



Scaling Impact for Community Development Financial Institutions

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In the wake of the Great Recession, the public conversation on economic growth has increasingly focused on how the benefits of growth are distributed. Wage stagnation, elevated consumer debt, rising income inequality, and demographic changes have all led to questions about how to generate growth in ways that also cultivate stronger families and communities. Regulatory and technological shifts in the financial services industry offer new opportunities to promote financial and economic inclusion but also raise concerns that new underserved markets could emerge.

The link between economic equity and financial and economic inclusion has long been the focus of community development financial institutions (CDFI). CDFIs—which can be loan funds, credit unions, banks, or venture capital funds—provide financial products and services to low-income, low-wealth, and underserved communities. Blending market-rate and subsidized funding sources, CDFIs offer a range of affordable and sustainable financial services that support wealth accumulation, neighborhood revitalization, and economic growth. CDFIs are certified by the Treasury Department’s CDFI Fund.¹

Over the past 35 years, the CDFI industry has become a leading partner for banks, foundations and other social investors, and governments engaged in community economic development. The success of the industry stems largely from CDFIs’ ability to use business discipline to earn a financial return for their investors while delivering social benefits to low-income and disadvantaged communities.

BOX 1

The Urban Institute's Collaboration with JPMorgan Chase

The Urban Institute is collaborating with JPMorgan Chase over five years to inform and assess JPMorgan Chase's philanthropic investments in key initiatives. One of these is Partnerships for Raising Opportunity in Neighborhoods (PRO Neighborhoods), a \$125 million, five-year initiative to identify and support custom solutions for the unique challenges facing disadvantaged neighborhoods in US cities, with community development financial institutions (CDFIs) as critical partners in that effort. The goals of the collaboration include using data and evidence to inform JPMorgan Chase's philanthropic investments, assessing whether its programs are achieving desired outcomes, and informing the larger fields of policy, philanthropy, and practice. This brief outlines the challenges CDFIs face as they attempt to scale their ability to promote economic inclusion and economic equity, while maintaining and improving financial strength. Urban Institute research is exploring the complexity of how to build CDFI capacity and impact, recognizing the diverse ways CDFIs serve their target communities.

As demand for CDFI services is likely to expand in today's economic climate, how can CDFIs continue to scale their ability to promote economic inclusion and economic equity? To better understand this question, the Urban Institute, with support from the JPMorgan Chase Foundation, convened leading small and midsize CDFI loan funds, banks and credit unions. This brief summarizes how participants perceived and managed the complex balancing act of growing their financial strength while achieving both margin and mission.

In this brief, we first examine what scale means for CDFIs and note participants' focus on scaling impact and their concerns about conflating size with scale. We next look more closely at how CDFIs use their development and technical assistance services to achieve deeper impact and the critical role CDFIs often play as conveners and thought leaders. We then offer insights participants shared from their past experiences. Finally, we highlight the important role funding and balance-sheet management play in determining the type of future growth the industry can achieve.

Different Approaches to Scaling Impact: CDFI Roles

Scaling mission-oriented institutions is complex. Size alone does not capture whether social performance, the second bottom line of all CDFIs, has also expanded. Participants agreed that a CDFI's growth should be measured by its impact, since impact—rather than volume—reflects how CDFIs are serving their target communities. To the participants, the important measure is whether their social performance has increased—whether they expand the type of impacts they achieve, the volume of their impact, or the communities they serve.

At the same time, participants did not think growth and mission are necessarily at odds with one another. Instead, a CDFI and its supporters should first consider what function or role the institution wants to play in its target market. Some participants see themselves as service providers: they offer a

suite of products to underserved markets or individuals, wherever they may be. Others are committed to being deeply place-based institutions, working to stabilize or provide opportunity to a particular community or region. Others follow both strategies. Some CDFIs will measure success through people-based metrics, others will choose place-based metrics, and some may use both. In addition, CDFIs frequently function as connectors or conveners for ongoing conversations that cross the philanthropic, business, and government sectors, bringing key players to the table and staffing the resulting collaborations.

