We Have New Tools To Capitalize CDFI Growth

—

Let's Use Them

BUSINESS OWNERSHIP INITIATIVE
aspen institute

Brett Simmons and Joyce Klein

OVERVIEW

For decades, when community development financial institutions (CDFIs) have been asked what they need to grow, the response has been the same: "More net assets." But while the need for net assets to support CDFI growth remains (and will not go away because of the scale of the challenge), the industry now has new capitalization tools to bring to bear to reduce this pressure. Many of the investors who support the CDFI industry – most particularly financial institutions – have advocated for the development of secondary markets as a means to scale CDFI lending. But adopting new tools – in this case, loan sales – requires a shift in the attitudes and behaviors of both CDFIs and, importantly, the funders and investors who play a powerful role in their choices. This brief addresses a set of critical questions that will arise as the industry puts this powerful growth strategy to work, focusing on how CDFI funders and investors should reconsider how they interpret key financial metrics related to portfolio quality, capital deployment, and earned income for CDFIs that are selling loans. For example, to more accurately assess the lending activity of CDFIs that are selling loans, we recommend that funders request and evaluate total assets under management rather than simply looking at outstanding loans held on the balance sheet or total deployment ratio.

WHY ARE LOAN SALES NOW A VIABLE FINANCIAL AND LENDING GROWTH STRATEGY?

The past three years (2020-23) have yielded a lot of innovation and growth in the CDFI industry, driven by the desire to adapt to circumstances resulting from the COVID-19 pandemic. One innovation involves the use of loan sales as a strategy to support CDFI portfolio growth and capitalization. While CDFIs that engage in mortgage lending and those that participate in the Small Business Administration's Community Advantage program have been able to sell loans via secondary markets, for the most part, CDFIs have held the loans they originate on their balance sheets.

During the pandemic, small business relief programs, such as the California Rebuilding Fund and New York Forward Loan Fund, enabled CDFIs to originate large numbers of small business loans in part because they could sell the loans they originated to special purpose vehicles (SPVs) or other entities that would hold the loans until maturity (or until forgiven). The success of these programs has led some states to begin replicating them in new programs created with funding provided through the State Small Business Credit Initiative (SSBCI). Scale Link (formerly the Entrepreneur Backed Assets Fund) was also launched during the pandemic; in its model, the loans purchased from CDFIs are sold to banks that acquire them because of the Community Reinvestment Act (CRA) value, making them a true secondary market transaction.[1]

[1] For the CDFIs selling loans, whether the loans go to an SPV or are sold onwards makes little immediate difference, but the variety of approaches shows how the field is evolving. In one, the SPV is much like a CDFI itself, requiring philanthropic subsidy and guarantees to exist. Scale Link, on the other hand, is selling loans to private buyers with the end goal of new revenue for the CDFI and no need for subsidy long-term. New SSBCI programs are also attempting to sell loans to private buyers through securitization with the hope of providing large amounts of capital not currently available to CDFIs, making them a true secondary market transaction.

WHY ARE LOAN SALES A VALUABLE TOOL FOR CDFIS (ESPECIALLY NOW)?

Because most CDFIs hold the loans they originate until maturity, their ability to increase their loan volume is dependent on growing their balance sheet. Their core capitalization and financial model is as follows:

- Raise grant funds to serve as net assets.
- Leverage net assets with debt provided primarily by banks motivated by CRA requirements and foundations providing program-related investments.
- Raise grant funds to support operating expenses not covered by lending revenues and offset the cost of higher-risk lending.[2]

In this model, origination growth is dependent on the ability to access grants to support net assets and the availability of low-cost debt. Many CDFIs have struggled to grow under this model, in large part because of the scarcity of grants to fund net assets (particularly in regions of the country where philanthropy is very limited). In addition, because most CRA-motivated debt investments are relatively small (often less than $3 million), CDFIs that succeed in raising net assets may still need to invest significant resources in managing relations with potentially dozens of debt investors with widely varying terms and covenants. By selling loans, CDFIs can increase the turnover or velocity of their lending capital, increasing originations without needing additional grants for net assets or new debt.

