Community Development Financial Institutions (CDFIs)

Providing Capital, Building Communities, Creating Impact

Fiscal Year 2002

A Publication of the CDFI Data Project

This report is a product of the CDFI Data Project (CDP)—an industry collaborative that produces data about Community Development Financial Institutions (CDFIs). The goal of the CDP is to ensure access to and use of data to improve practice and attract resources to the CDFI field. ***CDFIs: Providing Capital, Building Communities, Creating Impact*** analyzes fiscal year 2002 data collected through the CDP from 442 CDFIs.

A Publication of the CDFI Data Project

Written by the CDP Publication Committee:

- Aspen Institute
- Community Development Venture Capital Alliance
- Corporation for Enterprise Development
- National Federation of Community Development Credit Unions
- National Community Capital Association
- National Community Investment Fund

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Community Development Financial Institutions (CDFIs) provide critical financial products and services to economically disadvantaged people and communities throughout the United States. CDFIs respond to the gaps in the marketplace that mainstream financial institutions do not respond to by offering financial and development services to individuals, businesses, community services providers, and affordable housing developers in low-income communities throughout the United States.

Approximately 1,000 CDFIs operate today in the United States. This study includes data from 442 CDFIs in fiscal year (FY) 2002, one of the largest data sets ever collected on the CDFI industry.

Highlights of the data include:

CDFIs are growing rapidly, but continue to represent a fraction of the broader financial services industry. The 442 CDFIs in this study held $10.2 billion in assets. For CDFIs for which we have three years of data (284 CDFIs), assets grew at a compound annual growth rate of 13% per year. This growth is impressive as it occurred in the 2000 to 2002 time frame, when the U.S. economy was going through an economic slowdown and recession. Despite the continued growth in the industry, CDFIs represent only 0.1% of the $8 trillion in financial institutions.

While the industry shares a common goal to promote community development and meet the needs of underserved populations, there are substantial differences in institution types, corporate structures, products, and markets served, which allow for maximum value to customers. There are four main sectors of CDFIs—banks, credit unions, loan funds, and venture capital (VC) funds—that provide services to different, yet overlapping, segments of the community development universe. CDFIs offer a variety of financial products; while loans account for 97% of financing activity, other niche products such as equity investing, near-equity investing, and guarantees are growing segments in the CDFI industry.

CDFIs are having enormous impacts on low-income communities in the form of new high-quality jobs, affordable housing units, community facilities, and financial services to low-income people.

In FY 2002, CDFIs:

- Provided $2.6 billion in financing
- Financed and assisted 7,800 businesses that created or maintained more than 34,000 jobs
- Facilitated the construction or renovation of more than 34,000 units of affordable housing
- Built or renovated more than 500 community facilities in economically disadvantaged communities
- Provided mortgages to 4,100 people and provided more than 4,800 alternatives to payday loans

CDFIs serve markets traditionally underserved by conventional financial institutions. CDFI customers were 53% female, 60% minority, and 70% low income, all much higher proportions than the mainstream financial institution sector. These customers typically are those who have been turned down by conventional financial institutions because they do not have sufficient collateral or do not have sufficient capacity and resources to borrow from banks.

Portfolio performance is strong despite difficult economic times during the past few years. CDFIs are adept at managing risks through a combination of adequate equity capital and loan loss reserve, close monitoring of portfolios, and provision of technical assistance when needed. CDFIs had a net charge-off ratio of 0.7%, which rivals the net charge-off ratio of 0.97%[1] for all financial institutions. Delinquency ratios are also relatively low. Banks and loan funds had delinquency rates greater than 90 days of 1.4% and 3.6%, respectively, and credit unions, which measure delinquency by a different metric, had a delinquency rate greater than 60 days of 1.9%.

[1] Federal Deposit Insurance Company, December 2002.

Report Overview

The second section of this report provides a comprehensive overview of the entire CDFI industry. The next four sections provide a more in-depth discussion of the four institution types—community development banks, community development credit unions, community development loan funds, and community development venture capital funds. This is followed by a section on microenterprise financing and a conclusion discussing some of the opportunities and challenges the industry faces.

Figure **1** **Summary of FY 2002 CDFI Data**

	All	Bank	Credit Union	Loan Fund (1)	Venture Capital
Number of CDFIs	442	17	239	165	21
Total Assets	$10,215,859,701	$3,578,584,663	$3,087,949,723	$3,351,479,771	$197,845,543
Average Assets	$23,112,805	$210,504,980	$12,920,292	$20,311,999	$9,421,216
Total Full-time equivalent employees (FTEs)	4,586	1,317	893	2,305	71
Number of CDFIs Reporting	291	17	100	157	17
Total Loans and Investments Outstanding	$6,257,284,350	$1,995,324,237	$2,163,353,439	$1,987,042,883	$111,563,791
Average Loans and Investments Outstanding	$14,551,824	$117,372,014	$9,051,688	$12,902,876	$5,578,190
% of Loans and Investments Outstanding ($)					
Business	18%	57%	3%	14%	99%
Community Service	6%	1%	1%	9%	0%
Housing	60%	30%	40%	74%	0%
Microenterprise	2%	2%	1%	3%	1%
Other	1%	1%	4%	0%	0%
Personal Development	12%	10%	52%	0%	0%
Number of CDFIs Reporting	272	5	99	148	20
% of Loans and Investments Outstanding (#)					
Business	4%	19%	0%	9%	75%
Community Service	1%	0%	0%	3%	1%
Housing	26%	21%	8%	69%	0%
Microenterprise	6%	3%	1%	19%	24%
Other	4%	0%	6%	0%	0%
Personal Development	59%	57%	85%	0%	0%
Number of CDFIs Reporting	270	4	99	148	20
Total Capital (2)	$9,221,790,765	$3,214,230,247	$3,062,881,807	$2,682,281,742	$262,396,969
% of Debt Capital, Shares, & Deposits (3,4) from:					
Corporations	9%	24%	2%	8%	4%
Federal Government	7%	4%	0%	13%	20%
Financial Institutions	18%	2%	5%	39%	29%
Foundations	8%	0%	1%	17%	38%
Individuals	45%	61%	81%	4%	0%
National Intermediaries	2%	1%	1%	3%	2%
Nondepository Financial Institutions	1%	0%	0%	3%	4%
Other	3%	0%	6%	3%	1%
Religious Institutions	4%	2%	2%	6%	0%
State Government	3%	6%	0%	5%	1%
Number of CDFIs Reporting	275	6	99	151	19

Notes:
1. Loan funds include two multibank community development corporations.
2. Total capital for VC funds includes capital committed (and not drawn down) and is also called "capital under management."
3. Debt capital breakout does not include credit union borrowings.
4. One outlier is excluded from loan fund debt capital breakouts.

CDFIs are specialized financial institutions whose core purpose is to provide financial products and services to people and communities underserved by traditional financial markets. Currently, approximately 1,000 CDFIs operate in low-wealth communities in all 50 states, the District of Columbia, and Puerto Rico. CDFIs provide affordable banking services to individuals and help finance small businesses, affordable housing, and community services that, in turn, help stabilize neighborhoods and alleviate poverty. In addition, CDFIs provide credit counseling to consumers and technical assistance to small business owners and housing developers to help them use their financing effectively.

CDFI customers include a range of individuals and organizations:

> **Small business owners** who bring quality employment opportunities and needed services to economically disadvantaged communities

> **Affordable housing developers** who construct and rehabilitate homes that are affordable to low-income families

> **Community services providers** that provide childcare, health care, education, training, arts, and social services in underserved communities

> **Individuals** who require affordable banking services, including basic checking and savings accounts, responsible alternatives to predatory financial companies, and mortgages and other kinds of loans

Why Are CDFIs Needed?

A growing gap exists between the financial services available to the economic mainstream and those offered to low-income people and communities. CDFIs help bridge that gap by bringing capital and financial services to these underserved people and communities, affording them access to capital to start and expand businesses, build and purchase homes, and develop needed community facilities.

As mainstream lenders have increasingly consolidated, grown in size, and streamlined their operations, their connections to local communities have diminished. Millions of families today either have no relationship with mainstream lenders or depend on fringe financial institutions. This exacerbates long-standing difficulties that low-income families, and the nonprofit institutions that serve them, have had in accessing credit and financial services.

In the absence of these conventional financial service providers, high-cost check cashing services and payday lenders have moved into low-income communities. They prey on unsophisticated borrowers, draining wealth from these distressed neighborhoods and contributing to the growing economic inequality in the United States. Payday lenders, for instance, offer quick cash but charge exorbitant annual interest rates, in one recent study ranging between 450% and 880%.[2] CDFIs offer responsible alternatives to these predatory lenders, providing necessary products and services at a fraction of the costs to consumers.

Mainstream financial institutions also do not sufficiently meet the capital needs of nonprofit institutions that provide critical community services in economically disadvantaged communities and of small businesses that employ people and provide services in low-income communities. These organizations often do not have enough collateral to meet conventional banking standards or do not have the capacity and resources to borrow from banks. CDFIs are able to use their combination of flexible capital products, coupled with critical technical assistance, to serve these markets and at the same time manage their risks.

CDFIs respond to market needs for affordable housing, small business development and job creation, the creation of community facilities, financial literacy, and consumer education. They also provide safe and fair mechanisms for low-income customers to do such simple things such as opening a checking account and obtaining a mortgage.

CDFI activities fit into two broad categories. First, all CDFIs provide financial services, which include activities such as loans, equity investments, deposits, and consumer financial products. Second, all CDFIs also provide nonfinancial services. For some organizations, these represent fairly modest complements to their larger financial service activities; for others, they represent the majority of the organization's work. These activities include entrepreneurial education, homeownership counseling, savings programs, and financial literacy training.

[2] "Payday Lenders Burden Working Families and the U.S. Armed Forces", a report of the Southwest Regional Office of Consumers Union, July 2003.

The Four Sectors of the CDFI Industry

As with mainstream lenders, a variety of institutions have emerged to serve the broad range of needs in CDFI markets. While sharing a common vision of expanding economic opportunity and improving the quality of life for low-income people and communities, different business models and legal structures define the four CDFI sectors: banks, credit unions, loan funds, and VC funds.

> **Community development banks** provide capital to rebuild economically distressed communities through targeted lending and investing. They are for-profit corporations with community representation on their boards of directors. Depending on their individual charter, banks are regulated by some combination of the Federal Depository Insurance Corporation (FDIC), the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and state banking agencies. Their deposits are insured by the FDIC.

> **Community development credit unions (CDCUs)** promote ownership of assets and savings and provide affordable credit and retail financial services to low-income people, often with special outreach to minority communities. They are nonprofit financial cooperatives owned by their members. Credit unions are regulated by the National Credit Union Administration (NCUA), an independent federal agency, by state agencies, or both. In most institutions, deposits are also insured by the NCUA.

> **Community development loan funds (CDLFs)** provide financing and development services to businesses, organizations, and individuals in low-income communities. There are four main types of loan funds: microenterprise, small business, housing, and community service organizations. Each is defined by the client served, though many loan funds serve more than one type of client in a single institution. CDLFs tend to be nonprofit and governed by boards of directors with community representation.

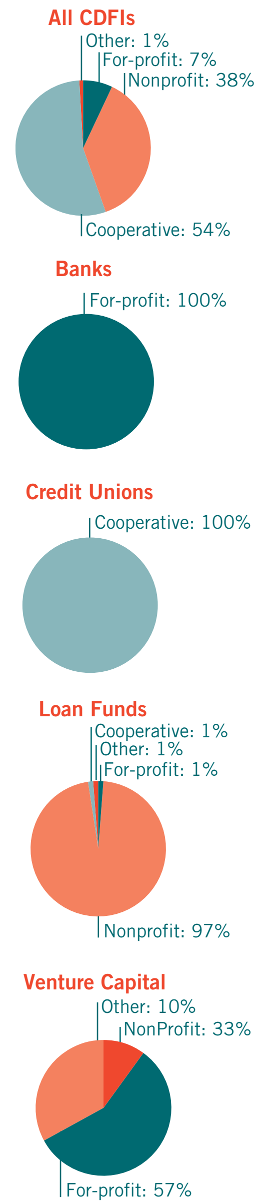
> **Community development venture capital (CDVC)** funds provide equity and debt-with-equity-features for small- and medium-sized businesses in distressed communities. They can be either for-profit or nonprofit and include community representation.

Within certain constraints, CDFIs choose the legal structure that maximizes value and resources to the people and communities they serve. The different corporate structures allow for different capitalization products, financing products, and regulations.

As demonstrated in Figure 2, community development banks are all for-profit entities and CDCUs are nonprofit cooperatives with members (and customers) as shareholders. Nearly all of the depositories—credit unions and banks—are regulated by state or federal agencies (or both) and use insured deposits and shares to capitalize their organizations.

The vast majority of CDLFs (97%) are nonprofit. The CDVC field is the most varied, with a third structured as nonprofits, nearly 60% as for-profits, and the remaining as quasi-government. The for-profit category includes limited liability companies (LLCs), limited partnerships (LPs), and C-corporations among their corporate structures. The loan funds and venture funds are unregulated institutions.

Figure **2** Legal Structures of CDFIs



Timeline of CDFIs

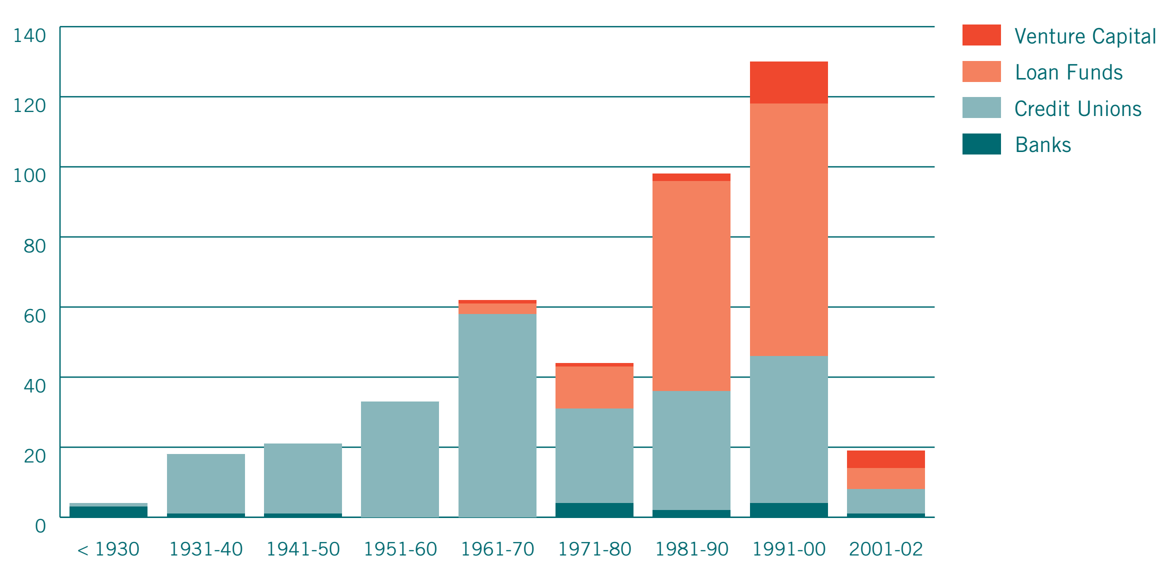
The roots of the CDFI industry go back to the early 1900s. Some of the first CDFIs were depository institutions including credit unions and banks. They collected savings from the communities they served in order to make capital for loans available to those communities. Credit unions and banks dominated the CDFI field until the 1960s and 1970s when community development corporations and community development loan funds emerged to make capital available for small businesses and affordable-housing developers.

In the 1990s, the CDFI industry grew significantly. Thirty-five percent of the CDFIs in our sample were established after 1990. Several factors contributed significantly to this growth, most notably, the creation and subsequent growth of the CDFI Fund (see p. 9). The federal government also strengthened provisions and enforcement of the Community Reinvestment Act (CRA) during the 1990s.[3] In particular, the 1995 CRA regulations, which classified loans and investments in CDFIs as qualifying CRA activity, increased those activities. National trade associations and intermediary organizations played a crucial role, emerging as important players dedicated to organizing and professionalizing the CDFI industry. Most important, by the mid-1990s, the industry had established a successful track record in making effective, prudent use of capital in economically disadvantaged markets.

The four institution types have distinct histories and growth trajectories (see Figure 3). Community development banks and credit unions are the maturest sectors, with institutions dating back to the turn of the 20th century. They have had slow and steady growth for the past several decades. Loan funds are much newer, with 85% of this sector established in the 1980s and 1990s. VC funds are newer still: Only two VC funds in this study began financing before 1980, and more than 75% started financing after 1996.

[3] The Community Reinvestment Act of 1977 places responsibilities on depository institutions to lend to, invest in, and serve all of the communities in which they receive deposits from customers.

Figure **3** **Number of CDFIs by Decade**



Year is year of charter for credit unions and year the institution started financing for other sectors.

What Is the CDFI Fund?

In 1994, the federal government established the CDFI Fund as a new program within the U.S. Department of Treasury. Its goal is to strengthen the growing network of CDFIs, using them to make capital and financial services available to the nation's underserved people and communities. The CDFI Fund operates three principal programs:

> **CDFI Program** provides loans, equity investments, and grants to CDFIs to support capitalization and capacity building, enhancing the ability of CDFIs to create community development impact in underserved markets. This program comprises three components: Financial Assistance, Technical Assistance, and Native American CDFI Development Assistance.

> **Bank Enterprise Award (BEA) Program** provides financial incentives to banks and thrifts to invest in CDFIs and support other community development finance work.

> **New Markets Tax Credit Program** is a new effort to provide tax incentives to the private sector to encourage companies to make more than $15 billion in equity investments in low-income communities.

The CDFI Fund is now the largest single source of funding for CDFIs, and the largest source of hard-to-get equity capital. It plays an important role in attracting and securing private dollars for CDFIs by requiring them to match their award with nonfederal funds. Between 1995, its first year of funding, and 2003, the Fund made more than $610 million in awards to CDFIs and financial institutions through the CDFI and BEA programs. CDFIs have received more than $430 million in awards, of which approximately 80% is equity capital.

CDFI Certification

CDFIs certified by the CDFI Fund must meet a number of criteria, including pursuing a primary mission of community development and providing financing as a primary line of business. The primary benefit of certification is access to the CDFI Program, which provides grant and loan support to CDFIs through a competitive application process.

As of January 2004, there were 643 certified CDFIs. Of the CDFIs in the CDP study, 261, or 59%, are certified CDFIs. Some CDFIs—including many surveyed by the CDP—are not certified, either because they have chosen not to apply for certification or they do not meet all of the Fund's eligibility criteria. Most banks, loan funds, and VC funds represented in this study are certified CDFIs (see Figure 4). The lower percentage of certified credit unions (38%) is due to the judgment of many qualifying small CDCUs that the costs of applying and reporting outweigh the benefits.

Figure **4** **Percentage of Certified CDFIs in the CDP Sample**

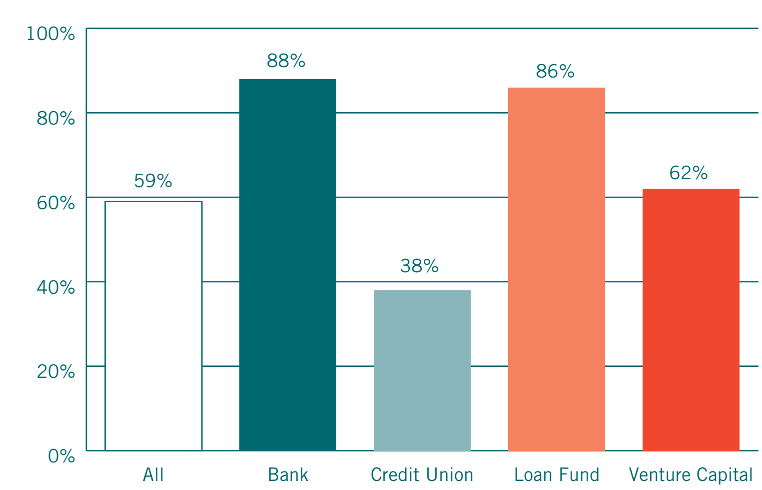
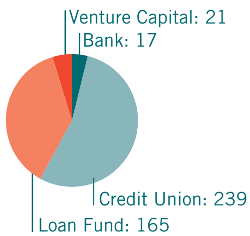


Figure **5**

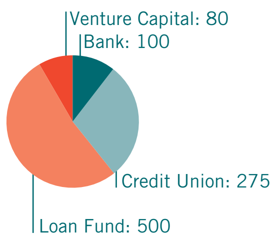
Size and Scope of CDFI Field

The FY 2002 CDP data set represents 442 CDFIs of the approximately 1,000 CDFIs operating in the United States. The CDP estimates that there are, in total, approximately 100 community development banks, 275 CDCUs, 500 CDLFs, and 80 CDVC funds. The CDP sample (Figure 5) represents a significant percentage of each of the CDFI sectors.