Discussion of how participants deliver impact ranged from how they deploy their credit tools to how they use their social and intellectual capital. On the credit side, CDFIs discussed several roles they play in their target markets:

- *Market maker.* Sometimes a disadvantaged community has a particular need that no existing product or service addresses. A CDFI might step in and design new products that can improve the economic well-being of the target population. ROC-USA, developed by the New Hampshire Community Loan Fund, helps manufactured-housing residents finance the conversion of their communities to resident ownership.
- *Market alternative.* Sometimes mainstream lenders do not or cannot meet the basic credit and investment needs of disadvantaged communities, particularly at a price that residents can afford. Mainstream institutions may not have appropriate products, may not be serving the area, or the community and the mainstream institutions may have a historic trust deficit. CDFIs are able to step in and offer the products and services that a mainstream lender has not been able to provide. Microlenders such as Opportunity Fund and LiftFund are alternative business lenders. Rural Community Assistance Corporation's household well-water loans are an example of a consumer-oriented product a CDFI can offer as an alternative to more expensive or nonexistent mainstream options.
- *Market catalyst.* Sometimes mainstream lenders are not sure how to deliver their suite of products and services to a disadvantaged community or cannot find a cost-effective way to originate loans in particular places. They might turn to CDFIs as a source of deal flow, tasking them with the structuring of complex deals that fit the risk tolerance of mainstream lenders. In this way, CDFIs help draw mainstream investors into new markets or attract a higher volume of financing into particular markets. Once the lender has grown more familiar with the market, it might even begin lending without the help of a CDFI. This type of activity has helped jump-start financing for both affordable housing and charter schools.

Participant CDFIs often filled more than one of these market roles, depending on the specific needs of and opportunities presented by their target markets.

Many participants also deployed their social and intellectual capital to create social benefits. Like financing, these tools can be expanded or used to help the CDFI achieve scale. Regarding the goal of leveraging social and intellectual capital to upgrade a particular neighborhood or locality, participants mentioned three primary approaches:

- *Community quarterback.* Sometimes key players in the local community development ecosystem have trouble coming together to develop or implement a shared vision. Given the hybrid nature of CDFIs—to achieve community development goals while seeking financial return—they can be a natural bridge between the public and private sectors, philanthropy, and community developers. The CDFI quarterback is often also able to help fund pieces of shared objectives. A CDFI may even develop a niche product in a particular sector, like healthy foods, charter schools or transit-oriented development, which the CDFI is able to scale by being a quarterback in different communities.
- *Economic development catalyst.* A CDFI's thought leadership may be applied more broadly in a community trying to find new economic drivers. In this model, CDFIs catalyze economic development and may help lead public conversations on inclusive growth, for example, and combine thought leadership with a suite of services. CDFIs employing this strategy are often deeply place-based and may make deliberate, sector-based investments that balance a market-driven investment approach with a commitment to sustainable and equitable models of growth that drive the creation of quality jobs. Craft3's work investing in regional food supply chains in rural and urban Oregon and Washington is one example of this approach applied at scale.
- *Multimarket catalyst.* Some CDFIs are structured as intermediaries to facilitate growth of locally based affiliates across markets. The goal is achieve more collectively than the groups could achieve alone, by bringing together organizations committed to a certain population, type of community, or product type. One prominent example is the National Association for Latino Community Asset Builders, which has chosen a path to scale where local organizations unite as a federation in order to access funding and technical assistance resources less expensively than if each smaller organization had tried to expand on its own.

Participants reported that their individual impact strategies led them toward different scaling strategies. The economic development catalysts focused on balancing expansion with local expertise because their work hinged on an ability to be known and trusted by many local stakeholders. Some community quarterbacks were able to move between markets and still serve the quarterback function by partnering with one or more local CDFIs or community-based organizations. The CDFIs serving as market makers, market alternatives, market catalysts, and multimarket catalysts felt the least constrained by geography and could rely on technology or partnerships to drive their growth.

How CDFIs Deepen Their Impact: The Role of Technical Assistance and Development Services

Participant CDFIs believed that achieving impact requires more than just originating a loan. To be most effective, participants said they first determine what the right tools are to tackle a given community development challenge. If the answer is more than a financial product, the CDFI must determine how to deliver some additional suite of services directly, through a subsidiary, or through a partnership.

Participants agreed that developmental services are crucial to the CDFI industry's social mission but recognized that the character of and funding for those services vary dramatically. The services a CDFI chooses to provide usually relate to the impact strategies the CDFI is pursuing.