Selling loans is a particularly important capitalization strategy in times when CDFIs are experiencing rapidly growing demand such as during a recession or pandemic, because it can take months, if not years, to negotiate new grants and debt investments. Loan sales are also important in a rising interest rate environment, as new debt investments will invariably come at higher costs. At the largest CDFIs, the cost of interest payments to debt investors can equal 15-25% of grant funds raised in a year. In a period with rising rates and pressure on foundation balance sheets, this figure can be even higher. Loan sales offer a much lower cost and potentially faster means to raise needed liquidity.

Selling loans becomes an even more powerful tool when sales also improve the returns that the CDFI generates on its loans. When Scale Link sells loans it has acquired from CDFIs to banks, it generates premiums, most of which are donated back to the originating CDFIs. In just 2.5 years, Scale Link has provided nearly $4.5 million of new revenue to its partners and over $45 million of capital. This reduces the CDFI's need to raise grant funding associated with originating smaller-dollar loans or taking higher levels of risk.

---

[2] For more on the importance of small-dollar lending in meeting the needs of business owners of color, and the financial challenges in scaling microlending, see https://www.youtube.com/watch?v=flGTtJK4BbY.

ARE LOAN SALES A SUBSTITUTE FOR CDFIS' CORE CAPITALIZATION STRATEGY?

While selling loans provides a valuable tool to support portfolio growth, it does not replace the need for CDFIs to raise debt or grant funding. Most CDFIs will need to employ these strategies simultaneously. And while selling loans may reduce the need to raise grants to fund net assets, grants to cover operating expenses will be essential for CDFIs that make smaller-dollar loans that typically do not generate sufficient income to cover their costs. As we saw with the Paycheck Protection Program and other pandemic relief programs, CDFIs will not be able to originate the small-dollar loans that are most needed by firms owned by people of color and women if they cannot access sufficient support to cover the related operational costs. Loan sales provide a valuable tool for CDFIs that want to grow. However, CDFIs that sell all their loans or originate significant amounts into SPVs can become overly dependent on a single funding stream. Thus, the goal for CDFIs is to have access to and use a larger set of capitalization tools, not to replace existing tools with loan sales.

WON'T SELLING LOANS UNDERMINE THE RELATIONSHIPS CDFIS HAVE WITH THEIR CUSTOMERS?

In the models cited above, the CDFIs retain servicing of loans that are sold and receive a servicing fee for that work. This allows them to maintain relationships with their customers – to ensure that they are treated in ways that are consistent with the CDFI's mission and values, and to enable them to meet the borrower's future financing needs more easily. The servicing fees also generate a new and reliable stream of income from the loans.

HOW WILL SELLING LOANS CHANGE HOW CDFIS (AND THEIR FUNDERS AND INVESTORS) MEASURE IMPACT?

CDFIs often measure their scale and impact in terms of their total assets and outstanding portfolios. Philanthropic and public sector funders who want to maximize the impact of their grant investments often consider a CDFI's deployment ratio – the ratio of total loans outstanding to loan capital — in deciding which CDFIs most "need" their resources. For CDFIs that sell loans, these figures may be misleading. Selling loans reduces the total balance of outstanding loans on the CDFI's balance sheet even if the total number of loans originated and serviced by the CDFI is in fact growing, as it recycles its capital more quickly. Loan sales also can provide a large cash infusion that will temporarily decrease the deployment ratio.

To more accurately assess the lending activity of CDFIs that are selling loans, we recommend that funders request and evaluate total assets under management rather than simply looking at outstanding loans held on the balance sheet. We also

recommend that they request information on the deployment ratio both before and after the time of the loan sale so that they can have a better picture of whether the CDFI is effectively deploying capital. Looking at these variables will also inform changes to the CDFI's profit and loss statement. Lenders selling many loans will be increasing originations and will likely be investing in additional staff and systems to support that growth. As a result, their ratio of staff expenses per dollar of on-balance sheet portfolio will increase. However, looking at their staff expenses relative to the total originations and assets under management is a better measure of total lending efficiency.

HOW WILL SELLING LOANS AFFECT A CDFI'S PORTFOLIO QUALITY?