CDP Sample



Total Number of CDFIs



Estimates from CDFI trade associations and intermediaries.

Asset Size of CDFIs

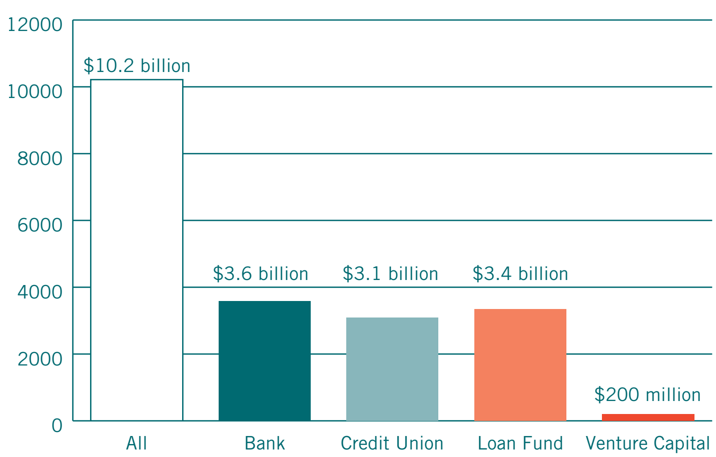
The CDFIs in this study managed $10.2 billion in assets at the end of FY 2002. While this represents a significant amount of capital for underserved communities, it is still quite modest compared with the mainstream financial sector. In 2002, for comparison, U.S. financial institutions alone controlled almost $8 trillion in assets.[4] Thus, while the growth of the CDFI sector over the past decade is significant in relative terms, the industry remains a specialized, niche player in the wider financial services industry.

Institution size varies substantially across and within the four CDFI sectors. The CDCU sector represents a large number of small organizations, the inverse of the banking sector. For example, 17 community development banks together hold more in assets ($3.6 billion) than the 239 credit unions ($3.1 billion). The median bank holds $144 million in assets, and the median credit union only $1.5 million. Loan funds represent 33% of our sample (or $3.4 billion) with a median size of $5.1 million. VC funds also tend to be small institutions relative to banks. Specializing in the niche products of equity and near equity, they managed 2% of total assets reported, with a median asset size of $6.5 million.

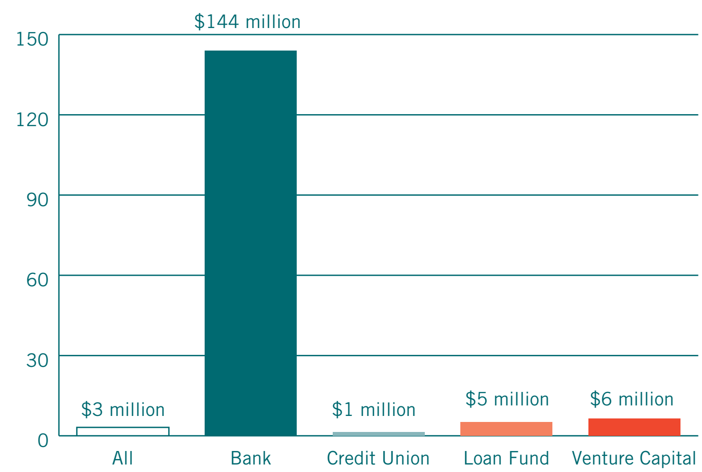
[4] As of December 31, 2002, according to the Federal Deposit Insurance Corporation.

Figure **6** **CDFI Assets**

Total Assets (in millions)



Median Assets (in millions)



Distribution of Assets

A small number of CDFIs also hold a substantial portion of the field's total assets. The largest 5 CDFIs control 39% of the sample's assets, and the largest 10 control 50%. The largest 5 CDFIs include institutions in three of the four sectors: two banks, two loan funds, and one credit union.

CDFIs vary widely by size. Some are small institutions that focus on the needs of a specific community or sector. Others are relatively large (though small by mainstream lending standards) and serve entire states or regions, using multiple products and services within an area. On the whole, the credit union sector is made up of small or very small institutions. Although not as small on average, most loan funds and VC funds tend toward this end of the spectrum as well. Most banks, on the other hand, are large or very large (see Figure 8).

While most organizations (76%) in the field have less than $10 million in assets, overall industry results are skewed by a handful of very large institutions, a category that includes banks, loan funds, and credit unions. Of the 19 CDFIs with more than $100 million of assets, three are loan funds, six are credit unions, and 10 are banks.

Figure **7** **Concentration of Assets**

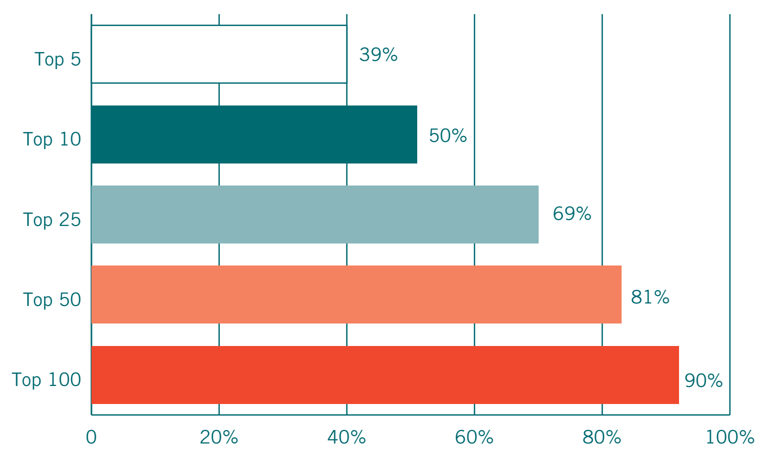
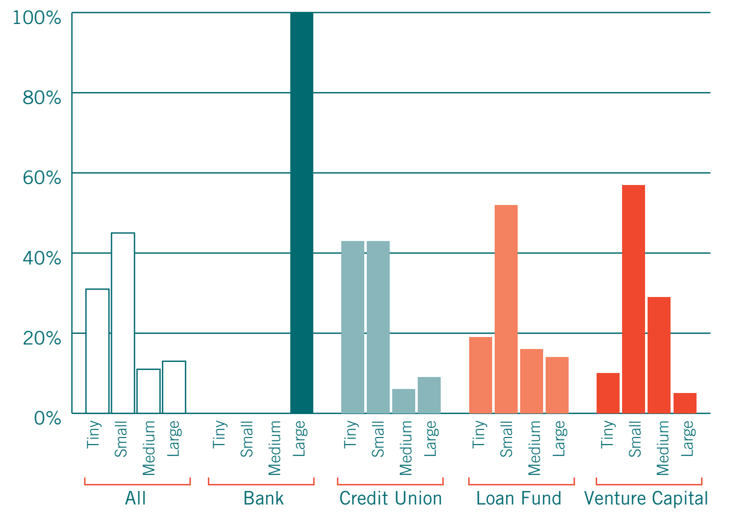


Figure **8** **Distribution by CDFI Size**



Tiny: Total Assets less than $1 million; Small: Total Assets $1-$10 million; Medium: Total Assets $10-$25 million; Large: Total Assets greater than $25 million

Markets Served

CDFIs tend to concentrate in certain areas of the country. The Northeast, Upper Midwest, Texas, and California have a high concentration of CDFIs (see Figure 9). CDFI financing activity also concentrates in these areas because of the high number of CDFIs in those areas. A few states that also house the largest CDFIs (North Carolina, Illinois, New York, and Texas) also hold a high concentration of CDFI financing activity. Five states (North Carolina, Texas, California, Michigan, and New York) are home to the CDFIs that did 65% of total financing activity in FY 2002.[5] CDFIs in our study are located in 48 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

Figure **10**
Rural–Urban Distribution

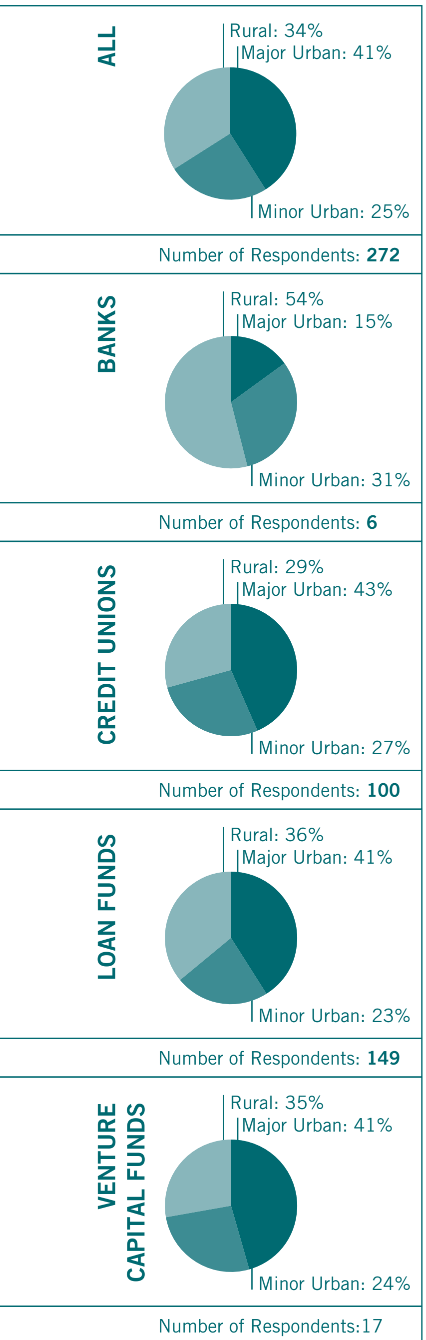
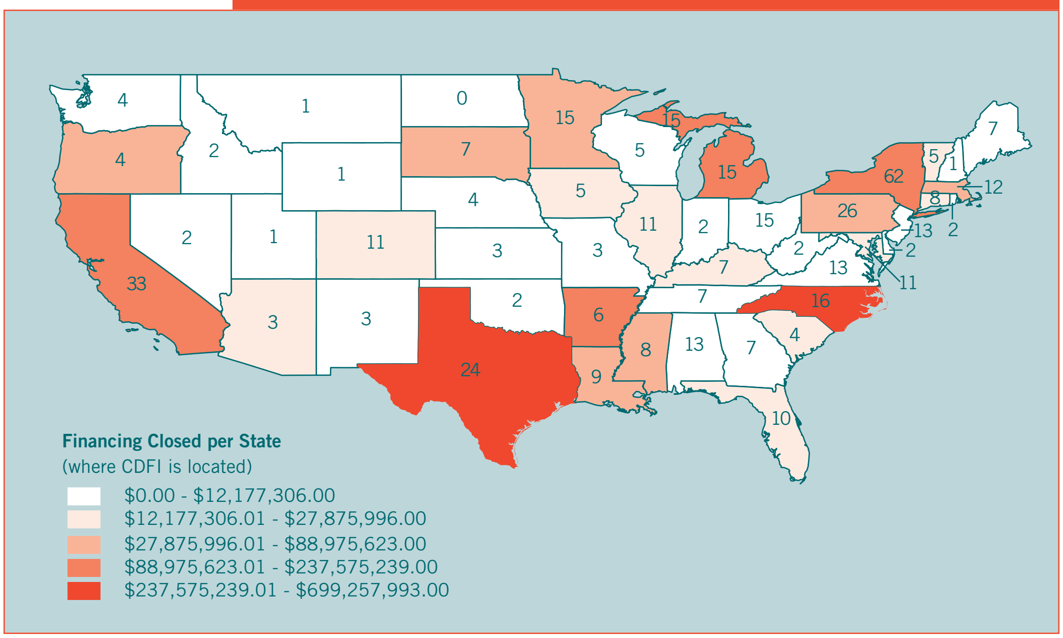


Figure **9** **Total Financing Closed and Number of CDFIs by State**

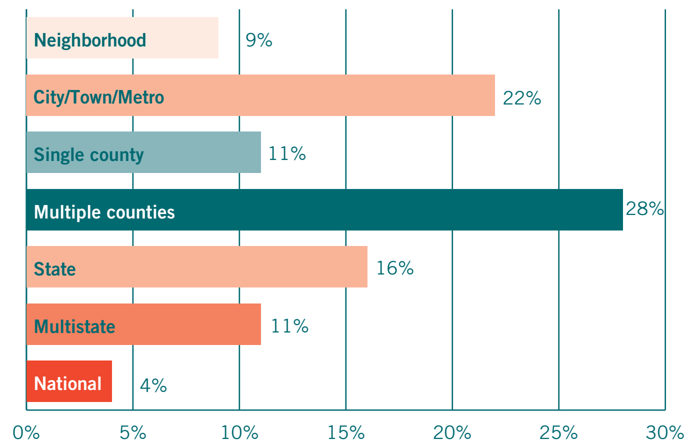


CDFIs serve a mix of rural and urban markets across the country. Of the CDFIs that reported, 146 CDFIs in our sample served both rural and urban markets, 102 operated exclusively in urban markets, and 24 operated exclusively in rural markets. Overall, 41% of CDFI clients are from major urban areas,[6] 34% from rural areas, and 25% from minor urban areas.[7] The principal variation is with banks, which in this study had a higher concentration in rural areas. However, only six banks responded to this question, and this is not representative of the community development banking geographical concentration, which tends to be urban. Credit unions, loan funds, and VC funds exhibit strikingly similar patterns of geographical coverage (see Figure 10).

[5] While 43 CDFIs in our study serve a multistate or national population, all of their financing is captured in the state where the CDFI is located.
[6] Major urban is defined as a metropolitan statistical area greater than one million residents.
[7] Minor urban is defined as a metropolitan statistical area less than one million residents.

There is significant variation in the geographical markets served by CDFI types ranging from a city or town to a national service area (see Figure 11). In general, credit unions tend to serve smaller geographical markets because their customers are typically in close proximity to the credit union, often going to the credit union branch for services. Venture funds, however, cover larger geographical areas. Seventy-six percent serve a state or multistate service area because their specialized equity products require a larger market area to operate efficiently. Loan funds vary in their markets served, and are the only CDFI type, with 11 loan funds, that serve a national service area. Many began serving a smaller area, but developed niche products and expanded to a larger service area.

Figure **11** Geographical Markets Served



Geographical Market Served by Institution Type

	All	Bank	Credit Union	Loan Fund	Venture Capital
Neighborhood	26	0	25	1	0
City, Town, or Metropolitan Area	66	4	36	26	0
Single County	33	1	21	10	1
Multiple Counties	82	6	14	58	4
State	48	0	4	35	9
Multistate	32	3	1	21	7
National	11	0	0	11	0
Number of Respondents	298	14	101	162	21

CDFI Outcomes, Impacts, and Clients

The work of CDFIs reaches many individuals and communities, particularly those traditionally underserved by mainstream financial institutions. CDFIs strive for—and achieve—social and economic benefits that align with their institutional missions. The community development impacts of CDFIs' financing and other products go well beyond easily measurable impacts. These include helping borrowers open their first formal bank account, improving financial literacy or entrepreneurial skills, opening bank or credit union branches in markets not typically served by financial institutions, and providing much needed technical assistance.

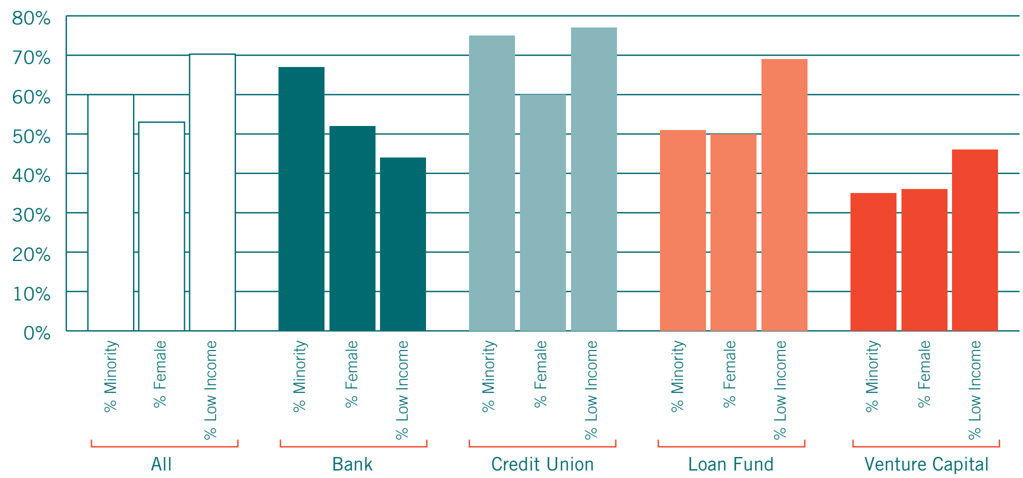
CDFI Client Characteristics

CDFIs are successful in reaching underserved customer groups—low-income families, minorities, and women, in particular. Seventy percent of CDFIs' clients are low income, 60% are minorities, and about 50% are women (see Figure 12). Credit unions, with their focus on financial services to low-income and minority individuals, had the highest percentage in all of these categories.

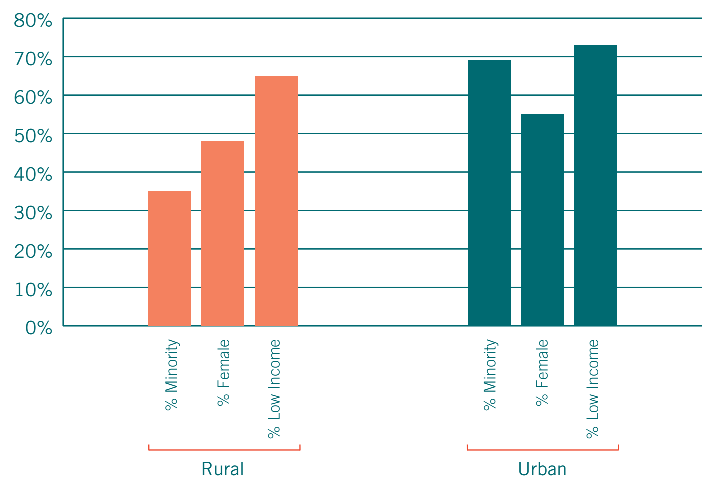
While CDFIs focus on serving low-income and minority markets, these markets represent a core niche for individual institutions. Fifty-four percent of all CDFIs report that more than three-fourths of their clients are low-income. Forty-four percent of the CDFIs report a similar concentration of minority clients. Customer profiles vary somewhat by the CDFI size and market served. Smaller and urban CDFIs have somewhat higher percentages of low-income, minority, and female customers.

Figure **12** **Customer Profile**

By Institution Type



By Rural/Urban Focus



CDFI Sectors Served and Outcomes

CDFIs provide financial and nonfinancial services to a variety of sectors and clients. While there is substantial variation among and between sectors, CDFI activities fall into six main categories: microenterprise, small- and medium-sized business, community services, housing, consumer, and other (see Figure 13 for a breakout by sector).[8] CDFIs that finance these different strategies are looking for different outcomes and impacts.

[8] Several CDFIs cannot break out their financing outstanding into these sectors; therefore, the total figures in each sector underrepresent the total financing activity among sectors.

Figure **13** **Financing Outstanding by Sector**

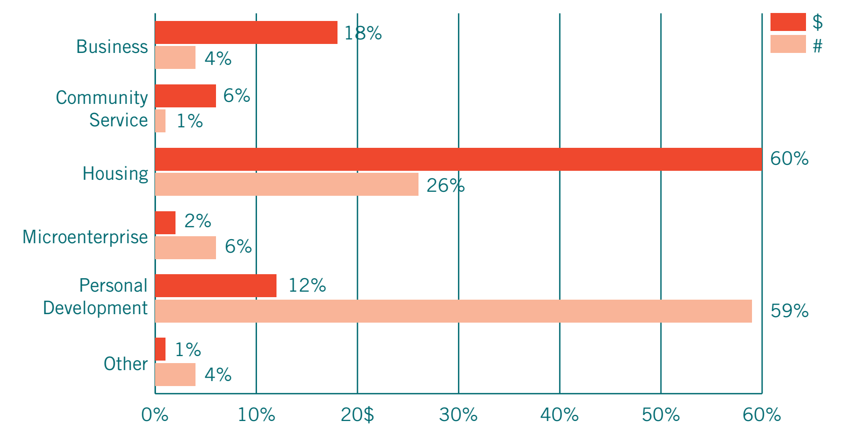
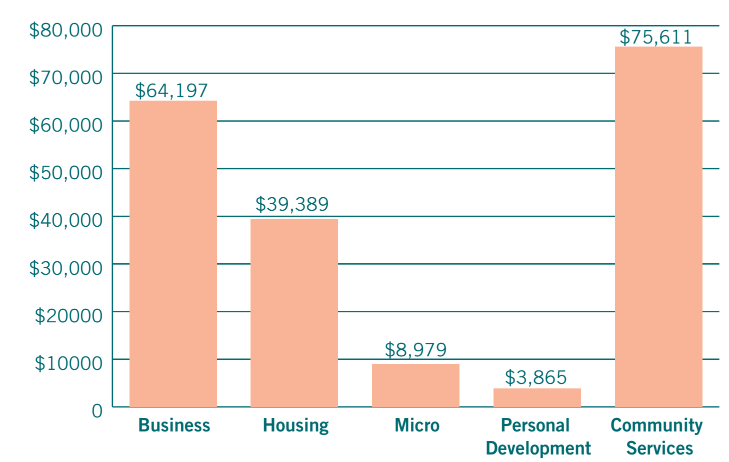


Figure **14** **Median Loan and Investment Size by Sector**



Microenterprise

$66 million outstanding at FYE 2002

8,740 transactions outstanding at FYE 2002

5,451 microenterprises financed in FY 2002

Microenterprise development includes financing to businesses that have five or fewer employees with a maximum loan or investment of $25,000. This financing is typically for the start-up or expansion of businesses, working capital, or equipment purchase.