Development services can be deployed proactively and deliberately as part of a wider impact strategy or more reactively. Participants identified five main types of services:

- *Integrated lending.* While most participants described specific technical assistance services, some large microlenders and smaller affordable housing lenders integrated their services with their lending system. Their origination and underwriting systems may be designed, for example, to identify needs and qualify customers who are likely to succeed. This is important because participants also recognized that declining a loan can be a vital part of meeting mission: if a borrower is not ready for a loan, it is counterproductive to burden him with unsustainable debt.
- *Business development.* Business lenders said they often try to provide some technical assistance to their small-business borrowers, including guidance on business planning, budgeting, or marketing. This assistance can be provided directly by the CDFI and its staff or through strategic partnerships. CDFIs that directly provide these services may fund them through fee-for-service government contracts or through general overhead by integrating the services into the CDFI's risk management practices. Other CDFIs have invested in technology platforms that offer borrowers tools and services in a cost-effective and scalable manner. Participants mentioned that Small Business Administration programs were an important source of funding for CDFIs providing these services to entrepreneurs, although some also stated that the programs could be difficult to use efficiently.
- *Financial capability.* CDFIs that work on housing or consumer finance often provide financial education, counseling, or coaching services to help strengthen borrowers' ability to repay loans and improve their financial health. These services are often funded by grants from foundations, governments, and financial institutions. However, some CDFIs are integrating financial capability training, particularly homebuyer preparation, into their business model through cross-subsidization by related lines of business such as real estate brokerage or housing development. One example of this approach is Homewise, a CDFI based in New Mexico.²
- *Deal structuring.* Some participants offer financial advisory services akin to investment banking to the community development ecosystem of their target markets. A CDFI may become deeply involved in advising stakeholders (including local governments and foundations) on structuring the partnerships and financing for a particular deal, helping the developer pull together the right combination of subsidized and private capital to maximize impact and achieve community impact and financial sustainability. The public-private nature of CDFIs makes them especially adept at bringing together the right array of organizations and funders. One example is the Detroit work by IFF, which has been working with foundations to assess local needs, identify high-quality service providers, and place those centers in the appropriate neighborhoods (Grace and Wood 2013).

- *Policy research and advocacy.* Most participants engaged in some form of policy advocacy, particularly if it could increase funding for the CDFI, directly or through improvement of the context within which funders operate. For example, many CDFIs have been trying to obtain improvements in the Community Reinvestment Act’s regulations and implementation. However, only a subset of participants engage in wider advocacy on issues related to the needs of their target communities. Some said they had to address predatory lending to prevent the loss of wealth in their communities and level an unfair playing field when competing against predatory lenders. Others worked in coalitions on issues such as immigrant services or increasing the minimum wage because they recognized that financial products and services alone could not meet the community development needs of their customers.

Participants acknowledged that policy work requires a unique skill set, and not all CDFIs can easily invest in the data analysis or storytelling resources required for effective policy engagement. Perhaps the most prominent example of a CDFI moving into policy advocacy is the Center for Responsible Lending, which has become the leading voice on predatory lending issues nationwide and is affiliated with Self-Help, a North Carolina-based CDFI. More recently, the Responsible Business Lending Coalition brought for-profit and nonprofit small business lenders together, including some CDFIs, to design the Small Business Borrowers’ Bill of Rights, which includes transparent pricing and terms and fair collection practices among its six fundamental financing rights.

Participants agreed they must be strategic about which services they provide and with what intensity. They make every effort to connect developmental services to their business model so services help improve balance sheets overall. They also think carefully about how to structure the work and whether to house it in a separate, related entity. Because a strong balance sheet is so critical to raising the debt and equity capital needed to deliver financial services to underserved communities, some CDFIs created subsidiaries to make sure they could deliver the right level of services without jeopardizing the balance-sheet strength of the parent CDFI.

Participants agreed that to be poised for growth, a CDFI must understand the business rationale for its services. As the old saying goes, “no margin, no mission,” and participants said technical assistance services or wider field-building could not come before the fundamentals of underwriting, funding, and managing deals well and on a timely basis. As CDFIs grow, it can be difficult to deliver these services cost-effectively, and some participants said their mix of services and the amount they could deliver evolved as the CDFI grew.

Lessons from CDFIs Expanding Their Footprints

Some participants had expanded their work by extending geographic reach, increasing volume in existing markets, reaching more-distressed markets, creating new products or services, or some combination of these approaches. Since a growing balance sheet does not necessarily equate to scaling impact, participants said they looked at the needs of their target markets and the effect they wanted to

have when deciding whether and how to grow. This, they said, helped determine the mix of financial services and technical assistance they would try to offer to new markets. Expansion is a risky venture, and a source of flexible subsidy or risk capital is essential for participants looking to grow and adapt to changing conditions in low-income and underserved communities.