Selling loans will always reduce the total amount of risk in a CDFI's current portfolio. This will be true even if all the loans sold are current at the time of the sale. This is because there is always some expected risk on any set of loans as they mature, and that risk will be transferred to the purchaser at the time of sale.

But while selling loans reduces future risk in an absolute sense, it often affects key ratios of portfolio quality in ways that make it seem that risk has increased. This is because purchasers typically buy only current loans. Consider the case of a CDFI with $20 million in gross loans receivable that elects to sell $3 million of its loans. Table 1 shows the status of the CDFI's delinquency ratios and loss reserves prior to the sale. At that time, 1% of the balances on its outstanding loans were more than 30 days past due, and the organization had a total loan loss reserve of just under 6% of outstanding balances.

As Table 2 shows, after selling $3 million in current loans, the CDFI's gross receivables drop to $17 million. Because the loans that were sold are no longer a risk to the organization, the CDFI would be able to reverse the loss reserves associated with the $3 million in loans, resulting in a $150,000 increase in net assets. However, because the total dollar amount of loan balances that are at risk has not changed (since only current loans were sold), the organization's delinquency rate (the percentage of loans more than 30 days past due) has increased from 1.0% to 1.2% because the size of the outstanding portfolio (the denominator) has declined. The new ratio suggests a deterioration in the loan portfolio that may be flagged by many debt investors and by the CDFI's board or risk committee members. However, the important outcome is that the CDFI's total **dollars** at risk are lower.

Table 1: Portfolio Quality prior to Loan Sales

Current	**$19,550,000**	**97.75%**
Less than 30	$250,000	1.25%
31 to 60	$125,000	0.63%
61 to 90	$50,000	0.25%
More than 90	$25,000	0.13%
Total Portfolio	**$20,000,000**	
Total >30 DPD	**$200,000**	**1.00%**
Total Reserve	**$1,155,000**	**5.78%**

Table 2: Portfolio Quality after Loan Sales

Current	**$16,550,000**	**97.35%**
Less than 30	$250,000	1.47%
31 to 60	$125,000	0.74%
61 to 90	$50,000	0.29%
More than 90	$25,000	0.15%
Total Portfolio	**$17,000,000**	
Total >30 DPD	**$200,000**	**1.18%**
Total Reserve	**$1,005,000**	**5.91%**

HOW SHOULD CDFIS AND THEIR INVESTORS EVALUATE THE PORTFOLIO QUALITY OF CDFIS THAT SELL LOANS?

First, they can request information on portfolio quality for all loans under management. This provides a holistic understanding of portfolio quality, irrespective of which portion is held by the CDFI.

Second, investors may request information on portfolio quality both immediately prior to and after the sale of the loans. For a direct comparison, it is also helpful to see the "after" picture as if the loan sale had not happened. This "before and after" lens provides a better picture of portfolio performance, especially when combined with the knowledge that the sale also empirically reduced the total risk of loss to the CDFI.

Third, they can ask about the planned use of the proceeds from the sale. CDFIs intending to quickly relend the proceeds could be asked to reverse only a portion of the loss reserve gain associated with loans that are sold. In doing so, the CDFI would more accurately reflect its long-term asset position since the loss reserve will quickly grow back to the amount from before the sale due to relending of the proceeds. This will mean that the CDFI's increase in net assets after the sale will not be as large. If the CDFI intends to use funds to pay down existing debt investments and resize the overall balance sheet, then holding back a portion of the planned reversal in loss reserves would not be required, as the net asset boost would be more permanent.

HOW WILL SELLING LOANS AFFECT A CDFI'S REVENUES AND ITS SELF-SUFFICIENCY RATIO?

CDFIs and their funders and investors may also need to adjust how they view the financial performance of a CDFI as it sells loans. Exhibit A provides illustrative proformas for a CDFI before and after it sells loans. As sales happen, the revenues from the loans are pulled forward to the present time, and the organization will need to understand and adjust to that as it manages its finances. Fees financed in are immediately realized and premiums are paid at sale (although sometimes amortized over the repayment period).