Clients are typically low- or moderate-income individuals in the very early stages of small business development. They have a skill or idea they want to turn into a business but lack the capital, the technical and management expertise, and the role models that higher-income entrepreneurs tend to access more easily. Most CDFIs that assist microenterprises provide substantial nonfinancial services, such as entrepreneurial training, business coaching, and networking opportunities. In the early stages of business development, these skill-building activities are often more critical to businesses than the infusion of capital. Microenterprise loans help provide self-employment opportunities for these entrepreneurs, many of whom would not have the opportunity without CDFI loans.

One hundred and twelve CDFIs in our sample (25%) provided microenterprise financing in FY 2002, of which 89 were loan funds. Of the 89 loan funds, 25% provided microenterprise financing exclusively as a financing strategy. Microenterprise financing is characterized by a high number of transactions and relatively small dollar amounts of loans. For the loan fund sector in FY 2002, microenterprise financing accounted for only 3% of financing outstanding in dollars outstanding but 19% in terms of the number of loans. See page 44 for a more in-depth discussion of microenterprise.

Small- and Medium-Sized Businesses

$538 million outstanding at FYE 2002

5,810 transactions outstanding at FYE 2002

2,393 businesses financed in FY 2002

34,283 jobs created and maintained in FY 2002 (includes activity from microenterprise financing)

Small- and medium-sized business development includes financing (both loans and equity investments) to businesses that have more than five employees or need more financing than microenterprises. Substantial technical assistance is also provided, though it tends to be more specialized one-on-one assistance than for most microenterprise programs. In their loans and investments to these businesses, CDFIs consider social benefits such as how many jobs will be created, what kind of salaries and benefits are offered, whether the business is located and provides services in a disinvested location, and what the environmental impact of the business will be.

One hundred thirty-two CDFIs in our sample provided business financing including all 20 of the VC funds, 87 loan funds, 20 credit unions, and five banks. Business financing represents virtually all (99%) of venture funds' financing and a majority (57%) of banks' financing, and smaller percentages of the credit unions' and loan funds' financing.
The CDFIs in our study that financed microenterprises and small- and mid-sized businesses created and maintained more than 34,000 jobs.[9]

[9] This figure is significantly underreported. It does not capture all self-employment activity of microentrepreneurs, job data from the 138 credit unions for which we only have call report data (see Appendix A), and those CDFIs that do not track this information.

Housing

$1.8 billion outstanding at FYE 2002

36,838 transactions outstanding at FYE 2002

34,504 housing units assisted in FY 2002

4,107 mortgages closed in FY 2002

Housing financing among CDFIs includes two primary subcategories: financing to housing developers and direct mortgage lending to low-income individuals.

CDFIs make loans to housing developers for predevelopment, acquisition, construction, renovation, working capital, and mortgage loans. These loans support the development of rental housing, service-enriched housing, transitional housing, and residential housing.

With a rapidly shrinking supply of affordable housing to low-income families in both the rental and ownership markets, this effort addresses a critical need in many communities. CDFIs facilitated the construction or renovation of 34,504 units of affordable housing in 2002, with 96% of the activity from CDLFs. These affordable housing units typically provide for monthly payments that run less than 30% of a household's monthly income and enable low-income individuals to own or rent quality housing while preserving sufficient income to pay for other critical products and services.

Because CDCUs generally do not track housing units (and these data were not reported from those that did not complete the CDCU survey), housing units are substantially underreported for credit unions. According to National Credit Union Administration (NCUA) aggregate data, CDCUs closed 6,172 real estate loans for $278,418,420 in FY 2002. CDCU survey respondents (42% of all CDCUs) alone accounted for 48% of all CDFI mortgage loans, which included a large portion of second mortgage loans taken out to finance renovation or improvements.

CDFIs also provide loans to low-income families who cannot qualify for a mortgage from the mainstream financial sector. CDFIs closed 4,107 mortgages to homebuyers in 2002. These are typically first-time homebuyers who also need significant help working through this process. Many CDFIs providing direct mortgage financing also offer homeownership counseling or other services. CDFIs provide this mortgage financing as an affordable product to homebuyers and act as an alternative to predatory lenders in the community.

Housing financing is the largest sector, accounting for $1.8 billion, or 60%, of the sample's total financing outstanding. Banks, credit unions, and loan funds all provide substantial amounts of housing financing. One hundred thirty-six CDFIs had housing financing in FY 2002, including 59 credit unions, four banks, and 73 loan funds. Credit unions primarily provide mortgage loans to individuals, and loan funds primarily provide loans to housing developers, although a growing number of loan funds provide mortgage products as well. Of the 73 loan funds that provided housing financing, 43 provided loans exclusively to developers, 11 provided loans exclusively to individuals, and 19 provided loans to both developers and individuals.

Community Services

CDFIs provide financing to community services providers—human and social service agencies, advocacy organizations, cultural facilities, religious organizations, health care providers, childcare centers, and education providers—which provide critical and much needed services to low-income people and communities. Many community services providers have one or more niche markets in which they operate. This expertise enables them to provide critical advice on issues affecting the particular industry. The borrowers are primarily nonprofits and often require some form of technical assistance such as cash flow forecasting or securing other funds.

Sixty-four CDFIs in our sample provided community services financing, with a large majority (52) being loan funds. Community services financing accounted for 6% of all CDFI financing outstanding in FY 2002 and 9% of loan fund financing. In 2002, CDFIs financed 550 community facilities in distressed communities across the country.

$185 million outstanding at FYE 2002

1,360 transactions outstanding at FYE 2002

550 community service organizations financed in FY 2002

8,455 new and existing childcare slots assisted in FY 2002

158,855 new and existing educational slots assisted[10] in FY 2002

652,304 new and existing health care slots assisted in FY 2002

[10] The educational slots assisted include one CDFI that assisted a school district, which impacts 158,000 slots alone. The remainder of the CDFIs assisted 8,700 slots.

Personal Development

Consumer financial services are for individuals and include all personal loans for health, education, emergency, debt consolidation, transportation, and other consumer purposes. CDFIs also provide nonfinancial services such as financial literacy training or programs that encourage savings. In many low-income communities, these consumer financial services are provided not by mainstream lenders, but by institutions that specialize in check cashing, payday lending, and wire transfers at exorbitant and predatory rates.

$368 million outstanding at FYE 2002

84,953 transactions outstanding at FYE 2002

4,823 payday loan alternatives in FY 2002

2,455 loans to people with no credit history in FY 2002

Of the 107 CDFIs providing personal development financing, a large majority (97) were credit unions. Similar to microenterprise financing, consumer financing is characterized by a high number of transactions and relatively small dollar amounts of loans. The consumer financing sector accounts for 59% of all CDFI transactions in our sample, but only 12% of the dollar amount of transactions. The median loan size of $4,510 is substantially lower than that in any of the other financing sectors. Many of these loans are to people who have not previously had a relationship with a financial institution and do not have a credit history.

CDFI Products and Services

CDFIs deliver a range of products to meet the needs of their communities. These include financing products, retail and depository services (such as savings and checking accounts and Individual Retirement Accounts), training and technical assistance, advocacy and research, and other services that benefit the communities they serve. Most CDFIs have strong market knowledge and long-term relationships with clients, which help them develop the right mix of products for the communities they serve.

Figure **15** **FY 2002 Financing**

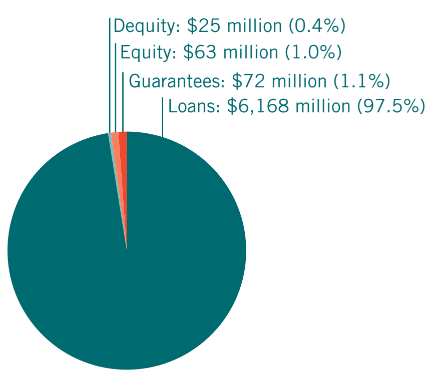
		# of CDFIs Reporting
Total Financing Outstanding in FY 2002 ($)	$6,330,056,642	430
Total Financing Outstanding in FY 2002 (#)	371,979	413
Total Financing Closed in FY 2002 ($)	$2,589,447,881	411
Total Financing Closed in FY 2002 (#)	268,434	411

At the end of 2002, the CDFIs in our study had nearly 372,000 financial investments outstanding, totaling $6.3 billion. Financing outstanding among individual CDFIs ranged widely, from $2,600 to $1 billion, with an average of $15 million. Again, the larger institutions account for a disproportionate share of financing. Ten CDFIs accounted for more than 55% of total financing outstanding.

CDFIs generated $2.6 billion of new financing activity in 2002: $1.9 billion of direct financing and $653 million of indirect financing. Direct financing includes loans, equity investments, and debt-with-equity-features closed during the year. Indirect financing is made by other financial institutions, in which the CDFI intervention (i.e., loan purchase[11] or guarantee) allows the financial institutions to finance additional community development loans and investments.

[11] Loan purchases are not a common activity for most CDFIs. The majority of the purchases are through a single CDFI, which purchases nonconforming home mortgages as a strategy to expand the scope of mortgage lending by mainstream financial institutions to low- and moderate-income borrowers.

Figure **16** **Financing Outstanding by Financial Product Type**



Financing Products Offered

CDFIs use four primary types of financing products to serve their communities: loans, equity investments, debt-with-equity-features (dequity), and guarantees (see Figure 16).

Loans

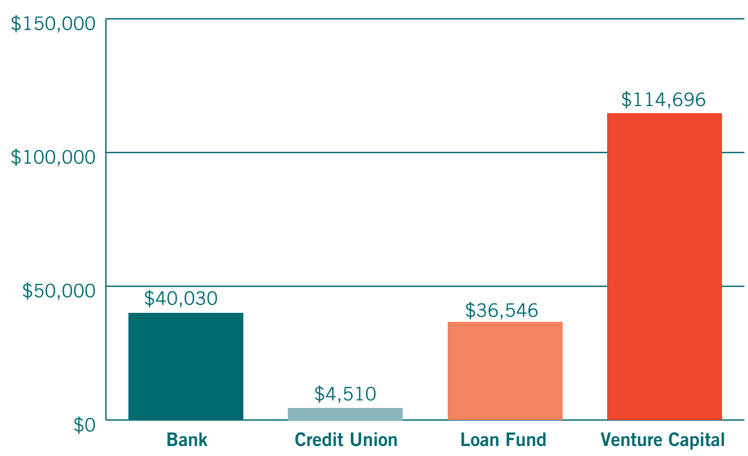
Loans are far and away the most used tool by CDFIs, representing $6.2 billion, or 97% of all financing outstanding. Loans represent virtually all financing from loan funds, credit unions, and banks. The only exception is VC funds, which are designed primarily for equity and near-equity investments.

CDFIs' loans include short-term (less than six months) and long-term (up to 30 years) loans, amortizing and balloon loans, and small (under $500) and large (more than $1 million) loans. Loan size varies greatly by the type of CDFI, largely according to the sectors and clients that the CDFI serves (see Figure 17). CDCUs primarily provide small loans to members, and, because of that, the average loan size at credit unions is significantly lower than that of other CDFI types. VC funds have a higher average loan size as they typically provide larger loans coupled with investments to businesses with high-growth potential that have substantial needs for working capital, equipment, or acquisition financing.

Equity investments

Equity investments are a newer but increasingly important tool for CDFIs as they seek to finance high-growth potential businesses that offer financial and social return. Equity investments are made in for-profit companies, where the CDFI receives an ownership interest in the company. In an equity investment, the CDFI shares both the risk and the potential financial gain the business experiences. The recent emergence of equity as a tool is reflected in the relatively modest numbers, and most such investment is concentrated in the VC sector: the $63 million in 248 equity transactions outstanding in 2002 represents 1% of the overall CDFI financing but 47% of VC financing (63% if one outlier is removed). Ninety-four percent of all equity investments are made by VC funds. Eleven loan funds made the rest, some of which have VC programs within the same corporate structure as the lending entity.[12] Credit unions and banks do not use equity financing. The median investment size at venture funds is $308,286 and the median at loan funds is $104,825.

Figure **17** **Median Loan Size by Institution Type**



Note: The CDP collects data on average loan size per CDFI. The median loan size represents the middle (or typical) loan size of the CDFIs in that sector.

[12] The CDP has divided CDFIs into four institution types: banks, credit unions, loan funds, and VC funds. For VC funds and loan funds, this represents the CDFI's primary institution type. Some CDFIs are classified as loan funds and have programs within their organizations that do VC investing. Some CDFIs are listed as VC funds and do a substantial amount of lending. Therefore, the VC fund and loan fund categories may underrepresent the lending and investing activity within that given sector.

Debt-with-equity-features

Debt-with-equity-features are loans that allow the CDFI to receive additional payments based on the performance of the borrower's company. Debt-with-equity-features include convertible debt, as well as debt with warrants, participation agreements, royalties, or any other feature that links the investment's rate of return to the performance of the company that received the investment. Twelve VC funds (or 57% of VC funds) and eight loan funds (5% of loan funds) use near-equity products. VC funds have always used these products in combination with equity to finance business growth. More recently, loan funds have begun using these products as well to offer an alternative to debt when the borrower requires more patient capital.

Debt-with-equity-features represented 0.3% of loan funds' financing but 16% of VC funds' financing. Twenty CDFIs provided debt-with-equity, representing a range of less than 1% to 100% of their financing outstanding, depending on whether it was a core product or an occasional instrument supplementing other loan and investment products. In 45% of the CDFIs using debt-with-equity, it represented more than 25% of their total financing.

Guarantees

Guarantees include letters of credit or guarantees provided to enhance the creditworthiness of a borrower receiving a loan from a third-party lender. CDFIs in our sample provided $72 million in guarantees by the end of 2002. Guarantees enable other financial institutions to participate in more community development lending activity because a loan or a portion of the loan that the financial institution makes is guaranteed to be repaid by the CDFI in the event of default. Guarantees also serve to keep interest rates reasonable because the financial institution is not taking as great a risk because of the guarantee. One loan fund represents a large majority—71%—of the guarantees outstanding. In total, 15 CDFIs used guarantees, including 14 loan funds and one VC fund. In three of those institutions, guarantees represented more than 25% of the CDFI's total financing.

Portfolio Performance

For the most part, CDFI portfolios have performed well even during the economic slowdown of the past few years. Figure 18 demonstrates delinquencies and loan losses at banks, credit unions, and loan funds. CDCUs measure delinquency rates by different metrics than loan funds and banks. Delinquency and loan losses are not reported for VC funds as they measure portfolio performance by the overall return on the fund as described in the VC section. Overall, net loan loss rates[13] for these groups of CDFIs was 0.7%, ranging from a total of 0.2% in the bank sector to 0.9% in the credit union sector; this rivals the net loan loss ratio at conventional financial institutions of 0.97% in 2002. Only 25 CDFIs, or 6% of the 413 banks, credit unions, and loan funds that reported had net loan loss rates greater than 10%.

CDFI delinquency rates are somewhat higher than their net charge-off rates. CDFIs are able to manage these delinquencies through technical assistance and frequent contact and monitoring of their borrowers. Also, CDFIs keep adequate loan loss reserves and equity bases to further protect their investors.

[13] Net loan loss rate is the net charge-offs during FY 2002 divided by total loans outstanding at FYE 2002.

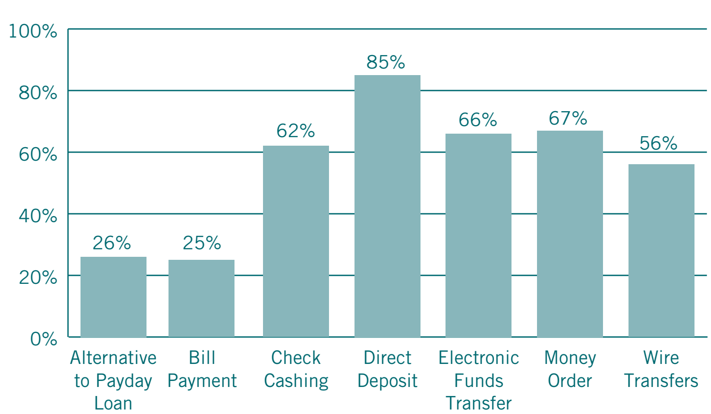
Figure **18** **Delinquency and Loan Loss Rates**

	Banks	Credit Unions	Loan Funds
2002 Net Loan Loss Ratio	0.2%	0.9%	0.8%
Delinquency Ratio > 90 days	1.4%	NA	3.6%
Delinquency Ratio > 2 months	NA	1.9%	NA

Financial Services

Banks and credit unions mobilize savings as well as provide access to credit. Data on deposit and transaction products were collected from 100 credit unions and eight banks for FY 2002. These institutions offered a broad range of products such as savings accounts, checking accounts, certificates of deposit, and Individual Retirement Accounts, as well as client services such as automated teller machine (ATM) access, check cashing, bill payment, and direct deposit. They have also crafted products unique to the field, such as Individual Development Accounts (IDAs), which use a mix of financial education, peer support, and matching funds to promote savings among low-income customers that can be used to invest in homeownership, small business development, or education.

Figure **19** **Financial Products and Services at Depositories**



Among credit unions, direct deposit is the most widely offered service, followed by electronic funds transfer and money orders (see Figure 19). Banks are much more likely to offer a broader range of services, in part because of the greater capacity provided by their larger deposit base. In addition to providing direct deposit, electronic funds transfer, and money orders, banks are also likely to offer ATMs and wire transfers. Alternatives to payday loans, exorbitantly high-interest short-term loans secured by the borrower's next paycheck, are also reported by approximately 25% of depositories. While many customers view these depositories just like any other financial institution, the difference lies in the customer base and the communities the organizations seek to serve.

Training and Technical Assistance Services

In addition to providing access to capital and retail financial services, CDFIs are distinct from mainstream lenders because they provide training, technical assistance, and other assistance to their customers to help increase their capacity and their access to financing. The type and amount of training and technical assistance that a CDFI offers depends on the needs in its market, whether those needs include packaging funding for an affordable housing developer, business plan training for an entrepreneur, or credit counseling for an individual. CDFIs provided training to nearly 5,000 organizations and more than 95,000 individuals through group-based training and one-on-one technical assistance.

Figure **20** **Training and Technical Assistance**

	# People or Organizations	# CDFIs Reporting
# People Receiving Group-based Training	48,005	155
# People Receiving One-on-One Technical Assistance	49,530	176
# Organizations Receiving Training	4,967	116

CDFI Growth from 2000 to 2002

CDFIs experienced growth in the past three years despite an economic slowdown that confronted the nation. For the CDFIs for whom we have three years of data (288 CDFIs), CDFI assets grew at a compound annual growth rate[14] (CAGR) of 13% between 2000 and 2002 and financing outstanding for the sample grew by 19%.

Growth rates at individual CDFIs varied significantly. Almost half of the sample experienced growth in financing outstanding from 2000 to 2002 of greater than 25% (see Figure 22). The banks had the greatest percentage of institutions (60%) that experienced this rapid growth during the three-year period. Sixteen percent of the sample experienced declines in financing outstanding. This results from having repayments in their portfolio during the three-year period greater than the amount of new financing closed. Also, some CDFIs sell loans or portfolios of loans, which also may result in declining financing outstanding.

[14] Compound annual growth rate (CAGR) is the rate of increase over a period of time that would exist if each and every year the rate of return were exactly the same.

