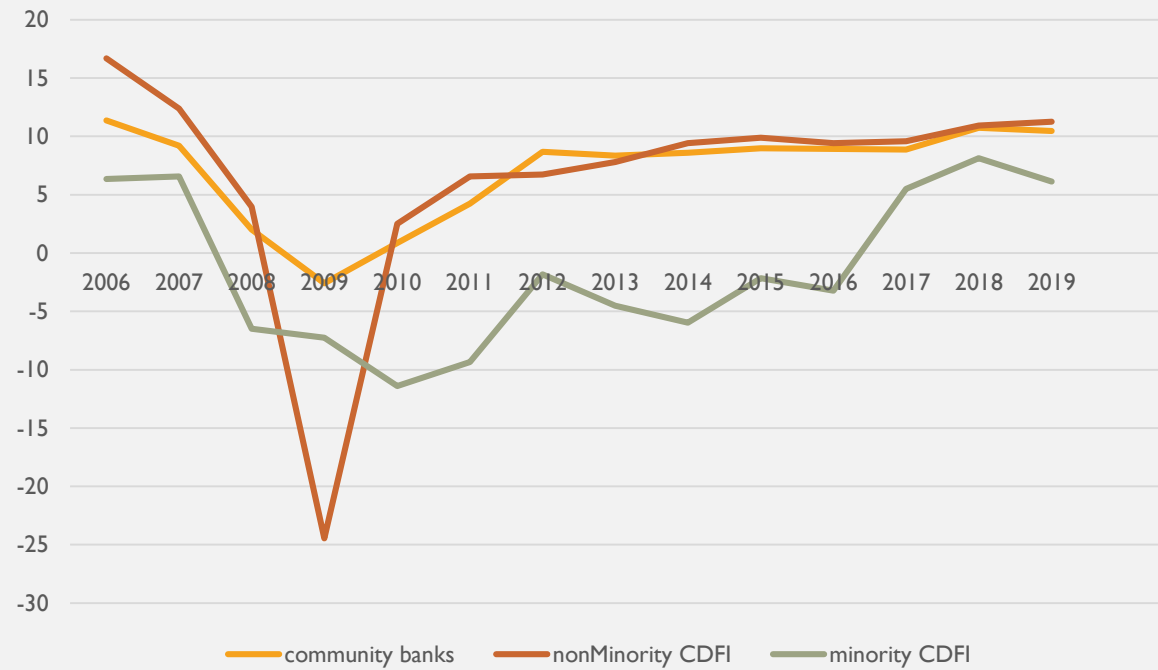


DIVIDEND PAYOUT AND ROE

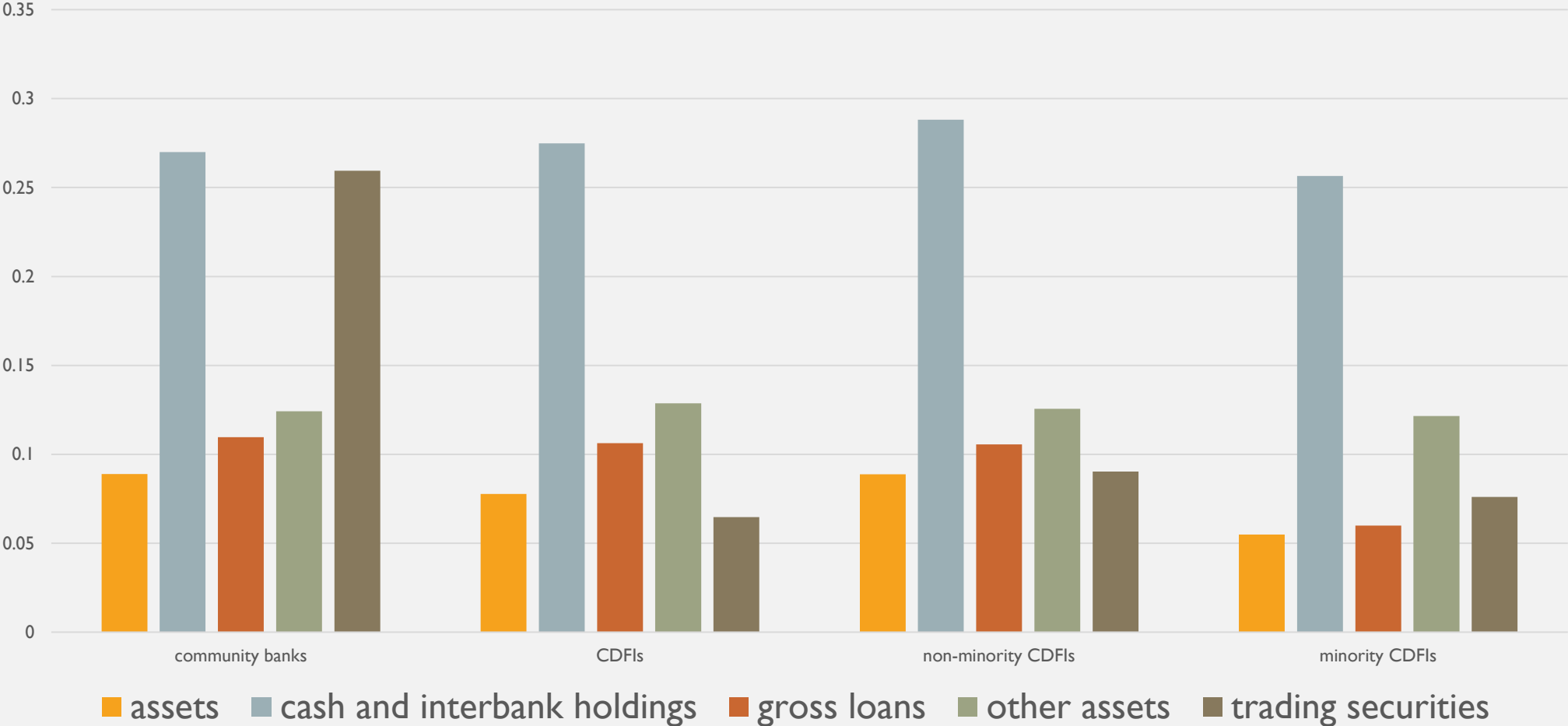
Dividend Payout



Return on equity (ROE)