Participants shared positive and negative experiences of expansion:

- *Technology offers new opportunities for CDFIs able to adapt.* CDFIs are now looking to leverage their data or partner with financial technology (fin tech) companies in new ways to modernize their approach to origination, underwriting, and lending. Participants recognized that technology will be critical to the industry's ongoing relevance and are trying to find the requisite resources to experiment with combining the best of the old and the new to scale impact for communities in need. Some said the key was hiring tech-savvy staff to improve the CDFI's ability to adopt and adapt technology into its business model. These ventures are relatively new, so results remain to be seen. One such partnership is between Opportunity Fund, Craft3, and Lending Club.³ Lending Club will automatically refer its declined loans to these two CDFIs if the application came from one of their target markets.
- *Growth allows CDFIs to invest in innovation and product development or take on work in more-distressed communities.* Some participants said one unexpected benefit of growth was the financial leeway to experiment with new products and services or work in harder-to-serve places. CDFIs had room to fail because small, risky bets would not jeopardize the financial health of the whole organization. In this way, expansion can allow a CDFI to become more innovative or reach additional communities, or those with greater challenges.
- *Expanding successfully requires a strong foundation of trusted relationships.* Numerous participants underscored the importance of trust and relationship-building. To grow successfully, a CDFI must deeply understand its target market. Expanding to new markets requires intense commitment to building trust with local leaders or community-based organizations. A focus on transparency and the early assignment of clearly defined roles and responsibilities were key to building trust. Capital Impact Partners' expansion into Detroit was seen by some as a compelling example of building trust and relationships, given its work with Midtown Detroit, Inc., and Invest Detroit as it grew. Some approached geographic expansion by hiring local experts or staff with linguistic or cultural competencies and training them in finance and credit analysis. VEDC's expansion from the Los Angeles area to broader California, and now to multiple states, was seen by participants as emblematic of this approach.
- *State, local, and federal agencies can all be important partners in growing a CDFI's footprint.* Many participants described their success with expanding through local or state government programs and traditional and nontraditional federal resources. CDFIs in states as diverse as South Carolina and Washington have benefited from state programs, both as conduits for federal funds such as the State Small Business Credit Initiative (Vasiloff 2015) and with purely local resources. Some said they were increasingly focused on developing relationships with

state and local financing sources to cultivate new funding sources. Others found federal agencies like the Small Business Administration a welcome source of funding through their microloan or Community Advantage programs. All agreed that the CDFI Fund's CDFI Program continues to be unique source of capital; few other sources offering unrestricted equity-like funding serve as a dependable source of balance-sheet strength and resilience for the industry. But the CDFI Program is subject to federal budgetary pressures, and demand will continue to outpace supply. As CDFIs expand to additional geographies or product lines, these unrestricted funds will likely be spread thinner, raising the importance of continuing to develop other sources of flexible funds.

Some CDFIs expressed concern that government programs, especially federal ones, were moving toward a secured lending model, in contrast to the traditional unsecured balance-sheet funding. This is particularly true of larger, long-term funding sources such as the CDFI Fund's Bond Guarantee Program and the Federal Home Loan Bank programs. Participants were concerned that the precedent these programs were setting might weaken the industry's prior capitalization strategy of placing public sources in an unsecured, first-loss position to attract more affordable private capital at scale. As one participant put it, "The most important thing we [CDFIs] do is to shape capital. Our radical act is to shape capital in a way that those without it can succeed. And we cannot do that, we cannot be helpful to people, without stable sources of equity capital."