Figure **21** **Growth from 2000 to 2002**

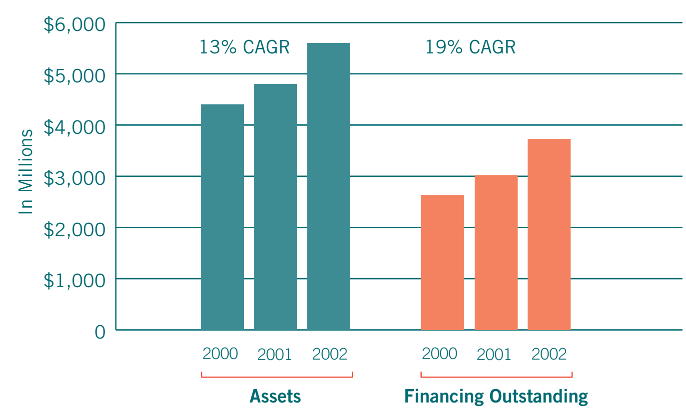
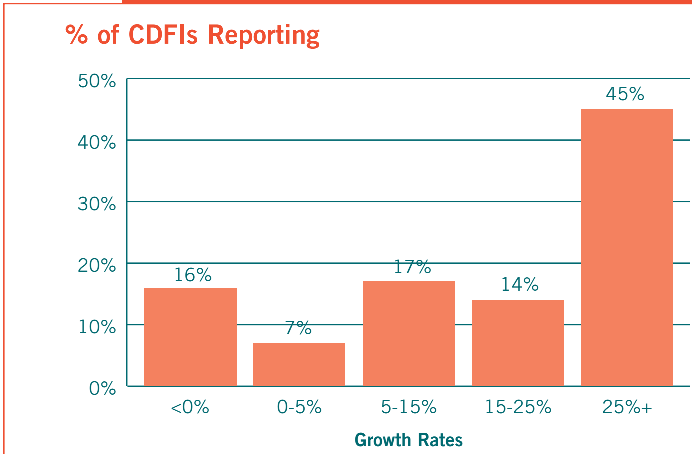


Figure **22** **Growth Distribution of Financing Outstanding**



Like all CDFIs, community development banks provide capital to rebuild low-income communities through targeted lending. As depository institutions, however, community development banks along with CDCUs also have the unique ability to offer federally insured deposits. This depository function not only allows community development banks to meet a wider range of individual financial needs, but it also enables them to leverage scarce equity capital with deposits to generate significantly higher levels of lending in their communities. Moreover, deposits allow banks to operate with relatively modest levels of subsidy, enhancing both autonomy and financial sustainability.

Community development banks offer loans to small businesses, commercial real estate developers, organizations that rehabilitate multifamily housing, local nonprofit organizations, churches, low-to-moderate income homebuyers, and other homeowners and residents for home improvement and personal needs. The scale of such lending efforts over the last 30 years has significantly stabilized many of the low-income communities where development banks operate, while changing both local residents' and outside investors' perception of the communities. By reconnecting the neighborhood to the broader regional economy and creating a renewed sense of personal and collective "efficacy," community development banks help stem the cycle of blight and disinvestment, especially in neighborhoods that have suffered "redlining" due to rapid racial transition.

In recent years, community development banks have also seen a renewed interest in their depository services as tools for asset building. The rise of the check cashing and payday lending industries has created a new awareness of the large unbanked and underbanked population. Community development banks are beginning to realize that many of the households in their communities have more immediate financial needs than are met by mainstream banks, making these households vulnerable to high transaction costs and predatory lending. In response, community development banks have been developing new strategies to meet these immediate liquidity needs while encouraging their customers to save and build good credit histories.

Community development banks are regulated according to type of institution and charter. In general, community development banking institutions can undertake an unusually broad range of commercial, real estate, and consumer lending activities. However, because banking regulations are designed to ensure the safety and soundness of institutions as well as to protect consumers, community development banks are limited as to the type and amount of equity investing they can do. Community development banks are regulated by one or more of the following government agencies:

- The Federal Deposit Insurance Corporation
- The Federal Reserve Banks
- The Office of the Comptroller of the Currency
- The Office of Thrift Supervision
- State banking authorities

Community Development Banks: Creating Impact

After attending a prestigious law school and working as a federal government lawyer, Warren Brown decided to change course and pursue his true passion: baking fabulous cakes from scratch. As he worked to understand the baking business and fine-tune his business plan, Warren first met City First's Chief Lending Officer Kim Saunders as a business instructor in the Development Corporation of Columbia Heights' Fast Track Training Program.

With more than $80 million in assets, City First is the only CD Bank in Washington, DC. Warren turned to City First for other key ingredients, including expert advice on financing and the Small Business Administration (SBA) guaranteed loan process. Cakelove opened in March 2002 in Washington, DC, to rave reviews on television, in magazines, and in daily papers. Warren hasn't looked back since. In fact, City First recently helped him secure a second SBA loan for his new dream, the Love Café, opening across the street in early 2004.

Size and Scope

As of year-end 2002, the CDFI Fund had certified 55 community development banks as CDFIs.[15] Together, these community development banking institutions had over $8 billion in total assets. Of the 55 certified CDFI banks, 44 (80%) are either owned or managed by racial minority groups. It is widely recognized that there are significantly more CDFI banks in the country than those that are certified by the Fund. For example, the National Community Investment Fund (NCIF) recognizes a nationwide network of about 100 banks whose primary purpose is community development.

Seventeen such community development banks (15 of which were certified) participated in the CDP in FY 2002. The combined assets of all 17 banks amounted to more than $3.5 billion, with the median bank having an asset size of $144 million. These 17 banks constitute 35% of the total assets of all CDFIs in the CDP data set, even though they were only 4% of the total number of institutions. Figure 23 provides the distribution of the banks according to asset size and shows that more than one-third of the banks are in the $150 million to $250 million asset range.

Figure **23** **FY 2002 Asset Size Distribution of CDFI Banks**

Asset Category	Number of Banks	Average Asset Size	Median Asset Size
$20 million to $60 million	4	$46,366,916	$51,438,500
$60 million to $150 million	5	$104,293,800	$99,009,000
$150 million to $250 million	6	$195,747,667	$194,226,000
$250 million and above	2	$848,581,000	$848,581,000

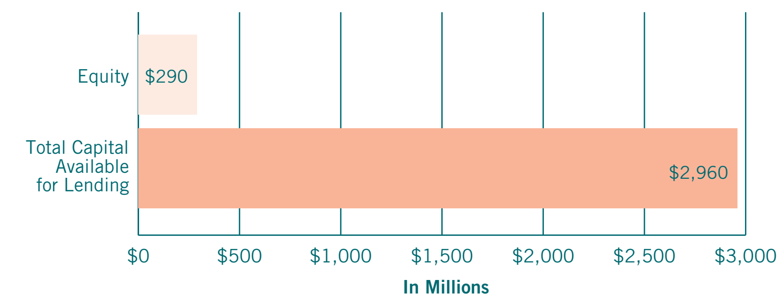
[15] The CDFI Fund certified a total of 72 banks and bank holding companies in 2002. However, combining all affiliated banks and bank holding companies reduces the number of certified CDFI banks to 55 different institutions.

Bank Capitalization

A community development bank typically raises equity by issuing stock as well as some hybrid forms of equity and debt. It then leverages this equity with federally insured deposits (mostly from individuals and corporations) in the form of savings accounts, checking accounts, and certificates of deposit.[16] Community development banks typically leverage every $1 in equity capital with over $10 in deposits and other borrowings, such as loans from the Federal Home Loan Bank, with some achieving much higher leverage ratios. The leverage ratio is 10.2 for the banks in the CDP data set (see Figure 24).[17]

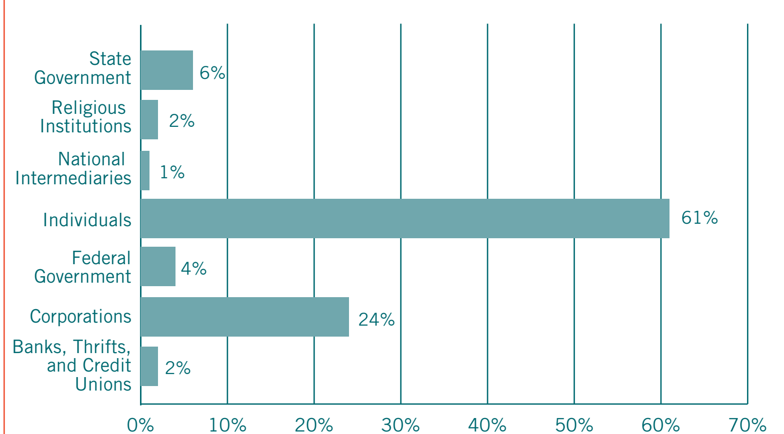
Despite federal insurance, however, deposits are finite and can become costly, especially since loan demand in the community is often too great to be supported by the supply of deposits from local residents and small businesses. To build their deposit base and "greenline" their low-to-moderate income service areas, community development banks also raise deposits from a range of socially responsible individual and institutional investors. Among the six community development banks that provided information on their sources of capital, deposits from individuals and corporations accounted for the vast majority of their lending capital (85%), while government and philanthropic funding made up a significantly smaller portion.

Figure **24** **Leverage at CD Banks**



Note: Total capital includes equity capital and leverage provided by deposits and other borrowings.

Figure **25** **Sources of Debt Capital, Shares, and Deposits**



[16] Deposit insurance is generally limited to $100,000 per bank, for each tax identification number; this applies to both individuals and corporations.

[17] The data set includes some de novo banks, which tend to have lower leverage ratios than more mature institutions that have developed robust deposit markets or other borrowing sources.

Financing Activity and Financing Performance

Community development banks are subject to the same safety and soundness regulations as other banks. Because of their experience and knowledge of the community, however, they are also able to provide products and services that mainstream banks find too risky or too costly. In addition, the products and services made available by community development banks are intended to have a multiplier effect on the community as a whole and on outside investors, generating development impact that goes beyond the individual investments.

Figure **26** **Composition of Loans Outstanding**

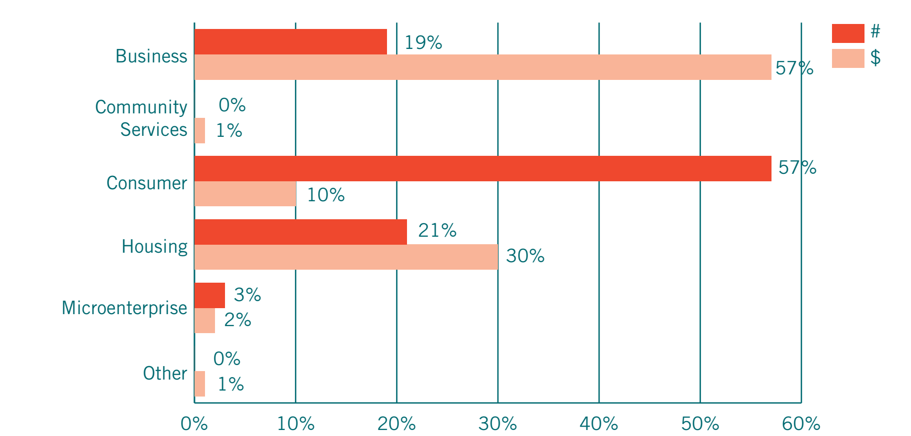
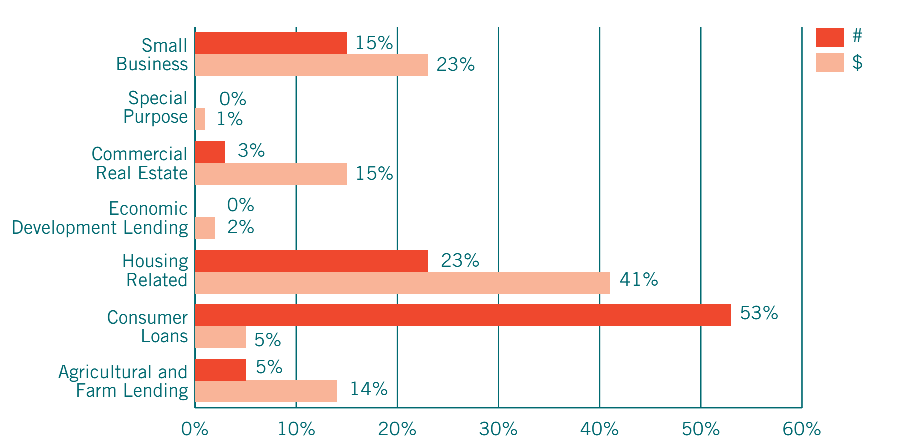


Figure **27** **Composition of Development Loans**



For example, many community development banks lend to small entrepreneurs who acquire multifamily residential properties to renovate for sale or lease. Such investments not only increase the supply of affordable housing in the community, but they also stimulate reinvestment by improving the area's appearance and changing the perceptions of outside investors. Community development banks have been particularly successful at striking a balance between raising property values and controlling the forces of gentrification; they accomplish this by lending on the cash flow that will be generated by rehabbed property occupied by low- and moderate-income residents, rather than on the improved property's prospective for-sale value.

Similarly, community development banks lend to churches and other faith-based and nonprofit institutions that play active roles in the community. These investments help build a social structure that helps families gain employment, provides childcare and education, cares for local seniors, and works to reduce crime in the neighborhood.

The CDP collected information on the types of loans provided by community development banks. Institutions responding to this section of the survey reported that the vast majority of their dollars funded small business and housing-related loans (57% and 30%, respectively, of dollars loaned). However, community development banks also provide a significant number of consumer loans (57% of total number of loans), thereby providing an important community-based alternative to fringe financial services providers.

NCIF conducts an annual survey among its investees to gauge the level of their development lending activities. NCIF defines a development loan as a loan that is made in a low-income community[18] or to a low-income borrower. In 2002, the 13 banks reporting to NCIF originated 4,846 new development loans, for a total of $328 million. On average, each bank invested more than $25 million in its target market. With an average loan size below $68,000, these banks underwrote commercial real estate, small business, facilities, mortgage, and consumer loans that fall outside the scope of mainstream lenders. In dollar terms, 62% of all the loans originated by the investee banks in FY 2002 went to low-income communities, while 66% of the total number of loans originated were such development loans.

[18] Excerpted from "RFSI: Risk Management Strategies for New Accounts," National Community Investment Fund, 2003.

The NCIF survey breaks the data into six major categories, each of which contains several subcategories: Consumer Loans, Small Business Loans, Special Purpose Programs, Commercial Real Estate Programs, Agricultural and Farm Lending, and Economic Development Lending Programs. Special Purpose Program loans include loans to community-based organizations and programs that promote childcare, business development, employment, and housing development. Economic Development Program loans include loans to nonprofits and government agencies and participation in multibank lending consortia.

Like the CDP survey, the NCIF survey found that most of the development loans went to businesses in low-income areas, with small business loans, commercial real estate loans, and agricultural loans making up 53% of the total dollar amount originated. Housing-related loans, like mortgages and affordable housing projects, made up the second-largest category with 41% of the total lending pool. In terms of number of transactions, the NCIF survey found that 53% of all transactions were consumer loans.

Community development banks efficiently use their limited resources for development work on the basis of the ratio of development loans to equity capital. With total equity capital of $158 million, the 13 reporting CDFI banks lent twice their total equity capital in development loans. Moreover, such a high level of development lending was achieved at the same time that the banks were maintaining an average return on assets ratio of 0.71%.

On average, the 17 community development banks in the CDP survey had $1.7 million in loans that were more than 90 days delinquent, which represents 1.17% of total loans outstanding. The average net loan loss to total loan ratio was 0.25%, with the median bank having a ratio of 0.20% (see Figure 28).

Figure **28** **Portfolio Performance at CDFI Banks in FY 2002**

	Sum	Average	Median
Loans Greater than 90 Days Delinquent	$28,587,124	$1,681,596	$922,000
Delinquency Rate Greater than 90 Days	1.43%	1.17%	0.95%
Net Loan Loss Rate		0.25%	0.20%

Depository Products and Services

Banks have always offered savings accounts and certificates of deposit to help individual households and small businesses build assets. The rise of the check cashing and payday lending industries, however, helped community development banks more deeply realize the crucial role they can play in an individual's journey toward long-term financial security.

Families who live from paycheck to paycheck use check cashers for a number of reasons. They may not be able to wait for their checks to clear, or they may need to leave a portion of their wages in an account to meet minimum balance requirements. Their wages may fall short of their needs, spurring them to go to payday lenders and pawnshops to obtain short-term credit. Finally, they may find that check cashers and payday lenders are more common than depository branches in the communities where they live. Although check cashers and currency exchanges meet the immediate need for liquidity, they generally do so at a high transaction cost, sending low-income households into a cycle of debt.

In recent years, community development banks have reached out to the unbanked population by offering more flexible direct deposit or starter accounts that have small or no minimum balance requirements. They are also experimenting with different forms of short-term credit, including overdraft protection systems. Just as important, they have provided extensive financial literacy training to help low-income families better manage their cash flow, take advantage of such resources as the Earned Income Tax Credit, and grow their limited incomes into assets, all of which helps low-income families move toward financial stability.

ChexSystems and the Unbanked[19]

Most depository institutions use a variety of risk-mitigation techniques that, intentionally or not, can reduce financial services access for low-income and unbanked consumers. One technique in particular—use of the ChexSystems database—has come to symbolize risk mitigation. ChexSystems is a private-sector database that contains approximately seven million names and is used by 80% of U.S. banks to track people with histories of checking account problems. Banks report to ChexSystems when customers have their accounts closed for repeated overdrafts, fail to repay overdrafts, or engage in fraud. Reported individuals stay in the system for five years, whether or not they have subsequently repaid their debt.

The main issue concerning consumer reporting agencies like ChexSystems is the fact that some banks automatically turn away checking-account applicants who appear in these databases, regardless of when or why they were reported and whether they have repaid their debts. In many cases, the customer's lack of financial sophistication may have led to unintentional overdrafts of a bank account. Those listed in ChexSystems who are of marginal means (believed to form a significant portion of the list) are then forced to use high-cost alternatives such as check cashers and currency exchanges.

In response, several CDFI banks have developed "second chance" accounts for individuals, listed in ChexSystems, who were not involved in fraud, and who complete a mandatory financial literacy program. Legacy Bank in Milwaukee, Wisconsin, is one of the leading proponents of the program. In cooperation with local community groups, Legacy provides financial management seminars and one-on-one consultations for unbanked individuals, and, once they complete the classes, Legacy offers them savings and checking accounts at minimal cost (only $10 is needed to open the account and there is no minimum balance required).

Legacy mitigates risk through a very close day-to-day monitoring policy. If a report shows that a customer may be having some trouble keeping his or her account current, the customer is contacted personally. Customers with two or more overdrafts are required to attend another financial management seminar. Failure to attend the seminar results in account closure. The bank has seen 100% participation in seminars by individuals experiencing problems. Customers, who see the program as an opportunity to overcome their financial mistakes and become part of the banking system again, have been very responsive to the bank and in many cases report possible overdrafts in advance.

[19] Excerpted from "RFSI: Risk Management Strategies for New Accounts," National Community Investment Fund, 2003.

As grassroots actors working in every corner of the country, CDCUs function like capillaries in the CDFI system. Spread across the urban and rural areas of 43 states, as well as DC and Puerto Rico, CDCUs comprised over half the institutions in this CDFI industry survey sample. Though there are some very large CDCUs, these credit unions are typically small organizations[20] founded and controlled by the low-income communities they serve.[21] Local area residents accounted for 81% of the CDCU field's total capital and 87% of its member deposits. The sector's 65% minority board representation strongly reflected the ethnic composition of members and surrounding communities.

The CDCU field is composed of institutions of varying capabilities and resources. Some offer the full panoply of financial services, including business and mortgage lending, and even online banking. However, all have a bedrock goal of providing basic financial products and services directly to individuals in economically distressed communities. These include deposit, savings, check cashing, and money transfer services in areas often abandoned by mainstream financial institutions. In 2002 the average CDCU opened 280 new accounts with people who were previously unbanked.

The CDCU sector offers every type of loan product, including commercial real estate, construction, and agricultural business loans and accounted for more than half of the mortgage loans closed by CDFIs in 2002.

However, the sector's focus is on providing small-scale loans deemed unprofitable by commercial banks and for which predatory lenders charge exorbitant interest rates. Personal development signature loans, usually for small sums to make ends meet, fix a car, cover education expenses or pay medical bills, constituted 55% of all CDCU, loans outstanding. Even the typical CDCU business loan is perceived to be too small to generate a large enough profit margin for most commercial banks. The $6,706 average CDCU loan is one-sixth the size of the CDFI industry average.

The typical CDCU is older than any other CDFI type.[22] CDCUs date from the earliest years of the CDFI movement. As cooperative, self-help arrangements formed organically from within their communities, they continue to embody the earliest goals and strategies of the CDFI industry.

Size and Scope

At the end of FY 2002, CDCUs held a total of $3.1 billion in assets, about 30% of the CDFI industry's total. The six largest—the top 3%—held 56% of total CDCU assets. From 2000 through 2002, the sector's assets increased at a CAGR of 13% per year for the 179 credit unions for whom we have three years of data.