Loan sales may also appear to reduce a CDFI's self-sufficiency ratio, particularly if any premiums received from the sales are structured as donations. In transactions with Scale Link, premium income from banks is sometimes structured as of a donation because this maximizes the CRA value to the bank.[3] Receiving the premiums as a donation also provides the originating CDFIs with maximum flexibility in using those funds (to support net assets, to cover the operating costs associated with very small loans, or to increase their ability to take risk). However, if these premium-related donations are treated as the equivalent of a philanthropic grant when the self-sufficiency ratio is calculated, the ratio is lower, suggesting that the CDFI is more reliant on fundraising. Because premium-related donations are different in nature –

[3] The small business loans purchased by the bank provide credit for the bank toward the CRA lending test, while premiums in the form of a donation receive CRA investment test credit.

in that they are directly tied to the origination of loans by the CDFI and reflect their regulatory value to the purchasing banks – they do differ from traditional grants. We recommend that CDFI board members and investors considering investments in CDFIs that receive premium-driven donations request or calculate an adjusted self-sufficiency ratio that treats these donations as earned or loan-related revenues, rather than as donated funds.

Exhibit A – Proforma Financials for CDFI Loan Sales

	Beginning Financials		Financials After Sale of $3,000,000		Net Change After Sale
Annual P&L		*Annual P&L*		*Annual P&L*	
Donation Income	$500,000	Donation Income	$950,000	Donation Income	$450,000
Earned Income	$500,000	Earned Income	500,000	Earned Income	$0
Self-Sufficiency Ratio[4]	*50%*	*Self-Sufficiency Ratio*[4]	*59%*	*Self-Sufficiency Ratio*[4]	*9%*
Lending Expense	$650,000	Lending Expense	$650,000	Lending Expense	$0
LLR Expense	$200,000	LLR Expense	$50,000	LLR Expense	($150,000)
G&A	$150,000	G&A	$150,000	G&A	$0
Net Income	**$0**	**Net Income**	**$600,000**	**Net Income**	**$600,000**
Balance Sheet		*Balance Sheet*		*Balance Sheet*	
Assets		*Assets*		*Assets*	
Cash and Equivalents	$750,000	Cash and Equivalents	$4,200,000	Cash and Equivalents	$3,450,000
Gross Portfolio	$20,000,000	Gross Portfolio	$17,000,000	Gross Portfolio	($3,000,000)
LLR	$1,155,000	LLR	$1,005,000	LLR	($150,000)
Net Receivable	$18,845,000	Net Receivable	15,995,000	Net Receivable	($2,850,000)
Total Assets	**$19,595,000**	**Total Assets**	**20,195,000**	**Total Assets**	**$600,000**
Liabilities		*Liabilities*		*Liabilities*	
Long-Term Debt	$13,000,000	Long-Term Debt	13,000,000	Long-Term Debt	$0
Total Liabilities	**$13,000,000**	**Total Liabilities**	**13,000,000**	**Total Liabilities**	**$0**
Total Net Assets	$6,595,000	*Total Net Assets*	7,195,000	*Total Net Assets*	$600,000
Net Asset Ratio	*33.66%*	*Net Asset Ratio*	*35.63%*	*Net Asset Ratio*	*1.97%*

Portfolio Aging			*Portfolio Aging*		
Current	$19,550,000	97.75%	Current	$16,550,000	97.35%
Less than 30	$250,000	1.25%	Less than 30	$250,000	1.47%
31 to 60	$125,000	0.63%	31 to 60	$125,000	0.74%
61 to 90	$50,000	0.25%	61 to 90	$50,000	0.29%
More than 90	$25,000	0.13%	More than 90	$25,000	0.15%
Total Portfolio	**$20,000,000**		**Total Portfolio**	**$17,000,000**	
Total >30 DPD	**$200,000**	**1.00%**	**Total >30 DPD**	**$200,000**	**1.18%**
Total Reserve	**$1,155,000**	**5.78%**	**Total Reserve**	**$1,005,000**	**5.91%**

[4] Will drop in future periods as LLR goes back up and the earned income drops from lost interest.

