



TOOLKIT

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

**Community
Economic
Development
Toolkit**



Disclaimer

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COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS
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TABLE OF CONTENTS

Introduction 3
Community Economic Development and integration 5
Background 6
What is a CDFI? 7
CDFI Program Benefits 7
CDFI Financial Assistance and Technical Assistance 9
CDFI Designation Requirements 11
Becoming a CDFI 11
CDFI Eligibility 11
CDFI Award Categories 11
CDFI Application for Technical Assistance Awards 11
CDFI Application for Financial Assistance Awards 12
Comprehensive Ratings for CDFI Investments (CARS) 13
Business Plan and Growth Strategy 13
Program Feasibility Concepts 14
Start Up or Expansion/Becoming a CDFI 15
Start Up CDFI 15
Slightly Experienced Loan Fund 17
Existing or Experienced Loan Fund 17
Summary Steps to Becoming a CDFI 17
Development Tips 18
Other Notes 19
Final Note 19
Appendix A – For More information 21
Opportunity Finance Network 21
Coalition of Community Development Financial Institutions (CDFI Coalition) 21
Community Development Financial Institutions Fund 21
California Association for Micro Enterprise Opportunity (CAMEO) 21
National Community Reinvestment Fund (CRF, USA) 22
For More information: Websites, Organizational Examples 22
NCB Capital Impact 22
Regional CDFIs 23
Clearinghouse CDFI 23
Coastal Enterprise, Inc. (CEI) 23
Community Based Funds 23
Fresno Community Development Financial Institution (FCDFI) 23
People Incorporated Financial Services 23

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

INTRODUCTION

This Community Development Financial Institutions (CDFIs) Guide is intended for use by community development organizations for the following purposes:

1. Organizations wanting to learn about CDFIs
2. Organizations considering becoming a certified Community Development Financial Institution which have an existing loan program
3. Organizations considering becoming a certified Community Development Financial Institution and have not operated a loan program
4. Organizations looking for CDFI services for their own use or for their community

The CDFI designation is a certification process conferred by the CDFI fund of the Department of Treasury. The designation is for financial institutions (and lending programs including community loan funds) and allows access to Treasury programs and investments. The designation has become a key identification factor for foundations, local, state and other federal programs to invest additional capital.

The mission of the Community Development Financial Institutions Fund is to “expand the capacity of financial institutions to provide credit, capital and financial services to underserved populations and communities in the United States”¹ The CDFI Fund has several programs that enhances access to capital. Upon receiving certification, CDFI’s are eligible to compete for technical assistance grants, capital grants, New Markets Tax Credits as well as other targeted incentive programs.

The CDFI designation allows lending programs access to compete for CDFI resources, but these resources are in very high demand. Since the start of the program in 1994, the competitive bar has risen dramatically and organizations receiving grants have significant experience in successfully operating a loan fund or conduction lending activities. Therefore we highly recommend that organization closely study the application guidelines found at www.cdfifund.gov.

*“CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers, flexible underwriting and risk capital for needed community facilities, and technical assistance, commercial loans and investments to small start-up or expanding businesses in low-income areas. CDFIs include regulated institutions such as community development banks and credit unions, and non-regulated institutions such as loan and venture capital funds”.*²

¹ Community Development Financial Institutions Fund “CDFI Certification Application”, Department of Treasury, June 2007, pg 4

² CDFI Fund Summary, www.cdfifund.gov

For successful loan funds, the CDFI designation is very important and allows your lending program to grow dramatically. Most foundation and corporate grants and investments from financial institutions look for the CDFI designation before grant or investment discussions begin. Over the last three years, financial institutions have been very actively seeking sound CDFIs to invest in. CDFIs have been a very successful mechanism for financial institutions to meet lending and investment measures required by the Community Reinvestment Act (CRA) and enforced by banking regulators. A high CRA rating is needed if the financial institution has plans to expand in the future.

Due to recent economic and financial turmoil, commercial lenders and investors have substantially tightened lending requirements, resulting in a “credit crunch” where credit needs are greater than resources. This economic landscape resulted in commercial financial institutions greater reliance on community loan funds and CDFIs as the mechanism to better serve market needs. Financial institutions began to invest and lend more aggressively to sound CDFIs. This investment and lending strategy enables institutions to meet CRA requirements while make safe and sound investments. CDFIs have built a strong reputation in understanding local credit nuances and needs resulting in strong loan portfolios.

Recently, the Federal Home Loan Bank (FHLB) system has allowed CDFI’s access to membership previously limited to commercial banks, thrifts and savings and loans (determined on a regional bank by bank approval process). There are very stringent requirements however access allows CDFIs to leverage CDFI equity and below-market financing to serve more customers and provide more lending products. The cost of funds from the FHLB is typically greater than the rates from grant sources for CDFIs, so the use of this resource is somewhat limited to larger CDFI involved with larger loans. Approval is heavily weighted on successful management experience and lending history.