CDCUs are typically substantially smaller than other types of CDFIs. The average CDCU had $12.9 million in assets, while the median CDCU was much smaller, with assets of $1.5 million. By comparison, the median assets for banks, loan funds, and VC funds were, respectively, $144 million, $5.1 million, and $6.5 million.

As of fiscal year-end (FYE) 2002, the CDCU sector had a total of 865,969 member depositors, with an average of 3,623 members and a median of 954.

The total equity of the CDCU sector was $312 million, while total net worth—equity plus secondary capital—was $323 million. The average CDCU had $1.3 million in equity, while the median had $123,000. The sector's total net worth comprised 11% of its total assets, while the median CDCU had a capitalization ratio of 10%, substantially exceeding federal statutory standards for "well-capitalized" credit unions.

[20] Median asset size at FYE 2002 was $1,452,155.
[21] About one-fourth of all CDCUs are single neighborhood organizations. Single town, metro area, or county CDCUs make up an additional 56% of the total. Multiple county or statewide organizations account for the remaining 19%.
[22] The median CDCU charter year is 1969, as compared with 1983 for the CDFI industry as a whole.

Figure **29**
Ethnic and Racial Breakout of CDCU Membership

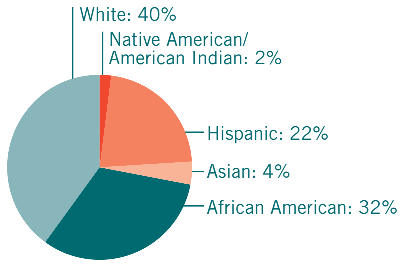
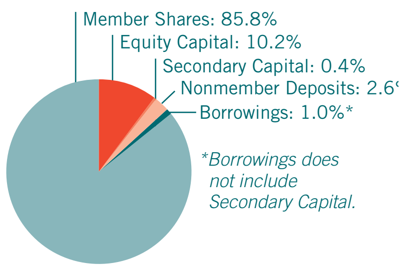


Figure **30**
Composition of CDCU Capital



Demographics

A few highlights of the demographics of CDCUs for FY 2002 include:

> Thirty-eight percent of the population served by CDCUs resided in major cities, 29% in minor urban areas, and 33% in rural areas

> The median CDCU had a 60% female membership

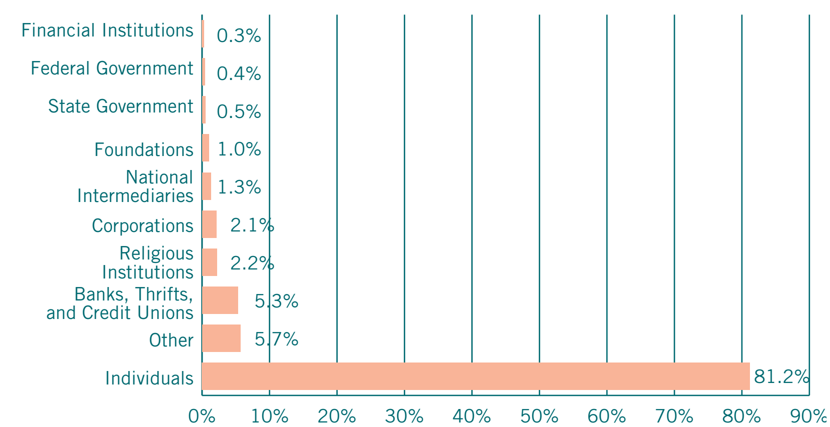
> The average CDCU identified a 74% ethnic and racial minority membership, the median or typical credit union had a 92% minority membership, and the weighted average was 60% minority membership (see Figure 29)

> Of the surveyed CDCUs, 220 were National Federation of Community Development Credit Union (NFCDCU) members and 77, or 32%, were faith-based credit unions

> Eighty percent of the membership of a typical CDCU was of low to moderate income. This survey finding is further underscored by the number of CDCUs falling under federal designation as serving economically distressed areas and populations:

- Of the 239 CDCUs surveyed, 86% were designated Low Income Credit Unions by the NCUA, the government regulator
- 76% of CDCUs were located in CDFI Fund designated economically distressed investment areas
- 40% were in CDFI Fund-designated hot zones

Figure **31** **Debt Capital Sources**



Board and Staff

The average and median board size was, respectively, eight and seven members. Sixty-five percent of board members were minorities and 44% were women.

CDCUs had an average of nine and a median of three staff members. Women constituted a substantial majority of CDCU staff members; they were 80% of the total. Minority staff members were 44% of the overall total, though the median, or typical, credit union had a staff that was approximately two-thirds minority.

Unsalaried employees constituted a notable 12% of CDCU staff. Of these, 8% were local volunteers and 4% were Americorps VISTA members receiving a stipend. Welfare-to-Work employees were 1% of total CDCU staff.

CDCU Capital

As of FYE 2002, CDCUs had $3.1 billion in total capital, $2.8 billion in debt capital,[23] and $2.6 billion in share deposits. CDCUs obtained their capital from member share deposits, nonmember deposits, borrowings, secondary capital loans, and equity (see Figure 30).

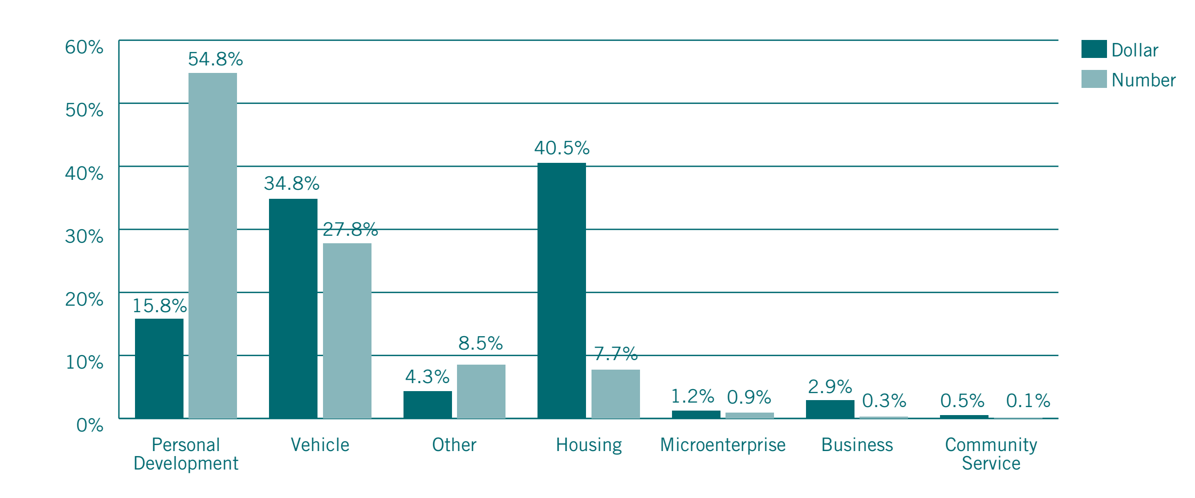
Individual member depositors (the individual shareholders) accounted for 87% of the CDCU field's total share of deposits and 81% of debt capital (see Figure 31).

[23] Includes share deposits and excludes equity.

Financing Activity and Performance

As of FYE 2002, CDCUs had 323,000 outstanding loans worth $2.2 billion. CDCUs deployed 70% of their assets in loans (the rate for commercial banks was 59%). The average credit union had $9.1 million in loans outstanding, while the median, or typical, CDCU had $809,868. Over the three-year period from 2000 to 2002, the dollar value of CDCU total direct financing outstanding increased by 20% per annum for the 179 credit unions for which we have three years of data. The sector closed 248,000 loans worth $1.2 billion in 2002.

Figure **32** **Composition of Loans Outstanding**



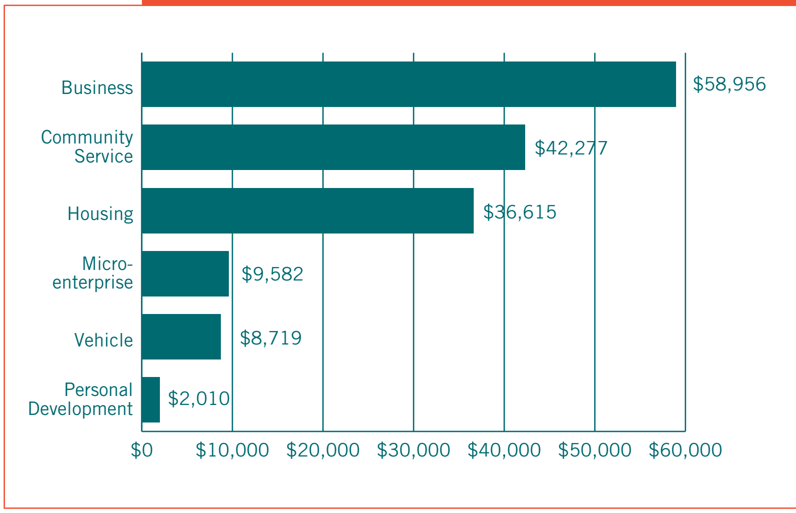
Housing loans formed the largest percentage of the dollar value of all CDCU loans outstanding. In FY 2002, the CDCU sector closed a total of 6,172 real estate loans for $278,418,420,[24] including 2,781 first mortgage loans worth $195,373,713. CDCU survey respondents (42% of all CDCUs) alone accounted for 48% of all CDFI mortgage loans closed in 2002.

The CDCU sector specializes in small loans that reflect economic conditions and market demand in low-income communities. These loans have profit margins that mainstream financial institutions generally perceive to be too low, leaving predatory lenders as the only other option.

Personal development loans were the most common type of loan on CDCU books, accounting for 55% of the total number of loans outstanding. These are typically very small loans for essential everyday expenses such as car repair, education, and medical bills that low-income people would not otherwise be able to afford. Figure 32 shows the different loan purposes as percentages of the total number and dollar value of loans outstanding.

Even CDCU business and housing loans are typically too small to be perceived as sufficiently profitable by commercial banks. The overall average dollar value of a CDCU loan, $6,706, was one-sixth of the CDFI industry average (see Figure 33 for average loan size by loan purpose).

Figure **33** **Average Loan Size by Purpose**



[24] NCUA aggregate data obtained from Callahan Peer-to-Peer.

Portfolio Performance

Being self-sustaining while fulfilling a mission of providing credit to people of modest means and often little financial experience is a challenging task, yet most CDCUs meet it. It requires flexibility, creativity, and a strong understanding of the market served (a market usually avoided by mainstream institutions because of unfamiliarity and fear of the typical low-income borrower's risk profile). As an example, 38% of CDCUs do not use credit scoring. Of those that do, only 8% rely on it as the sole determinant in loan underwriting.[25] In 2002, 42% of CDCUs closed loans to members with no previous credit history; the median or typical CDCU closed 15 such loans, 10% of its total loans originated for the year.

Although CDCUs serve underserved and low-income individuals, CDCU loan performance was comparable to that of mainstream financial institutions. Total delinquencies greater than two months constituted 1.94% of total CDCU loans outstanding. This was greater than the mainstream credit union rate of 0.8%[26] but smaller than the commercial bank rate of 2.53%.[27] Total net loan losses were 0.92% of total loans outstanding. Again, this was somewhat higher than mainstream credit unions (0.5%), but better than financial institutions (0.97%). The median or typical CDCU rate was 0.69%.

[25] Fiscal year 2001 survey by NFCDCU.
[26] NCUA
[27] FFIEC

Other Products and Services

In the last three decades, mainstream financial institutions have steadily abandoned economically distressed communities and predatory lenders have thrived. CDCUs are often the sole option left for basic financial services, such as depository accounts or reasonably priced small-scale loans. In addition, CDCUs also provide special products and services uniquely tailored to assist low-income members improve their financial condition and avoid predatory lenders.

Financial Counseling and Training

Seventy-six percent of CDCUs have some type of member technical assistance or training program and 7% of total staff time is devoted to these activities. The most common form of technical assistance to members comes in the form of consumer credit counseling and financial literacy training; 72% of CDCUs offer this service. Business and homebuyer counseling is offered by 35% and 42% of CDCUs, respectively. Twenty-seven percent of CDCUs also mentor other community organizations, such as other credit unions or small businesses. Figure 34 shows the average and median CDCU training activity in 2002.

Figure **34** **CDCU Training and Technical Assistance in FY 2002**

	Average CDCU	Median CDCU
Number of Individuals Who Received Group-based Training	133.0	30.0
Average Number of Hours of Group-based Training per Individual	8.4	2.0
Number of Individuals Receiving One-on-One Technical Assistance	318.3	46.5
Average Number of Hours of One-on-One Technical Assistance	5.5	1.0
Number of Organizations that Received Training	5.1	0.0
Average Number of Hours of Training per Organization	4.3	0.0

Community Development Credit Unions: Creating Impact[28]

Christmas 2002 was a happy one for the Belval family of Milton. On December 1, 2002, a fire destroyed their mobile home and belongings. However, because of a new mortgage from Burlington's Vermont Development Credit Union (VDCU), Leo Belval, his wife, Cheryl, and daughter, Shana, were in their new mobile home by mid-January. "I feel great about it because VDCU stepped up to the plate, financed the home, and the rate is exceptional," said Belval, a mechanic for Overnite Transportation in South Burlington.

A conventional lender would not have made the loan for the home on leased land owned by the Vermont Housing Authority at the Birchwood Mobile Home Park. "It's very hard to get a loan for a home on leased land," Belval said. "A conventional mortgage would have been difficult. When you mention leased land, that's it." VDCU has made its name on being different. "We've learned how to make good loans to populations that are more fragile," said credit union CEO Caryl Stewart. Now in its 14th year, this credit union has made close to $80 million in loans and boasts a loss rate of "half of a percent," Stewart said. "It stacks up very well to banks."

VDCU's performance has attracted investors who support its mission of helping high-risk people obtain financing. "In 1999 we decided to invest $100,000 of our trust with them," said Gary Kowalski, minister at the Unitarian Universalist Church in Burlington. "We have a commitment to serve the Old North End of Burlington and the VDCU is the only financial institution in that part of the city. They have a very good track record economically. They do good in a way that is fiscally responsible." Fred "Chico" Lager, the former CEO of Ben & Jerry's Homemade, has invested in the credit union's certificate of deposit, which is rolled back into customer loans. "I support their work," he said. "They are giving access to banking services to people who otherwise have no access to them."

Stewart said all the credit unions of this type "attempt to achieve a high level of sustainability with loans. But, within that attempt we serve a population that isn't served in the regular marketplace. Conventional wisdom calls these people high-risk but we've shown they are not high risk." While the VDCU may serve a "high-risk population," Stewart said her credit union does not make loans without careful screening of borrowers. "We make loans only when we are sure they can pay it back through counseling-based lending," she said. VDCU helps potential borrowers get rid of bad debt and track their financial life and often makes a "tracker loan," which creates positive credit history. "You are basically establishing a payment history that shows you can meet your obligations, and gives you your credit report," Stewart said. Fifty percent of possible customers are not immediately bankable and must improve their financial standing to qualify for a loan. However, Stewart said, "We don't say no, we say when."

The VDCU makes four types of loans. The most popular are individual development loans for transportation and education, and payday loans for specific bills. The credit union, Stewart said, has even been involved in international financing when one customer got a loan to send back to his family in Vietnam so that the family could purchase a water buffalo. VDCU also makes loans for home improvements and mortgages, such as the one the Belvals received.

[28] Excerpted and edited from a 12/23/2002 *Burlington Free Press* article titled "Giving Vermonters Credit," by Art Edelstein.

IDAs and Payday-Alternative Loans

Predatory lenders have thrived by stripping the modest wealth that still exists in low-income communities by charging exorbitant interest rates and other fees in the context of general economic distress and bank flight. In contrast, CDCUs have initiated unique programs specifically designed to build the wealth of low-income members and counter the wealth-destroying practices of predatory lenders.

CDCUs reward thrift by matching their members' IDA savings. As of the end of 2002, 28% of CDCUs had an IDA program. The average CDCU had 45 IDA accounts worth $140,588, while the median or typical CDCU had 15 IDA accounts worth $15,403. The average amount in an IDA account was $2,047, while the median amount was $480.

Payday lenders target low-income people, often short of cash for basic daily expenses, for short-term high-rate loans secured by the borrower's next paycheck. In addition to providing basic offerings such as personal development loans, which are similar to payday loans but with a lower interest rate, CDCUs have also instituted loan programs specifically to combat payday loans. Eighteen percent of CDCUs had a payday-alternative loan program. The average CDCU closed 285 such loans for $85,861, while the median, or typical CDCU closed 42 loans for $14,535. The average payday-alternative loan amount was $766.

CDLFs provide financing and development services that improve community services, preserve and create jobs, and expand affordable housing available in low-income communities throughout the United States. The loans fund sector is extremely diverse; some loan funds are niche players offering a single loan product to one type of client (i.e., childcare providers), while other loan funds offer a range of different products (loans and equity) to a number of sectors (business, housing, and community facilities).

There are four main types of loan funds serving low-income communities and customers: housing, community facilities, microenterprise, and business. Many loan funds, however, provide financing to several of these sectors.

The loan fund sector has changed significantly over the past 20 years as these organizations have responded to market and client needs. Some examples of how the sector has evolved include:

> Many CDLFs began by focusing on a single sector, most notably, housing or business, but have expanded the types of clients they serve. In our sample, 39% of the loan funds focused on a single sector, and 61% served more than one sector. As demonstrated in Figure 35, the CDFIs that finance microenterprise and housing are most often the ones that are single-sector organizations.

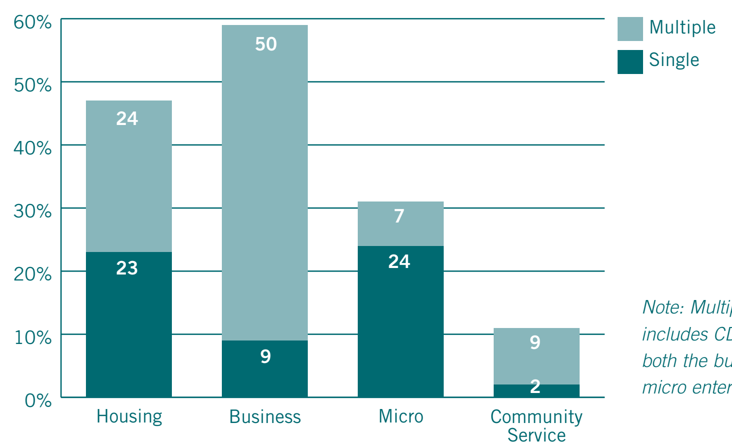
> Many loan funds in our sample have changed their product mix to better meet customer needs. Virtually all loan funds began providing only loans to their customers. In our sample of 165 loan funds, 8 of the organizations now provide debt with equity features, 11 provide equity, and 14 provide guarantees.

> Many loan funds have expanded their geographical market area as they have developed core competencies with a particular client base or a particular product. For example, one childcare lender recently expanded from one state to a multistate region.

> Several loan funds have started subsidiary organizations such as CDCUs or VC funds to address a particular market need or market challenge. Nine loan funds in our sample are now affiliated with CDCUs or VC funds.

The CDP sample includes 165 loan funds, which represents approximately one-third of the approximately 500 CDLFs in existence today. The loan funds in our sample had $3.4 billion in assets at the end of FY 2002. As with the CDFI industry as a whole, a few large organizations dominate the sector. The three loan funds with more than $100 million in assets accounted for $1.6 billion or nearly 50% of the sector's assets. Overall, the loan fund sector comprises primarily smaller and mid-sized organizations. The median asset size for loan funds is $5.1 million.

Figure **35** **Primary Sector Served**



Note: Multiple sector includes CDLFs that serve both the business and micro enterprise sectors.

Financing Activity and Performance

Loan funds provided $1.2 billion in financing in FY 2002 and had $2 billion in financing outstanding at the end of FY 2002. The average amount outstanding was $12.9 million, and the median was $2.7 million. Most loan funds began as either housing or business funds, and those two sectors remain the most prevalent among loan funds in terms of dollars of financing outstanding (see Figure 36).

The loan fund sector has a majority (74%) of financing outstanding in the housing sector. Housing loans to nonprofit and for-profit developers for affordable rental housing, for-sale homes, and transitional housing are a core niche of loan funds. Loan funds provide financing where banks will not, or loan funds work with financial institutions to leverage their dollars. For example, loan funds may provide a subordinate loan with the bank providing the senior loan; the subordinate loan is often necessary to get the bank to participate on the project. There is also an increasing number of loan funds providing loans to individuals for home purchase and repair. Of the $1.5 billion housing activity at loan funds, $1 billion was for individuals and $500 million was to housing developers. One large loan fund that operates a secondary market mortgage program accounted for a majority (95%) of the $1 billion in housing loans to individuals. However, there were an additional 29 loan funds that provided housing loans directly to individuals with $44 million outstanding at the end of 2002, and this financing continues to increase in the loan fund sector.