Participants also offered caution about what growth could achieve and whether growth was always desirable. Some preferred to remain relatively high-touch lenders who spend time structuring each deal and stay in frequent contact with borrowers to help restructure loans if needed. Even participants who had grown or were expecting to grow expressed concern in three areas:

- *Not all forms of expansion result in operational efficiencies for a CDFI.* The industry has long focused on growth as a means to fiscal sustainability, and many CDFIs have grown their balance sheets and lowered their operating costs. However, some participants noted that growth did not always bring operational efficiencies or major cost savings. Adding new product lines or substantially increasing the volume of an existing product may require new investments in infrastructure or systems. In other instances, meeting social performance goals meant investing in relationship-building in new areas or opening new offices.
- *A CDFI cannot fill every role in a local community development ecosystem.* Expanding to places with deep need or weak community development infrastructure was an exceptional challenge for participants. Communities must have the right absorptive capacity to successfully deploy community investments.⁴ CDFIs finance community development but cannot take on all the roles of a community developer: organizing residents, identifying community needs, functioning as a project developer or manager. CDFIs can help *support* the development of the wider community development ecosystem. For example, when the community is only able to support smaller transactions, a CDFI may decide to do the deal despite a lower return and higher transaction cost. CDFIs might also spend more time offering technical assistance or developing

relationships to lay a solid foundation for transactions in a lower-capacity area, charging higher fees or securing grant funding to help recoup the additional costs. Some participants noted that this challenge was particularly acute in places that were historically poorer, lower density, less urban, and with fewer investors motivated by the Community Reinvestment Act to help build and sustain their community development ecosystem.

- *Public-sector programs could improve how CDFIs balance size and scale objectives.* Participants agreed that two important sources of capital are the new markets tax credit (NMTC) and the CDFI Bond Guarantee Program. However, many felt that neither program is well suited for supporting CDFIs focused on deepening impact. Instead, both programs encourage large loan sizes and do not give enough consideration to applicants who might achieve greater impact with smaller projects. Some CDFIs have been able to overcome those disincentives: Coastal Enterprises Inc.'s (CEI) NMTC program has developed partnerships to originate smaller loans in hard-to-serve rural communities, extending CEI's reach and enabling partners to benefit from the NMTC program and more cost-effectively manage the program's administrative complexities.

Conclusion: How to Finance the Scaling of Impact

The CDFI industry's history of success is driven by its ability to learn, adapt, collaborate, and innovate while staying focused on mission. Careful financial stewardship and strong support from funders, including an increase in federal funding, allowed the industry to weather the Great Recession with few institutions forced to close. Many were even able to design new products and services to meet new needs, such as foreclosure rescue services.

With the uneven nature of the recovery from the Great Recession, many public- and private-sector partners are turning to CDFIs to address the challenges posed by greater economic inequality and exclusion. But CDFIs are being asked to respond at a moment of public-sector austerity and decreased (or more expensive) resources from traditional private sources such as Community Reinvestment Act-motivated banks. The secured lending structure of some public programs, like the Bond Guarantee Program and Federal Home Loan Bank programs, may weaken the industry's capitalization strategy of placing public sources in an unsecured, first-loss position to attract more affordable private capital at scale, in turn potentially limiting growth. In addition, many parts of the country still lack access to CDFIs. The industry needs to determine the best way to expand the reach of its services and adapt its business model to today's funding realities. And CDFIs must do it while preserving—and expanding—their impact. As one participant warned, “A lot of us confuse scale with size, at peril to our missions.”

CDFIs, now established as serious players in financing equitable economic development in underserved communities, face the challenge of bringing new equity and debt investors to the sector while adapting to technological changes (Nowak 2015). CDFIs need both a healthy income statement and a healthy balance sheet to meet the increased demand for their services. Having the right forms of capital, both debt and equity, will be a critical factor in the industry's continued growth. In addition to

growth in equity—from retained earnings, the CDFI Fund, philanthropic investors, or other sources—CDFIs will be looking to mission funders, who invest at concessionary rates to drive the institutions' mission, as well as the continued support of market-rate lenders who can offer the large-volume funding necessary to meet the needs of America's underserved communities.

Notes

1. For more background on CDFIs, see Swack, Northrup, and Hangen (2012).
2. For a description of the Homewise model, see Theodos, Plerhoples Stacy, and Monson (2015).
3. For a more detailed description, see Eric Weaver, "Opportunity Fund Partnering with Lending Club, President Clinton Announces," Opportunity Fund, June 11, 2015, <http://www.opportunityfund.org/media/blog/clinton-announces-partnership-between-opportunity-fund-and-lending-club>.
4. For a more in-depth discussion of taking a system's view of community investing and understanding absorptive capacity, see Hacke, Wood, and Urquilla (2015).

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As we were publishing this brief, we were saddened to learn of the death of John Berdes of Craft3. John was a true original thinker and doer, and a hero to the communities in which he worked. We will miss him.



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