ASSET AND LOAN GROWTH

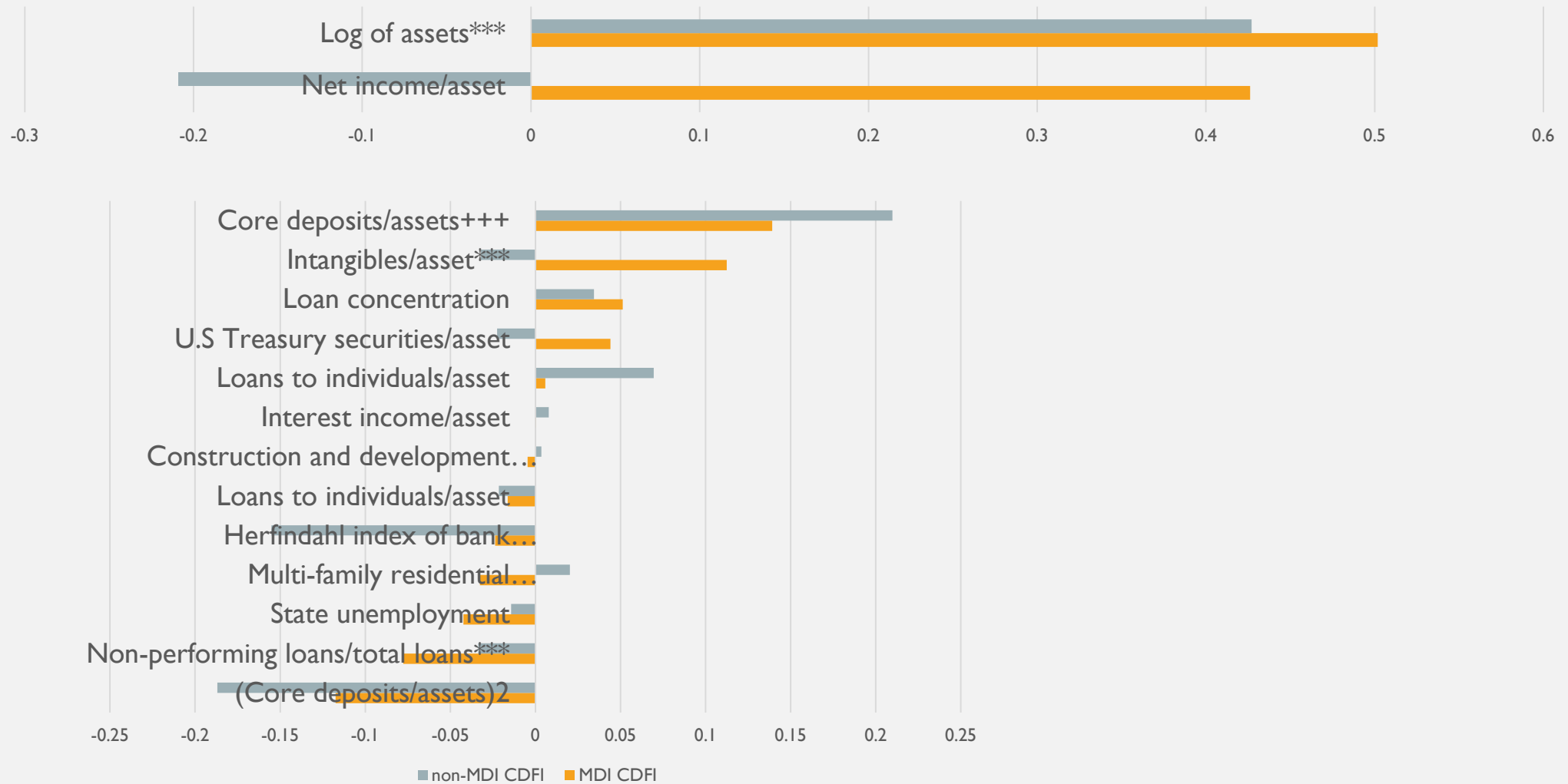


RELATIONSHIP BETWEEN BANK EQUITY CAPITAL