A growing number of loan funds are providing loans to community service organizations to enhance the services available in low-income communities. These clients, such as childcare centers, social services agencies, and arts facilities, often lack sources of capital because of their limited resources, knowledge about financing, and collateral. Loan funds work with these clients to educate them about financing options and how financing might help them solve their particular challenges. Of the 53 loan funds that provided community service financing, 11 had community service as their primary financing sector, and 23 loan funds had at least 25% of their financing to community service organizations. At the end of FY 2002, loan funds had nearly $180 million in financing outstanding to community service organizations.

Loan funds typically charge interest rates based in part on the risk of the transaction. While loan funds are not as aggressive about risk-based pricing as conventional financial institutions, they typically charge higher rates for higher-risk loans (Figure 37). Loan funds charge the highest rates for microenterprise loans (an average of 9%), since those loans carry the highest risk. Community facility and housing loans typically carry lower levels of risk and have somewhat lower rates than the business loans. When the borrowers require more patient capital for business loans, some loan funds also provide debt-with-equity-features, but they expect a higher return in the range of 18%-25%.[29]

[29] Dequity Financing in Community Development Business Lending, National Community Capital, 2003.

Figure **36** **Composition of CDLF Financing Outstanding**

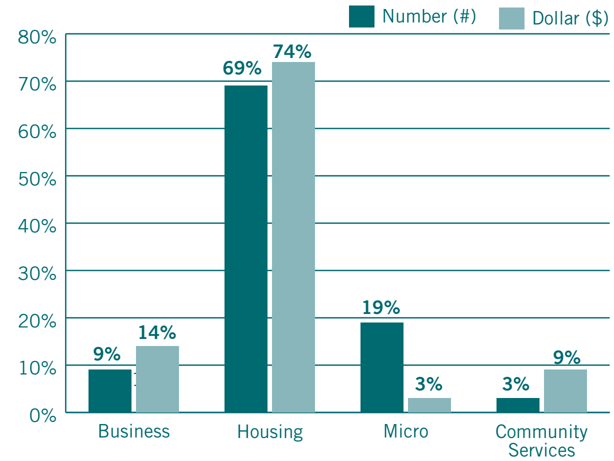
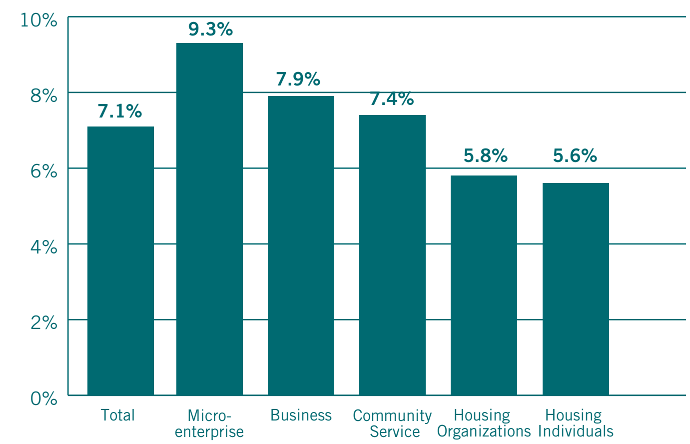


Figure **37** **Interest Rates Charged**

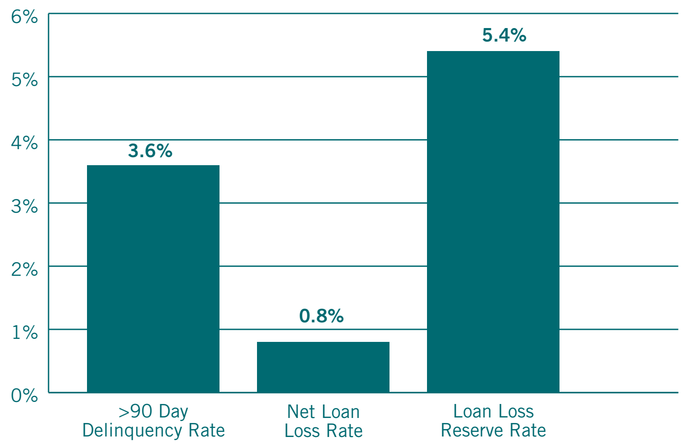


Based on a subset of 119 CDLFs that reported these data

Portfolio Performance and Managing Risk

Loan funds are adept at managing risk in their markets. They manage their risk by keeping adequate loan loss reserves and equity capital to protect investors from potential losses. Loan funds also manage their risk by knowing their clients, monitoring their portfolio frequently, and offering substantial training and technical assistance both before and after the loan closing.

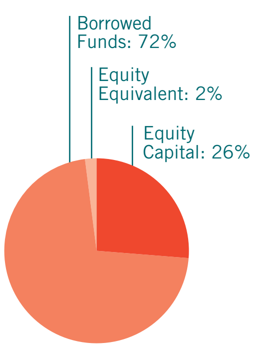
Figure **38** **CDLF Portfolio Performance**



CDLFs charged off only 0.8% of their loan portfolios in 2002. Fifty-five loan funds experienced no losses in 2002, and only 15 loan funds (or 9% of the loan funds) had net loan loss rates greater than 10%. These rates vary among different types of loan funds; the net loan loss rate for loan funds with a primary activity of business or microenterprise was 3.7%, while the rate for loan funds with a primary focus of housing or community facilities was 0.2%. Business lenders tend to make riskier loans, but plan for those higher losses by keeping higher loan loss reserves; loan loss reserves at business and microenterprise loan funds were 12%, which is three times their net loan loss rate in FY 2002. CDLFs are generally conservative in the amount of loan loss reserves they hold. Figure 38 demonstrates that a loan loss reserve rate of 5.4% for CDLFs was more than six times the net loan loss rates, and 1.5 times the delinquency rates greater than 90 days for the sector a whole.

Capital Under Management

Figure **39**
CDLF Capital Structure



The total lending and investing pool, or total capital, of loan funds in our study was $2.7 billion at the end of 2002. The average capital size was $16,869,696, with a range of $95,000 to $1 billion.

Loan funds secure close to 72% of their capital from borrowed funds, or debt capital (see Figure 39). These funds are typically lent to loan funds at below-market rates. The average cost of borrowed funds for loan funds that reported this figure was 3.1% in 2002. Some larger loan funds, however, are finding creative ways to use more debt capital that is closer to market rates from financial institutions.

Equity Equivalent Investments (EQ2s) are a growing source of loan fund capital. EQ2s are highly subordinated debt instruments with features such as a rolling term and limited right-to-accelerate payments that enable them to function similar to equity. Banks are the primary investors in EQ2s because of the favorable CRA treatment.[30] Thirty-two loan funds secured EQ2 totaling $67 million at the end of 2002. While this represents only 2% of loan fund capital, it is an important and growing source of capital, because typically it is long-term capital (7–15 years), has a rolling term, and allows CDFIs to leverage additional debt. Only nonprofit CDFIs use EQ2s.

[30] Lenders can receive either enhanced lending test credit or investment test credit for making EQ2 investments in CDFIs. Banks accounted for approximately 80% of EQ2s.

More than one-quarter of loan funds capital, or $703 million, is equity capital. Equity capital is critical to loan funds because it enables loan funds to leverage more debt, provides a cushion to protect debt and EQ2 investors, and allows loan funds to take more risks. This capital cushion is particularly critical for these unregulated CDFIs. Equity at loan funds is the most difficult type of capital to raise, and is built from a combination of grants to the loan fund to grow their equity capital base and any net income that loan funds designate to grow their capital. Nearly 60% (see Figure 40) of loan funds have equity capital ratios greater than 30%.

A majority of investor capital—debt and EQ2—is from banks, thrifts, credit unions, and nondepository financial institutions, which together accounted for 42% of borrowed funds and EQ2. Financial institutions are a growing source of capital among loan funds because loan funds provide a safe investment vehicle for banks, banks can receive CRA credit for their investments, and loan funds are flexible partners.

Other key sources of loan fund capital are foundations and the federal government, accounting for 17% and 13%, respectively, of total investor capital. Some foundations offer below-market and long-term loans, called program-related-investments (PRIs). Sixty-seven loan funds in our study had $164 million from foundations in FY 2002. Loan funds also use several federal government programs to capitalize their loan pools including the CDFI Fund, the SBA, and United States Department of Agriculture.

Figure **40** **Distribution of Equity Capital Ratio**

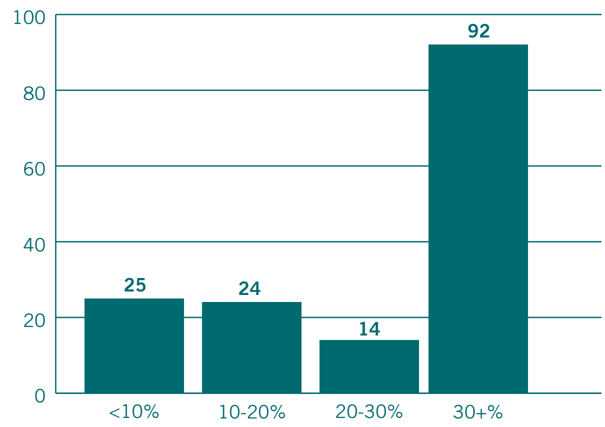
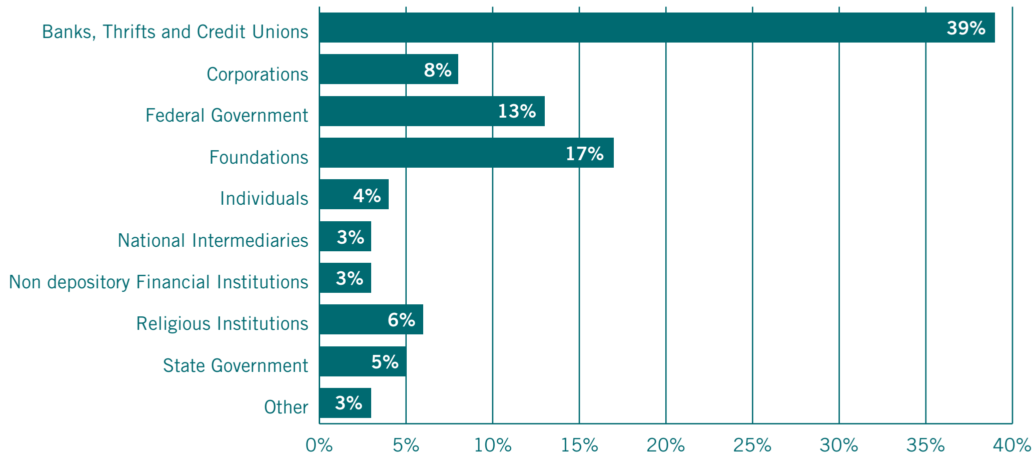


Figure **41** **CDLF Investor Capital**



Note: Excludes one large loan fund that operates a secondary market program and has a unique capital structure.

Other key sources of investor capital are religious institutions and individuals. While these investors account for only 6% and 4%, respectively, of loan fund investor capital, individuals represent a large number of investors and religious investors represent some of the first supporters of loan funds. Many loan funds have as part of their purpose educating investors and providing an alternative socially responsible source into which investors can put their money, and thus loan funds see individuals as an important investor source.

Community Development Loan Funds: Creating Impact

On September 4, 2003, Ala Costa Center formally celebrated the opening of a second campus. The organization has been providing support, guidance, structure, and respect for children with developmental disabilities in Alameda and Contra Costa counties in California for the past 31 years. Until now, the Center was able to serve only 50 students through after-school and holiday programs from one location in North Berkeley. Although Ala Costa was already very successful and had a sparkling reputation, the Board and staff couldn't turn their backs on the waiting list of more than 100 students who desperately needed their services. Thus began the hunt for financing options that would allow them to open a second campus.

It was in mid-search that Holly Gold, Executive Director of Ala Costa Center, got in touch with Northern California Community Loan Fund's (NCCLF) Director of Lending, Dutch Haarsma. NCCLF is a loan fund with $12 million in capital serving northern California with housing, facilities, and business loans. "Although we were enthusiastic about the project, the underwriting process was a challenge because Ala Costa didn't have a conventional form of collateral," says Dutch. "Fortunately, NCCLF had just begun a new loan guarantee program with The San Francisco Foundation that allowed us to make a commitment to Ala Costa."

"Dutch made the loan work every step of the way," says Holly. "If he needed something he would help me get it. He made it clear that NCCLF believes in our project and would help us make it happen. He took our loan to The San Francisco Foundation. We couldn't have finished the project without the loan guarantee."

Fortified with a $232,000 loan and a tenacity that would help see the job through, Holly and Ala Costa Center oversaw the new campus built out on the grounds of East Oakland's Thurgood Marshall Elementary School. There are already 20 students enrolled at the new campus, which will eventually take in 30 more.

Ala Costa Center is now busy incorporating their new campus into the already-existing program, and welcomes the challenge of providing programming for 100 developmentally disabled students, ages 5 to 22, 250 days a year. The Center meets client needs that conventional schools and daycare can't: Ala Costa promotes social interaction and helps students become productive and healthy members of society. And because Ala Costa is the only alternative for many low-income and single-parent homes, the programs they offer benefit not just the students, but also the students' families and, ultimately, the entire community. "Loans work," says Holly, "and this loan will work for us. $232,000 is a lot of money, but a small amount when you consider it has helped us do so much for so many people."

CDVC funds use the tools of VC—patient capital and business management expertise—to grow small- and medium-sized businesses that create good jobs for low-income people and promote entrepreneurial capacity in economically distressed urban and rural areas. This chapter begins with a summary of the size and scope of the CDVC industry based on the Community Development Venture Capital Alliance's (CDVCA) ongoing research and then describes in detail the capitalization, financing activities, technical assistance activities, and social impacts of a representative sample of CDVC funds that were surveyed as part of the CDP.

Size, Scope, and Characteristics

The number of CDVC funds has grown dramatically over the past 10 years, from just a half dozen funds investing in the early 1990s to 79 funds actively investing or in formation by the end of 2002. Capital under management has also grown substantially. Total capital under management grew from $300 million at the end of 2000 to $485 million at the end of 2002. At the end of 2002, the CDFI Fund had certified 18 CDVC organizations as CDFIs. Considering that the traditional VC industry barely increased at all over this period, this growth is extraordinary.

CDVC funds focus their activities in specific investment areas that traditional VC funds overlook. CDVC funds are active in Appalachia, rural Minnesota, Baltimore, and Cleveland—places not typically associated with VC. CDVC funds are also active in regions that have become synonymous with VC such as Silicon Valley, Boston, and New York City, but they often invest in neighborhoods and smaller towns overlooked by traditional VC firms. In either case, commitment to a particular geographical area, whether it is a rural region or an urban center, is one of the distinguishing features of the CDVC industry.

Figure **42** **CDVC Capital Under Management, 2000-2002**

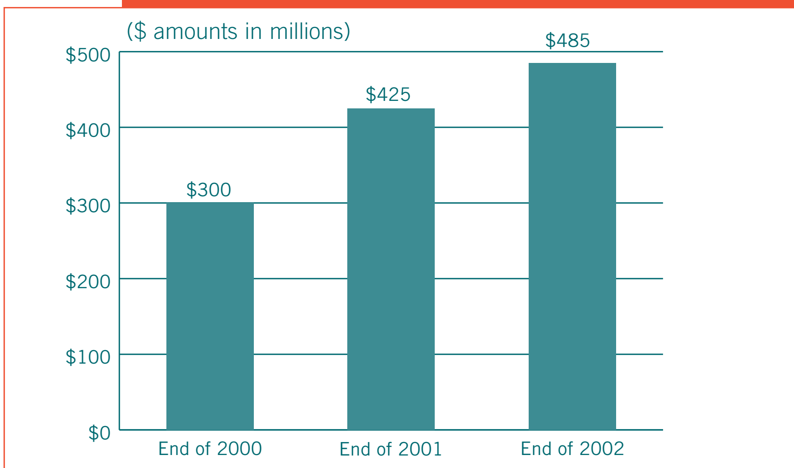
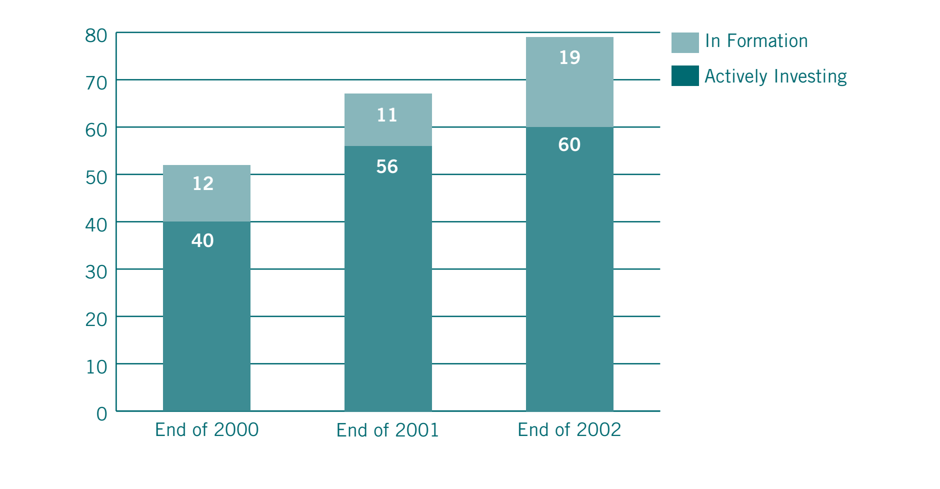


Figure **43** **Number of Funds by Stage, 2000-2002**



The Venture Capital Cycle

VC investing is a highly cyclical process with three main stages. The cycle starts with fund-raising, proceeds to the investing in and adding value to the fund's portfolio companies, and culminates in the harvesting of those investments through "exits." Funds exit from their equity investments through the sale of their equity to a new investor, sale to employees of the portfolio company as part of an employee stock ownership plan (ESOP), sale to management as part of a management buyback, or, in a few cases, through an initial public offering (IPO). With an IPO, the fund sells its equity in a public stock market such as the NASDAQ or the over-the-counter market. In the world of CDVC, the most common form of exit is the sale of the company to a third party.

Losses on portfolio companies often occur early in the investment cycle, and exits typically happen five to seven years after the initial investment. The result is what VC investment professionals refer to as the J-curve; funds show losses in their early years, but profits take off as they begin to exit their investments.

The fact that most CDVC funds are still young, coupled with the J-curve nature of equity investment returns, means that it is still too early to make a definitive assessment of the financial returns to CDVC investing. Preliminary results for some of the older funds, however, show that they are making gross internal rates of return between 8% and 17%.

Figure **44**
Corporate Structure of CDVC Funds

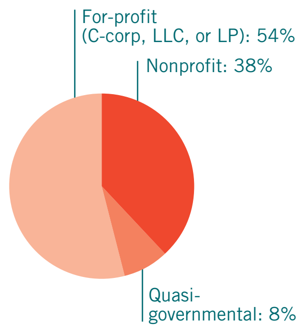
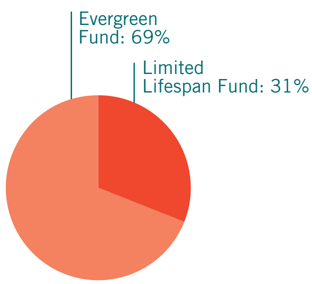


Figure **45**
CDVC Models



CDVC Organizational Structures

In contrast to other CDFI sectors in which the organizational structure of each sector is relatively homogenous, there are a variety of organizational structures in the CDVC field. More than half (54%) of all CDVC funds are for-profit, 38% are nonprofit, and 8% are sponsored by a state or local government, which also provides the capital. In addition, a CDVC fund can be either a limited lifespan fund or an evergreen fund. The limited lifespan model, the traditional VC model, is an LP or LLC established with a 10-year lifespan. In the evergreen model, the fund is established as an ongoing enterprise. Of the CDVC funds reporting, approximately 3 of 10 CDVC funds were organized as limited lifespan funds, all of which are for-profit, and 7 of 10 were organized as evergreen funds, split roughly evenly between for-profits and nonprofits. Fund managers chose among these various models on the basis of their expectations of which investors they want to attract, tax and liabilities issues, their own experiences, and the goals of the organization.

Types of Portfolio Companies

CDVC funds invest in businesses that have strong competitive advantages in their markets and offer the potential for rapid growth. Companies use the patient capital provided by CDVC funds to fuel that growth. Funds look for businesses that can create good entry-level positions for low-income people, especially businesses that can offer their employees superior benefits and the opportunity for advancement.