Loan sales to SPVs typically do not come with significant premiums, but they do impact a CDFI's earned income and expenses (although in different ways). The CDFI immediately receives an origination fee and also gains some servicing fee income but loses all interest income from the loans it originates. Simultaneously, because the CDFI also needs less debt capital, it reduces its interest expense. It also reduces its loan loss provision expenses (and does not have to reserve against losses) since the loans are not held on its balance sheet. Finally, in most programs, client acquisition costs are reduced because the public sector supporters (or other partners) are conducting advertising for the program. Thus, CDFIs reduce their client acquisition cost but may increase their underwriting expenses due to the higher origination volume. After balancing these changes to their costs and revenues, most CDFIs have been able to generate some positive income from participating in these programs.

CONCLUSION

The CDFI industry has long needed new tools to support the capitalization needs of growing lenders. As such, the emergence of loan sales and secondary markets is a valuable and long awaited development. Although CDFIs and their investors and funders have called for the emergence of these tools, realizing their value will require new ways of thinking and new practices. CDFIs will need to think of their loans as assets that have value for others and to identify when selling them can yield important financial benefits while still maintaining valued client relationships. Funders and investors will need to adapt their investment and grantmaking practices to account for the impact of these strategies on financial ratios that inform their decisions. By making minor modifications to their calculations and time horizons for these ratios, CDFI investors and funders can become important allies as CDFIs build more diversified and sustainable financial models.

ACKNOWLEDGMENTS

The authors are Brett Simmons, managing director at Scale Link, and Joyce Klein, senior director at the Aspen Institute's Business Ownership Initiative, an initiative of the Economic Opportunities Program.

Suggested Citation

Simmons, Brett, and Joyce Klein. "We Have New Tools To Capitalize CDFI Growth – Let's Use Them." Business Ownership Initiative, Economic Opportunities Program, The Aspen Institute. October 2023. https://www.aspeninstitute.org/publications/we-have-new-tools-to-capitalize-cdfi-growth-lets-use-them/

ABOUT

Scale Link

Scale Link, previously the Entrepreneur Backed Assets (EBA) Fund, empowers community-based financial institutions (CDFIs) to lend to small businesses in low-income communities and those owned by people of color. It does so by purchasing existing loans originated by CDFI microlenders and creating a secondary market for them. By bundling microloans from different CDFIs and pooling them together for banks to purchase, Scale Link provides the CDFIs with capital for new lending. This translates into real change for the communities and people who need it most. Learn more at scalelink.org.

Business Ownership Initiative

The Business Ownership Initiative, an initiative of the Aspen Institute Economic Opportunities Program, works to build understanding and strengthen the role of business ownership as an economic opportunity strategy. We work closely with micro- and small business practitioners and the institutions that invest in them around the US to build knowledge and strengthen practice by exploring innovation, conducting research, evaluating new ideas, and supporting leaders. BOI also serves as a resource to donors and investors interested in microenterprise in the United States. Learn more at aspeninstitute.org/boi.

Economic Opportunities Program

The Aspen Institute Economic Opportunities Program (EOP) advances strategies, policies, and ideas to help low- and moderate-income people thrive in a changing economy. We recognize that race, gender, and place intersect with and intensify the challenge of economic inequality and we address these dynamics by advancing an inclusive vision of economic justice. For over 25 years, EOP has focused on expanding individuals' opportunities to connect to quality work, start businesses, and build economic stability that provides the freedom to pursue opportunity. Learn more at aspeninstitute.org/eop.

The Aspen Institute

The Aspen Institute is a global nonprofit organization whose purpose is to ignite human potential to build understanding and create new possibilities for a better world. Founded in 1949, the Institute drives change through dialogue, leadership, and action to help solve society's greatest challenges. It is headquartered in Washington, DC and has a campus in Aspen, Colorado, as well as an international network of partners. For more information, visit www.aspeninstitute.org.

This brief was developed as part of the Global Inclusive Growth Partnership, a collaboration between the Aspen Institute and the Mastercard Center for Inclusive Growth

GLOBAL INCLUSIVE GROWTH PARTNERSHIP

Center for Inclusive Growth | aspen institute