GROWTH, PROFITABILITY AND ASSET GROWTH STRATEGY

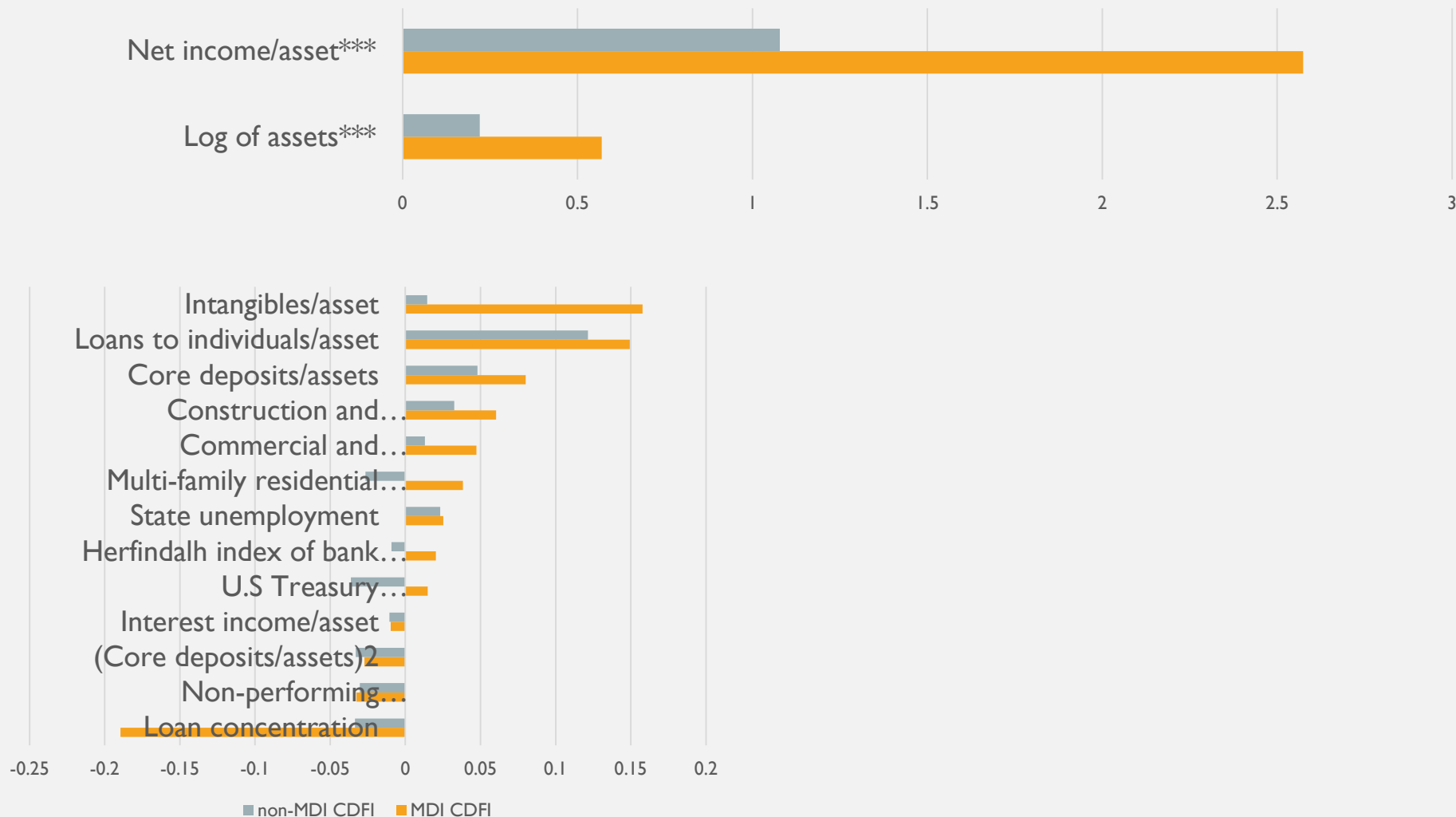
(OLS REGRESSION ESTIMATES)