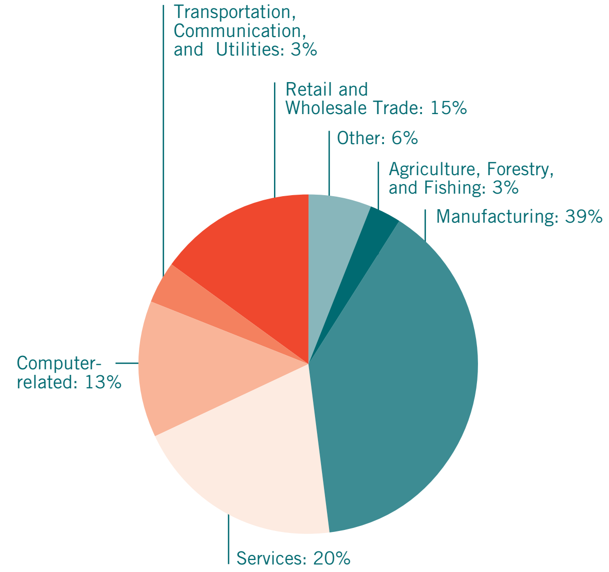
Figure 46 shows the breakout of CDVC fund portfolio companies as of the end of 2002. Manufacturing is the single biggest sector for CDVC fund portfolio companies. The investment opportunities offered by the manufacturing sector are well matched to CDVC funds' investment preferences. Manufacturing companies can offer good jobs to persons with modest skills. Also, manufacturing companies can have proprietary product and process advantages that can produce the large financial returns sought by fund managers.

Services, the second largest category of CDVC fund portfolio companies, include business services such as bulk mailing for companies, energy management and procurement, computer repair, and workforce staffing; social services such as childcare and adult day-care centers; and health care services such as health care staffing.

Retail and wholesale trade includes a wide range of companies from apparel to surgical products to dog treats and accounts for 15% of all CDVC portfolio companies. Computer-related companies—mostly investments in software and Internet service providers in parts of the country where traditional VC is scarce—accounted for 13% of the companies outstanding at the end of 2002.

The sections that follow report on data from the 21 CDVC funds that responded to the FY 2002 CDP survey. Some organizations in the CDP data set are involved in both CDVC investing and traditional business lending, using the same pool of capital for both types of financing activities. The following sections report only on the organizations that have CDVC investing as their primary financing activity. For a comprehensive overview of the entire CDVC industry, including the CDVC investment activities of the business loan funds that do CDVC investing and the New Markets Venture Capital Companies, see CDVCA's forthcoming "Report on the Industry '03".

Figure **46**
CDVC Funds' Portfolio Companies by Sector



Capitalization

The 21 CDVC funds reported total capital under management of $262.4 million. Twenty of the 21 funds reported detailed information on their capital structures. Of the $220.1 million that these funds managed, the vast majority of the capital, $160.7 million (73%) was equity capital, $20.0 million (18%) was debt, and the remaining 9.1% was equity grants.

Banks are the single largest equity investors in the CDVC industry. Bank investments accounted for 38% of all equity dollars invested. Bank investments into CDVC funds (and certain types of loans) can qualify for CRA credit under the regulation's Investment Test. Federal and state governments were the second-largest category of investors and accounted for 29% of all equity investments. This category included $9.25 million in equity and equity grant investments by the CDFI Fund. Nondepository financial institutions (insurance companies and investment banks) accounted for 14% of the total equity capital. Foundations contributed 12% of equity; individuals, fund parents and affiliates, and other sources invested the remaining 7%.

Foundations are the largest providers of debt capital to the CDVC industry. Debt from foundations, including PRIs, accounted for nearly 40% of all debt. Banks were the next largest provider of debt capital with nearly 30% of the total, followed by federal and state governments, which together provided approximately 20%. The remaining 17% came from nondepository financial companies and other sources.

Figure **47**
Capitalization of CDVC Funds

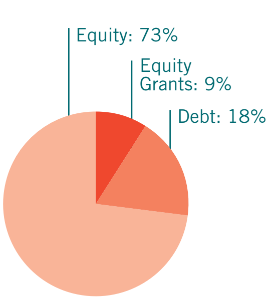


Figure **48**
CDVC Equity Capital by Source

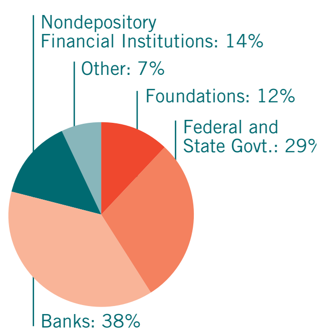
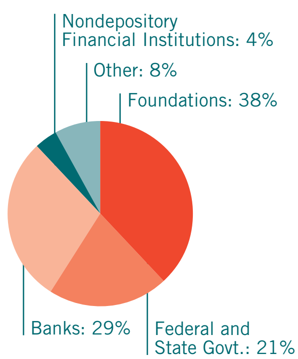


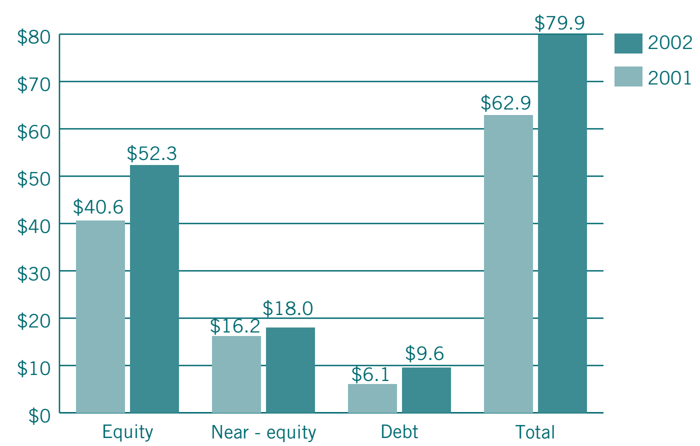
Figure **49**
CDVC Debt Capital by Source



Financing Activities

Twenty of the 21 funds reported their investments outstanding at the end of 2002, which totaled $79.9 million, including equity investments of $52.3 million, near-equity investments of $18 million, and debt of $9.6 million.[31] The $79.9 million in outstanding investments represents a 26.9% increase from the year before when outstanding CDVC investments totaled $62.9 million.[32]

Figure **50** **CDVC Investments Outstanding in 2001 and 2002 (in millions)**



As noted in the introductory chapter, CDVC funds focus on providing "patient" capital—capital that does not require immediate repayment (the way most debt is usually structured). Most CDVC capital is invested either as equity—common or preferred stock, LP interests, or membership shares—or, as near equity—debt with warrants, convertible debt, or debt with royalties. Figure 51 shows total dollars invested during each year by instrument type from 1999 to 2002 for the funds that reported to CDVCA.

[31] These numbers exclude the debt investments of one fund that uses the same pool of capital to make both equity and traditional debt investments.
[32] This reflects data for 18 funds reporting in 2001 and 20 funds reporting in 2002.

Figure **51** **Dollars Invested Each Year by Instrument Type, 1999 to 2002 (in millions)**

Year	FY 1999	FY 2000	FY 2001	FY 2002
# of Funds Reporting	12	14	17	20
Equity	$6.1	$13.0	$12.5	$11.8
Near Equity	$3.6	$6.2	$6.3	$5.1
Debt	$3.7	$3.9	$3.2	$4.3
Total	$13.4	$23.1	$22.0	$21.2

Technical Assistance

CDVC funds provide vast amounts of highly targeted technical assistance to the portfolio companies in which they invest, as well as companies in which they consider investing. CDVC fund managers collectively review thousands of business plans each year. The direct technical assistance provided to portfolio companies and the review of business plans are especially valuable features of the CDVC model. CDVC funds invest in sectors and in areas where entrepreneurial capacity is often underdeveloped and where business management expertise can be rare. By reviewing and commenting on business plans and helping their entrepreneurs develop successful businesses, CDVC fund managers offer business management expertise where there is often too little to go around. Many entrepreneurs funded by CDCV funds frequently conclude that the technical assistance (TA) and business management expertise brought by the fund managers was as important as the equity capital.

Figure 52 shows results on the 16 funds that reported data on one-on-one TA. These funds provided targeted TA to 212 companies that averaged 95 hours of TA per company. Some funds spend substantially more time with their portfolio companies and one reported spending 320 hours—eight full weeks—of TA on each company in which it had invested. Fourteen funds provided data on business plans and reported reviewing 1,914 plans, or nearly 137 plans per fund during 2002. A few funds also provide more general training to entrepreneurs and the local business community. The six funds that reported such programs trained nearly 1,000 people with programs ranging from angel breakfasts to venture fairs to formal classroom-style programs teaching entrepreneurship and small business management skills.

Figure **52** Technical Assistance and Training Provided by CDVC Funds

Businesses Receiving One-on-One TA	Avg # of Hours of TA per Company	# of Business Plans Reviewed	Avg. # Business Plans Reviewed by Fund	# of Persons Receiving Training
212	95.1	1,914	137	944

Social Impacts

CDVC funds make equity investments into fast-growing companies, especially companies that can create good jobs for low-income people. Figure 53 shows the employment impacts of the 14 CDVC funds that reported the total number of full-time equivalents (FTEs) at the time of their initial investment into each portfolio company and at the end of 2002. FTEs grew from 6,157 to 8,011, a 30.1% increase.

Figure **53** **Job Change Numbers for Selected Funds**

FTEs at Time of First Investment	FTEs at End of 2002	% Change
6,157	8,011	30.1%

Note: Based on the 14 funds that provided complete data on total FTEs.

The focus on low-income job production is reflected in the higher rates of job creation in low-income jobs versus non-low-income jobs (see Figure 54). The 10 funds that collected data on these measures reported a 103.6% increase in the number of low-income jobs at their portfolio companies and a 25.3% increase in non-low-income jobs. Overall, total FTEs at these companies grew 55.7%.

Figure **54** **Comparison of Low-Income and Non-Low-Income Job Change Numbers for Selected Funds**

	FTEs at Time of First Investment	FTEs at End of 2002	Change
Low-ncome FTEs	1,430	2,912	103.6%
Non-Low-Income FTEs	2,255	2,826	25.3%
Total FTEs	3,685	5,738	55.7%

Note: Based on the 10 funds that provided complete data on low-income and total FTEs.

Second Venture Capital Funds

One of the most significant developments in the CDVC industry over the past few years has been the success of several management firms at raising second funds. Boston Community Ventures, CEI Ventures, Inc., Pacific Community Ventures, and The Reinvestment Fund are now managing two funds. The success of these four managing firms at raising and closing on their second funds suggests that double-bottom-ine investors are increasingly more comfortable with the CDVC model.

Figure 55 compares the first and second funds for these four organizations. Both the total dollars raised and the average size of those funds show dramatic increases from the period of the mid- to late-1990s, when their first funds closed, to the period after 2000, when the second funds closed. The four first funds had total capital under management of $26.4 million for an average of $6.6 million per fund; the four second funds have a total capital under management of $94.3 million and an average fund size of $23.6 million.

Figure **55** **Comparison of First and Second Funds** ($ amounts in millions)

Managing Firm	First Fund	Year	Second Fund	Year
Boston Community Ventures	$5.0	1997	$16.4	2001
CEI Ventures, Inc.	$5.5	1996	$20.0	2001
Pacific Community Ventures	$6.3	1999	$13.1	2002
The Reinvestment Fund	$9.6	1997	$45.0	2002
Total Dollars	$26.4		$94.3	
Average Size	$6.6		$23.6	

Larger fund sizes have brought other significant changes. First, second funds have tended to expand their investment areas. The typical first fund defined a metropolitan region or one state as its investment area; second funds have tended to increase their investment area to encompass several states. Second, investment size per company has increased substantially from first to second funds. These four first funds made average investments per company of about $325,000; second funds' investments have averaged just over $731,000 per company. The increased size of capital under management, enlarged investment area, and larger per-company investments are all part of management firms' desire to "get to scale."

Community Development Venture Capital Funds: Creating Impact

Pacific Community Ventures (PCV), manager of PCV Investment Partners I and II, provides resources and capital to businesses that have the potential to bring significant economic gain to low-income communities throughout California. In mid-2001, PCV began working with Niman Ranch, a leading producer and marketer of fine quality beef, lamb, and pork. PCV, which runs an extensive business advisory services program, matched up Niman with a volunteer business advisor to help the company develop its human resource practices. Shortly thereafter, PCV invested as a part of Niman's Series B round of financing.

Niman Ranch raises its stock following a strict code of ecological and husbandry principles and supports small family farms using the same practices. By working with a network of small family farmers, Niman can control its meat all the way from the farm until it reaches its customers. Shipping or delivering directly from its processing facilities, Niman Ranch distributes its products to fine restaurants and retailers across the country and directly to consumers via an online store.

Niman's packing plant is located in an Enterprise Zone in East Oakland, where it provides good jobs to approximately 100 residents of low-income Bay Area communities. On average, these employees earn $11 per hour (higher than San Francisco's Minimum Compensation Ordinance) and remain with the business for more than two years. Niman provides health care for all of these employees, paying 100% of the cost of this coverage. Additionally, these employees are eligible for a 401(k) to which Niman provides a company-funded contribution.
Niman Ranch was named to the Inc. Magazine Inner City 100 list of fastest-growing companies in America's inner cities for 2002 and 2003.

Microenterprise financing provides small—less than $25,000—loans to entrepreneurs to start or expand their businesses. These entrepreneurs cannot get financing from banks and require the flexibility of CDFIs to make their dreams a reality. Businesses are diverse; some of the growing sectors among microentrepreneurs include in-house childcare centers, jewelry, clothing, and specialty foods. Loans from CDFIs provide self-employment opportunities for these entrepreneurs.

This section presents and discusses FY 2002 CDP data from a large group of CDFIs that provide financing to microenterprises.[33] The intent of this chapter is to highlight the size and scope of microenterprise activity and outputs within the CDFI industry, as reflected in the CDP database; to examine the degree of microenterprise support within different types of CDFIs; and to briefly discuss the issue of sustainability with respect to microenterprise services. The chapter draws primarily from CDP data and secondarily from data collected by the MicroTest project at the Aspen Institute.

Of the 270 CDFIs that identified their loans and investments in a particular sector (i.e., housing, business, microenterprise, community facilities, or consumer), there were 8,740 microenterprise loans outstanding at FYE 2002 of a total of 146,217 loans and investments. This makes microenterprise the fourth most common use of CDFI capital with 6% of all CDFI financing outstanding. This percentage is slightly higher than the 3.6% of CDFI loans reported to the CDP for FY 2000 by a somewhat smaller sample (379 then vs. 442 now) of lenders.[34]

Size and Scope of Microenterprise Activity

Of the 442 CDFIs that reported to the CDP for FY 2002, 112 (about 25%) held some microenterprise loans in their portfolio.[35] The total amount of the microenterprise portfolio in this group of 112 CDFIs was $65.9 million and their average microenterprise portfolio at the end of FY 2002 was just over $588,000 (the median was $277,591). The range of microenterprise portfolios in the group was very broad from a low of $2,426 to a high of over $7 million. Eighteen CDFIs held at least $1 million in microenterprise loans.

[33] The CDP would like to thank Ilgar Alisultanov for his assistance in analyzing the CDP FY 2002 database for this chapter.
[34] See "Microenterprise Support within Community Development Financial Institutions", The Aspen Institute, Washington, DC., 2003., p. 8.
[35] These figures are based on all CDFIs reporting at least $1 outstanding in microloans at FYE 2002.

Figure **56** **Size of FY 2002 Microenterprise Portfolios within CDFIs**

Size of Micro Portfolio	Number of CDFIs	Average Micro Portfolio	Average Total Portfolio	% of Total Portfolio in Micro	Total Micro Portfolio
Less than $250,000	50	$82,165	$6,170,344	1.3%	$4,108,259
$250,001 to $500,000	26	$354,345	$3,018,970	12.0%	$9,212,972
$500,001 to $1,000,000	18	$693,951	$5,097,113	13.6%	$12,491,116
More than $1,000,000	18	$2,229,006	$68,615,805	3.2%	$40,122,115
Total	112	$588,701	$15,302,172	3.8%	$65,934,462

Figure **57** **Microlending by CDFI Type**

Type of CDFI	Number of CDFIs	Number of Microloans	Microloans per CDFI
Loan Fund	88 (86%)	7,521 (86%)	85
Credit Union	21 (10%)	847 (10%)	40
Bank	1 (3%)	238 (3%)	238
Venture Capital	1 (2%)	134 (2%)	134
Total	111 (100%)	8,740 (100%)	79

Figure 55 distributes the 112 CDFIs engaged in microenterprise lending according to the size of microenterprise portfolio. It shows that CDFIs with between $250,000 and $1 million in microenterprise loans are more likely to have smaller total portfolios and consequently a greater share of microloans in their total portfolios than are either very small or very large microlenders. Interestingly, those large microlenders are also simply large lenders, with average total portfolios of more than $68 million. For these lenders, even though microenterprise lending represents a small fraction of their overall portfolio, it is nevertheless an important contribution to the amount of financing—62% of $65 million—invested by CDFIs in microentrepreneurs in the sample.

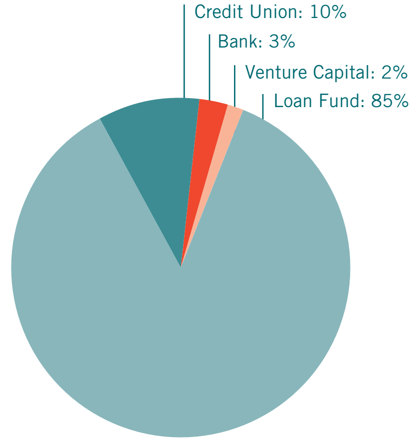
To estimate the total amount of financing outstanding to microenterprises as of the end of FY 2002, it is necessary to look beyond the figures reported to the CDP by these 442 CDFIs. Figures reported to the MicroTest project by 30 microenterprise lenders that did not report to the CDP add another $15.8 million to the $65.9 reported to the CDP, for a total of approximately $81.7 million in microloans outstanding in 142 CDFIs and microenterprise programs. Given that there are dozens more microenterprise lenders than these 142 on whom portfolio data is available through either the CDP or MicroTest, it is certain that this $81.7 million figure undercounts the total amount of financing in microenterprises in the United States.

Microenterprise within Different CDFI Institution Types

Of the CDFIs that reported some microlending activity, 88 (79%) are loan funds and 21 are credit unions. These two CDFI types provided more than 95% of all the microloans reported to the CDP.

Not surprisingly, in terms of portfolio size by CDFI type, loan funds as a group held 79% of the total outstanding microenterprise portfolio ($51 million of the $65 million). Slightly over $8 million in microlending by credit unions constituted another 13% of the total portfolio. Surprisingly, one large rural bank reported over $4 million in microenterprise loans in portfolio.

Figure **58** **Microenterprise Portfolio by CDFI Type**



Frequency of Microenterprise Lending

In order to get a sense of the significance to the CDFI of its microenterprise activities, it is instructive to analyze the percent of its total loans that a CDFI has invested in microbusinesses (see Figure 59). Eighty of the 442 CDFIs (18%) have more than 10% of their total loans in the microenterprise sector. Among the CDFIs financing microbusinesses, a majority (59%) invested at least 25% of their total loans in microbusinesses. Forty-seven CDFIs reported that a majority of their loans went to microentrepreneurs. While lending to microbusinesses is a part of the activities of at least a quarter of all CDFIs, just over 10% of all CDFIs have made microlending the main focus of their community development activities.

Figure **59** **Frequency of Microenterprise Lending**

Microenterprise Loans	Number of CDFIs	% of All CDFIs	% of Active Microlenders
All CDFIs	442	100%	n=112
CDFIs with:			
At Least One Microloan in Portfolio	111	25%	100%
At Least 10% of Loans in Micro	80	18%	72%
At Least 25% of Loans in Micro	65	15%	59%
At Least 50% of Loans in Micro	47	11%	42%
At Least 75% of Loans in Micro	29	7%	26%
At Least 90% of Loans in Micro	26	6%	23%
100% of Loans in Micro	23	5%	21%

FY 2002 Lending to Microenterprises

In addition to reporting the portions of their outstanding loan portfolios in different sectors, CDFIs also reported their FY 2002 microenterprise activity, which provides a sense of annual activity or productivity. Of the 442 CDFIs reporting, 109 (about 25%) financed at least one microenterprise during the year. Of these CDFIs, 83 (76%) were loan funds. These loan funds financed 4,395 (81%) of the 5,451 microenterprises financed by all CDFIs in the CDP in FY 2002.

Figure **60** **Microenterprises Financed in FY 2002 by CDFI Type**

	Loan Fund	Credit Union	Bank	Venture Capital	Total
Total Microenterprises Financed	4395	592	422	42	5451
Percent of Total	81%	11%	8%	1%	100%
Average Number of Microenterprises Financed	53	31	70	42	50
CDFIs Responding	83	19	6	1	109
Percent of Total	76%	17%	6%	1%	100%

Portfolio Quality

Microenterprise lending can carry elevated levels of risk relative to other kinds of CDFI loans for a variety of reasons. Often, the entrepreneur is unable to access a bank loan because of a poor credit rating or lack of demonstrated business experience. Sometimes, the business itself is in a risky or low-yield sector of the local economy; sometimes the business is still in a start-up mode. One would expect to see somewhat elevated levels of delinquency, then, in the portfolios of those CDFIs focused on lending to microentrepreneurs.

Figure 61 shows delinquency data for three groups of CDFIs: those “stand-alone” microenterprise lenders who lend only to microbusinesses; those CDFIs that have at least one loan in portfolio to a microentrepreneur, but also lend to other sectors; and those CDFIs that do not finance microenterprises. As expected, portfolio quality indicators do vary for these groups of CDFIs. Importantly, however, all groups, including the CDFIs dedicated to financing just microbusinesses, demonstrate strong portfolio quality. CDFIs engaged in microenterprise have learned to manage these risks by having higher levels of loan loss reserve and providing substantial technical assistance to their borrowers.

Figure **61** **Delinquency Data for FY 2002**

Delinquency rate	31-60 days	61-90 days	>90 days	Average Outstanding
Microenterprise-Only CDFIs	5.2%	2.8%	6.0% (n=22)	$1,264,717
CDFIs with at Least One Microenterprise Loan	4.6%	1.5%	3.7% (n=63)	$22,814,324
CDFIs with No Microenterprise Loans	1.9%	0.7%	1.8% (n=81)	$29,501,404

Sustainability of Microenterprise Lending Programs

There are several possible ways to examine the sustainability of microenterprise lending, depending upon how one defines sustainability. The approach taken here is to look at select data available on microlending programs that have participated in the MicroTest project at the Aspen Institute. Surely one aspect of sustainability is the extent to which microenterprise lending program budgets have changed over time. Growing average program budgets seem to indicate that managers have succeeded in securing funds (both earned and grant related) to support their activities. As Figure 62 shows, average program budgets for microenterprise programs with active loan funds have in fact grown over the past three years.

Lending programs typically strive to cover as much of their credit program's operating costs as possible through revenue earned from the operation of that program. Operational self-sufficiency is a sustainability measure that indicates the percent of a credit program's operating costs covered with earned income: The higher the operational self-sufficiency ratio, the more sustainable the credit program is understood to be. Average rates of operational self-sufficiency have hovered just above 30% for programs in MicroTest over the past three years. Some lenders are achieving much higher results (17 of the 46 lenders in FY 2002 covered an average of 70% of their credit program's operating costs), but for many this remains a tough challenge.

Figure **62** **Indicators of Microenterprise Lending Program Sustainability**

Sustainability Measures	FY 2000	FY 2001	FY 2002
Average Microenterprise Program Budget	$552,899 (n=45)	$630,856 (n=53)	$751,300 (n=46)
Average Operational Self-Sufficiency	33% (n=44)	31% (n=50)	33% (n=46)

While progress is being made by many microenterprise-focused lenders (particularly those with large outstanding portfolios and effective cost-containment strategies), the issue of sustainability will likely remain a topic of some importance and debate within the field for several more years. Meantime, it is also clear that microenterprise program managers have been effective at raising the necessary funds to sustain their work of supporting the establishment and growth of small local businesses. Clearly, the mission of microenterprise development agencies cannot be overlooked in a review of sustainability figures.

Microenterprise Jobs

The CDP data do not distinguish between the number of jobs assisted (the sum of jobs created and jobs maintained) by microenterprises and the number of jobs assisted by small businesses. Instead, for each CDFI the sum of jobs assisted by both microenterprises and small businesses is reported. In order to get some sense of the average number of microenterprise jobs assisted per CDFI, it is necessary to isolate just stand-alone microenterprise CDFIs and examine their reported jobs numbers. Unfortunately, just 13 microenterprise-only CDFIs reported job numbers for FY 2002 (see Figure 63). While the numbers below are drawn from a small sample of CDFIs, they nevertheless indicate the kind of impressive results that microenterprise-focused CDFIs can achieve with respect to helping entrepreneurs to create new jobs and maintain existing jobs.

Figure **63** **Microenterprise Jobs**

Jobs Created	482
Jobs Maintained	3,843
Jobs Assisted	4,325
Average Number of Jobs Assisted per Microenterprise CDFI	333

Microenterprise Funds: Creating Impact[36]

Candice and Dan Heydon aren't just purveyors of mushrooms, they're passionate about them. Even after some 13 years in the mushroom business, Candice says plainly, "We're not tired of eating, growing or talking about mushrooms." And not surprisingly, a visit to Oyster Creek Farm & Mushroom Co. is an education even for those who can easily tell the difference between a shiitake and a crimini.

Beginning cautiously, the Heydons connected with a California-based mushroom company that provided them with about 20 varieties of fresh mushrooms that they could then sell in Maine to test the East Coast market. For help in operating a business, they turned to Coastal Enterprises, Inc. (CEI), a diversified CDFI based in Wiscasset, Maine that operates a microlending program. Candice and Dan used a number of CEI services: business counseling, courses, and seminars (including classes in Web site design, marketing, and bookkeeping software), and a variety of lending programs.

"All the money we've put into this business we got from CEI," says Candice, explaining that she has used several of its lending programs. Additionally, Oyster Creek participated in CEI's innovative "micro-equity" program, which gave CEI an equity position and provides the business with an infusion of capital. "They do everything they can to help me stay in business."

Slowly but steadily, Oyster Creek has grown and stabilized to the point where, several years ago, both Candice and Dan were able to give up outside employment to devote themselves full time to mushrooms. Over time, they've expanded their customer base to include restaurants around the state, cooperatives, farmers markets, and sales over the Internet. Moreover, they no longer rely on a California supplier, instead growing several varieties on their property and purchasing others from mushroom foragers from throughout Maine.

[36] This entrepreneur profile is excerpted with the permission of FIELD (Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination) from http://fieldus.org/Postcard/Mushroom/postcard2.html.

Through the data and information in this report, CDFIs have demonstrated that they are:

> Serving niche markets in economically disadvantaged communities throughout the United States that are not being adequately served by conventional financial institutions

> Financing seemingly "high-risk" transactions in a prudent and effective way

> Providing investors the opportunity to be socially responsible and financially prudent at the same time

> Generating a variety of impacts in the communities they serve, including new jobs, new affordable housing units, community facilities, and retail services for low-income people and in low-income communities

> Weathering the economic slowdown and recession because they are financially strong and emerging from those uncertain economic times as stronger organizations

The CDFI industry, however, is at a critical juncture. CDFIs have demonstrated through their successful track record that the financial and development services they provide in low-income communities work, but they will need to develop new ways of doing business if they intend to grow to scale and have increasing impact in low-income communities. Some of the opportunities and challenges facing CDFIs today include:

> **Becoming more efficient and self-sufficient.** With fewer and fewer government and private subsidy dollars available, CDFIs will need to continue to find ways to become more efficient and self-sufficient in their business activities. This may involve some combination of mergers among CDFIs doing similar work, outsourcing certain aspects of CDFI operations, forming strategic partnerships that leverage core competencies of other private and public sector organizations, and developing appropriate systems that allow for growth and scale.

> **Finding new approaches to capital aggregation**. For the CDFI industry to grow to scale, CDFIs will need to more effectively tap capital markets and use capital market-like tools. There are many CDFI industry leaders developing or already using some tools such as managing lines-of-credit and floating rate capital from conventional financial institutions, selling loans and/or loan portfolios, and using credit enhancements to bring in new sources of market-rate capital. CDFIs will need to become more sophisticated in using these and other tools to grow to scale, and to have greater impacts on low-income communities throughout the United States.

> **Determining how to better track the impact and outcomes of CDFI work**. As presented in this report, the CDP collects important, but limited, data on outcomes and impacts of CDFI work. The impacts that CDFIs are having go well beyond these new jobs, affordable housing units, community services, and financial services. CDFIs face many challenges collecting the appropriate information. These range from finding the resources to collect this information from their borrowers and investees to determining what changes in a business or organization can be attributable to CDFI financing and technical assistance. This information is critical for CDFIs to make strategic decisions about their organizations and for funders and investors to demonstrate the needs for continued and increased funding to the industry.

Appendix A:

Methodology

As partners in the CDP, five national trade associations and intermediaries, Aspen Institute, Community Development Venture Capital Alliance, National Federation of Community Development Credit Unions, National Community Capital, and National Community Investment Fund, worked together as the Data Collection and Cleaning Committee to collect data across the four types of CDFIs. Each data collector was responsible for collecting CDP data from their member or constituent CDFIs. National Community Capital acted as project manager, consolidating all of the data collected.

The Data Collection and Cleaning Committee defined common data points and definitions across the various institution types, and developed data cleaning protocols that all data collectors were required to follow. National Community Capital, as data consolidator, also applied financial formulas during data consolidation to perform further quality assurance. Each trade association was responsible for designing its own survey instruments for distribution to their constituent CDFIs. The instruments were based on consensus language that defined cross-sector CDP data points, as well as on language appropriate for individual CDFI sectors.

Overall, the CDP sent out 542 surveys for FY 2002 and compiled data for 442 CDFIs, a response rate of 82%. The CDP collected 512 surveys in FY 2001 and 379 surveys in FY 2000. The CDFI Fund was a participant in the CDP in FY 2000 and FY 2001, but not in FY 2002. During 2003, the CDFI Fund contracted with an outside contractor to perform their data collection on an ongoing basis. This resulted in the decline in survey respondents from FY 2001 to FY 2002. This data set still represents one of the largest and most comprehensive samples of CDFI data to date in the field. Nonetheless, it only represents a subset of CDFI industry.

CDFIs reported information based on their own FY, which may be different from the calendar year and may vary from institution to institution.

Not all questions were relevant to all CDFIs and thus were not answered by every institution. In addition, some CDFIs were unable to answer some of the survey questions. As a result, the number of responses to individual questions may frequently be less than the total study size and is noted accordingly.

Use of Public Data for Credit Unions

The CDP sent surveys to 239 CDCUs for FY 2002. The survey requested data on organizational characteristics, financial position, products and services, and community development outputs as of the end of FY 2002.

A total of 101 credit unions (42%) sent back completed questionnaires. For 138 nonresponding credit unions, financial data were obtained from regulatory “call reports” prepared by all federally insured U.S. credit unions. Data on nonfinancial fields were unavailable for nonrespondents.

Consequently, when a survey question sought the same information provided on the call report, these data were obtained for all 239 CDCUs. Thus, it was possible to include an aggregated tally for the whole CDCU movement (as defined by this study) for these data points. For those survey questions, the sample size was all 239 credit unions. For requested data unique to the survey (and thus not available for non respondents), this report presents only the numbers drawn from the respondents. The sample size in these cases is limited to the 101 institutions that responded.

Appendix B:
Glossary of Terms

Staffing and Governance

Full-Time Equivalents (FTEs): Includes full- and part-time employees of the organization and volunteers who fill regular staff positions. Excludes temporary staff and professional services conducted outside of the office by third parties, such as accounting, bookkeeping, and legal counsel. One FTE is at least a 35-hour workweek.

Specialized Staff (FTEs): Staff dedicated to one or more specific functions.

> **Lending/Investing:** Includes all FTEs performing the following functions: portfolio management, loan/investment underwriting and outreach, and loan/investment administration.

> **Training and Technical Assistance:** Includes all FTEs providing training and technical assistance. Training refers to a forum such as a workshop, while technical assistance is customized to an individual or specific organization.

> **Financial Services:** Includes all FTEs providing services such as savings products, checking accounts, and other services (e.g., wire transfers). Includes all work performed by tellers.

Capital Available for Financing

Total Lending/Investing Pool or Capital Available for Financing: Includes all capital for lending and investing held by a CDFI, as of FYE 2002. This lending/investing pool includes only capital shown on the statement of financial position as received—it does not include capital commitments, grants receivables for capital, or undrawn funds, with the exception of the venture fund sector (which includes committed capital).

Total Lending/Investing Pool = Borrowed Funds + Deposits + Shares + Nonmember Deposits + Secondary Capital + Equity Equivalent Investments + Equity Capital.

> **Borrowed Funds:** Loans payable related to financing. Also referred to as debt capital or investor capital. Funds lent to a CDFI from a third party that the CDFI will relend or reinvest in the communities it serves.

> **Deposits:** Funds placed in a depository institution by individuals or organizations, typically earning interest and insured by governmental agencies.

> **Shares:** A deposit made in a credit union that confers ownership rights in the credit union on the depositor.

> **Nonmember Deposits:** Funds placed in a credit union by individuals or organizations that are not members of the credit union. Nonmember deposits do not confer ownership rights in the credit union to the depositor and are typically limited to a small percentage of a credit union's total deposits.

> **Secondary Capital:** A specific type of capital used only by low-income designated credit unions. It is defined by the National Credit Union Administration as having several key characteristics: uninsured, subordinate to all other claims, minimum maturity of five years, and not redeemable prior to maturity.

> **Equity Equivalent Investment (EQ2):** Unsecured debt that has some of the same advantages as equity because it is subordinate to all other debt and carries a rolling term, the investor has a limited right to accelerate payment, and interest is not tied to income. The investing bank also receives advantageous CRA credit.

> **Equity Capital:** Also referred to as net assets dedicated to lending by nonprofit loan funds, and equity by credit unions, banks, and venture funds. It is the amount of equity at the CDFI that is available for lending or investing.

Capital Under Management (VC): Traditional VC funds, organized as limited lifespan funds, are described in terms of their "capital under management" not their "total assets" as banks, credit unions, and loan funds do. Capital under management is the total amount of capital that investors have committed to the fund and includes drawn and undrawn capital. The chapter on CDVC funds reports CDVC capital under management by summing the capital commitments for each of the limited lifespan CDVC funds and the total assets for each of the evergreen funds.

Capital Sources

Nondepository Financial Institutions: Includes all financial institutions that are not banks, thrifts, or credit unions, including mutual funds, insurance companies, and finance companies.

Sectors Served

Microenterprise: Financing to for-profit and nonprofit businesses with five or fewer employees (including proprietor) and with a maximum loan/investment of $25,000. This financing may be for the purpose of start-up, expansion, working capital, equipment purchase/rental, or commercial real estate development or improvement.

Business: Financing to for-profit and nonprofit businesses with more than five employees or in an amount greater than $25,000 for the purpose of expansion, working capital, equipment purchase/rental, or commercial real estate development or improvement.

Housing: Financing to housing developers for predevelopment, acquisition, construction, renovation, lines of credit, working capital, and mortgage loans to support the development of rental housing, service-enriched housing, transitional housing, or residential housing. Includes housing financing to individuals to support homeownership and home improvement. Home equity loans are not included here unless the purpose of the home equity loan is to finance housing-related activities (e.g., home repair, purchase of another home). All other home equity loans are classified based on the purpose of the loan (e.g., a home equity loan that helps the borrower start a business is classified under business).

Community Services: Financing to community service organizations such as human and social service agencies, advocacy organizations, cultural and religious organizations, health care providers, and childcare and education providers. Uses include acquisition, construction, renovation, leasehold improvement, and expansion loans, as well as working capital loans and lines of credit.

Consumer Financial Services: All personal loans (secured and unsecured) to individuals for health, education, emergency, debt consolidation, and consumer purposes. Generally, personal loans for business are classified as microenterprise or business; personal loans for home improvement or repair are classified as housing.

Other: Any activities not covered in the sectors defined here (includes financing to other CDFIs).

Financing Outstanding

Total Loans Outstanding: The number of loans for which principal was outstanding as of the last day of the fiscal year. These loans may have originated during the fiscal year or in a previous year. This number includes any loans that have been restructured, but not those loans that have been written off.

Debt-With-Equity-Features: Includes convertible debt, as well as debt with warrants, participation agreements, royalties, or any other feature that links the investment's rate of return to the performance of the company that received the investment.

Equity Investments: Investments made in for-profit companies in which the CDFI receives an ownership interest in the equity (stock) of the company.

Guarantees: Includes guarantees or letters of credit provided to enhance the creditworthiness of a borrower receiving a loan from a third-party lender.

Total Loan Losses: The net amount charged off. Losses are reported after default, foreclosure, and liquidation and are the net of any recovered assets. If any amount is reclaimed in the current fiscal year on loans/investments that were written off in previous years, that amount is subtracted from the amount written off in the current fiscal year.

Loan Loss Reserves: Funds set aside in the form of cash reserves or through accounting-based accrual reserves that serve as a cushion to protect an organization against potential future losses. Loan loss reserves typically show up as a contra-asset on the balance sheet.

Deposit Products and Services

Individual Development Accounts (IDAs): Matched savings accounts, similar to 401(k)s, that can be used by low-income households to purchase homes, seek postsecondary education, capitalize small businesses, or engage in other types of economic development activities.

Geographic Area Served

Major Urban Area: In a metropolitan statistical area of equal to or greater than one million. Includes both central city and surrounding suburbs.

Minor Urban Area: In a metropolitan statistical area of less than one million. Includes both central city and surrounding suburbs.

Rural: All areas outside major urban and minor urban areas.

Clients Served and Outcomes

Low-Income: A customer who has an annual income, adjusted for family size, of not more than: 80% of the area median family income for metropolitan areas, or, the greater of (1) 80% of the area median family income, or (2) 80% of the statewide nonmetropolitan area median family income for nonmetropolitan areas.

Jobs Created: The change in the number of jobs at a microenterprise or business financed between two fiscal years (i.e., the net job change). When calculating the number of jobs at the microenterprise or business, only permanent full-time-equivalent jobs are counted.

Jobs Maintained: Total number of employees at microenterprise or business financed at the time a given loan or investment closed.

Jobs Assisted = Jobs Created + Jobs Maintained.

Housing Units Created: Includes new construction or units projected to be constructed or complete rehabilitation of existing housing units that were previously unoccupied.

Housing Units Renovated or Preserved: Renovated includes units that have been renovated or are projected to be renovated. Preserved includes mark-to-market and similarly preserved units.

Appendix C:
The CDFI Data Project

The CDP is an industry collaborative that produces data about CDFIs. The goal of the CDP is to ensure access and use of data to improve practice and attract resources to the CDFI field. The CDP will bolster capacity building, capitalization, policymaking, and research to strengthen CDFIs. The CDP collected FY 2002 data on 442 CDFIs. The data set includes approximately 150 datapoints on operations, financing, capitalization, and impact. The 442 CDFIs represent one of the largest data sets ever collected on the CDFI industry, and a substantial subset of approximately 1,000 CDFIs that operate across the nation. Supported by The John D. & Catherine T. MacArthur Foundation and The Ford Foundation, this initiative convenes leading organizations in the CDFI industry.

Partner Organizations

Aspen Institute
Economic Opportunities Program
One Dupont Circle NW, Suite 700
Washington, DC 20036
Ph: 202.736.5800
Fax: 202.467.0790
www.fieldus.org
National nonprofit that disseminates best practices and educates policymakers, funders, and others about microenterprise

Association for Enterprise Opportunity
1601 North Kent St, Suite 1101
Arlington, VA 22209
Ph: 703.841.7760
Fax: 703.841.7748
www.microenterpriseworks.org
National member-based trade association of more than 500 microenterprise development programs

CDFI Coalition
1601 North Kent St, Suite 803
Arlington, VA 22209
Ph: 703.894.0475
Fax: 703.841.7748
www.cdfi.org
Lead organization in the United States that promotes the work of CDFIs

Community Development Venture Capital Alliance
330 Seventh Ave, 19th Floor
New York, NY 10001
Ph: 212.594.6747
Fax: 212.594.6717
www.cdvca.org
Certified CDFI intermediary that serves community development venture capital funds through training, financing, consulting, research, and advocacy

Corporation for Enterprise Development
777 North Capitol St NE, Suite 800
Washington, DC 20002
Ph: 202.408.9788
Fax: 202.408.9793
www.cfed.org
National nonprofit that promotes asset-building and economic opportunity strategies, primarily in low-income and distressed communities

National Community Capital Association
620 Chestnut St, Suite 572
Public Ledger Building
Philadelphia, PA 19106
Ph: 215.923.4754
Fax: 215.923.4755
www.communitycapital.org
National membership network that finances, trains, consults with, and advocates for CDFIs

National Community Investment Fund
2230 South Michigan Ave, Suite 200
Chicago, IL 60616
Ph: 312.881.5851
Fax: 312.881.5801
www.ncif.org
A certified CDFI that channels equity, debt, and information to locally owned banks, thrifts, and selected credit unions with a primary purpose of community development

National Federation of Community Development Credit Unions
120 Wall St, 10th Floor
New York, NY 10005
Ph: 212.809.1850
Fax: 212.809.3274
www.cdcu.coop
A certified CDFI intermediary that serves over 200 low-income credit unions across the United States

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