	Assets		Risk- Weighted Assets		Gross Loans		Securities		Cash and Interbank	
	Coef.	t-stat	Coef.	t-stat	Coef.	t-stat	Coef.	t-stat	Coef.	t-stat
CDFI_MDI	9.91	3.17	7.30	1.81	9.02	2.56	-32.86	-19.9	8.79	2.76
CDFI_NON_MDI	-2.10	-0.5	-2.08	-0.52	-1.74	-0.39	1.09	0.15	-4.70	-0.78
Equity Ratio 2016	-1.22	-2.9	-1.46	-3.2	-1.88	-6.6	0.21	0.6	-0.60	-2.19
CDFI_MDI*Equity Ratio in 2016	-1.75	-0.9	-2.74	-1.16	-1.65	-0.77	5.20	15.1	-1.00	-0.5
CDFI_nonMDI*Equity Ratio in 2016	1.07	0.56	1.37	0.72	1.22	0.64	1.63	0.65	0.20	0.1
Change in Equity Ratio	0.07	0.78	0.02	0.24	0.06	0.77	0.20	1.92	0.03	0.44
CDFI_MDI*Change in Equity Ratio	0.30	1.99	0.34	2.14	0.36	2.3	0.25	2.44	-0.11	-0.59
CDFI_nonMDI*Change in Equity Ratio	0.25	0.77	0.21	0.67	0.16	0.54	0.24	0.62	0.08	0.41
Net income/assets	0.36	2.24	0.28	1.83	0.30	2.32	0.07	0.23	0.48	3.92
CDFI_MDI*Net Income/Assets	2.52	3.15	2.27	1.56	2.17	2.77	-10.18	-34.7	2.48	1.88
CDFI_nonMDI*Net Income/Assets	-1.07	-1.6	-1.13	-1.46	-0.98	-1.19	-0.57	-0.46	-1.26	-1.71
Intercept	11.84	8.91	10.48	7.57	9.88	8.39	12.26	7.44	11.17	11.41
Number of obs	2,499		2,365		2,457		1,493		2,067	
R-squared	0.043		0.0544		0.079		0.0234		0.0205	

STANDARDIZED COEFFICIENT FIXED EFFECTS ESTIMATES OF THE EFFECTS OF DETERMINANTS OF EQUITY CAPITAL, UP TO 2018



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

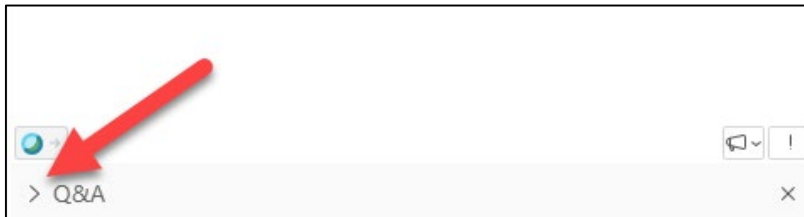
Question & Answer



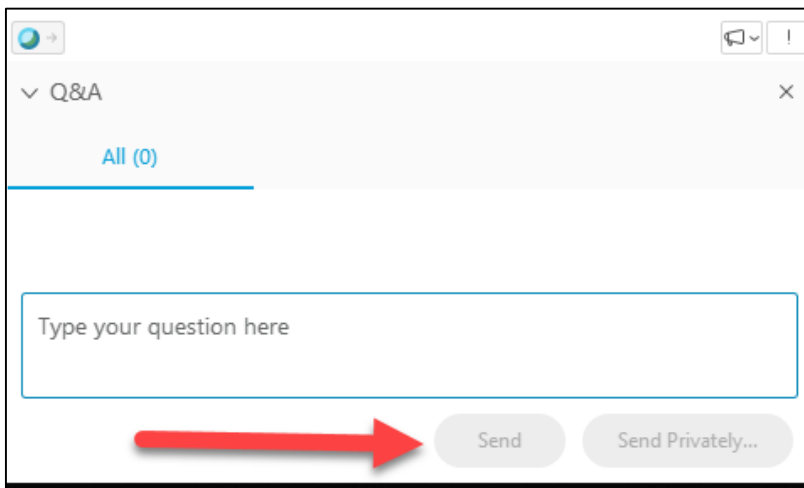
Emily Wavering Corcoran
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Next Steps

- 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