An additional very important resource was created by the Small Business Jobs Act of 2010 which include the CDFI Bond Guarantee Program which will be administered by the CDFI Fund. With current low interest rates, CDFIs will be able to lock in current extremely low interest rates of up to 30 year debt. This would result in a capital infusion for CDFIs of \$3 billion dollars (by 2014), at rates in the current market at about 3%.

“Key features of the program include:

- 1. \$3 Billion in bond guarantee authority through 2014 with minimum bond size of \$100 million*
- 2. CDFIs will be able to issue taxable bonds with terms up to 30 years*
- 3. The Federal Government Guarantee ensures repayment of verifiable losses of principal, interest, and call premium, if any, on bonds and notes*
- 4. The Federal Financing Bank will buy 100 percent of bonds and notes issued to simplify execution and minimize cost and pricing*
- 5. Participating CDFIs will be required to establish a risk share pool of three percent of the bond or note amount*

6. *Proceeds can be used by CDFIs to finance or refinance activity that meets the community and economic development t definition of the Riegle Act (enabling legislation for the CDFI Fund).’’³*

COMMUNITY ECONOMIC DEVELOPMENT APPLICABILITY AND INTEGRATION

CDFIs play an integral role in a community economic development strategy. CDFIs bring capital to underserved markets that include business finance (start up, micro, non-profit, small and business expansion), real estate development finance (affordable housing, commercial and office, community facilities and industrial) and personal finance (auto, home or personal). This capital creates economic stability while creating jobs and opportunities for community residents. CDFIs also bring communities a higher level of technical expertise in business and finance increasing the potential for sustained community stability and growth.

CDFI’s have also enabled financial institutions to become more effective in meeting customer demands in low income and disadvantaged communities. The growth of successful CDFI’s allows funds to more easily cover operating and overhead expenses and generate additional income to support other organizational community development activities such as business technical assistance programs and expansion of lending services to meet other aspects of community credit needs (such as auto loans, micro loans, home or business loans). A stronger and financially viable lending business will enhance the overall success and longevity of your community development organization.

The CDFI designation increases resources (expertise and capital) resulting in greater lending activities. This expansion enhances the organization and community. The effects are substantial and include:

For the Organization:

1. Allows for expansion and stability for the organizations lending efforts
2. Generates additional income for the program
3. Supports and allows for the creation of additional complementary programs, services and projects
4. Expands staff capacity a capabilities by attracting and retaining experienced professionals in business finance and development

For the community:

1. Increases access to capital
2. Increased access related resources such as training and technical assistance in the areas of finance and business development
3. Enhances the local economy by supporting important segments of the economic infrastructure including business, residential and industrial sectors

³ Dolan, Cathy “CDFI Bond: Opportunity of a Decade, Community Investments” Federal Reserve Bank of San Francisco, Fall 2011, page 28

Successful lending efforts (and ancillary financial programs) results in economically stronger communities, stronger workforces, more informed and capable businesses and tenants, and ultimately a stronger and more inclusive economy.

Because CDFI fund resources are limited, highly competitive and require a strong track record and high level of expertise, alternative solutions include the creation of partnerships with existing CDFIs. Partnerships could be as simple as having an existing CDFI expand their market area to include your geography or by providing a local site for training and technical assistance services. Another solution can include creation of a new fund targeted to the needs of your community but is managed and operated by a successful CDFI.

CDFI's are important resources for low income communities. "CDFIs are profitable but not profit maximizing. They put community first, not the shareholder. They have had great success over the past 30 years, and have a proven track record of making an impact in those areas of America that need it most".⁴

In a June 2009 speech, Federal Reserve Chairman Ben Bernanke recognized that CDFIs facilitate economic growth and development:

*"Today, nationwide, there are more than 1,000 certified CDFIs with a collective \$25 billion in assets. These organizations have loaned and invested billions of dollars in our nation's most distressed communities and have attracted many conventional investors into underserved areas....As a complement to lending, CDFIs offer training and technical assistance to their customers, directly or through partnerships, thus increasing borrower capacity and mitigating loan risk. Successful CDFI borrowers' often graduate to conventional financing as their needs grow, thereby attracting the participation of mainstream lenders while freeing up CDFI resources to plant new seeds in the community"*⁵

This guide will provide you background on the CDFI program, discuss program aspects and summarize the eligibility/application process. The guide will also discuss and present successful CDFI strategies and identify resources for organizations interested in pursuing a CDFI designation. We will also discuss various strategies for partnerships that will bring the benefits CDFI's offer to your community or organization.

BACKGROUND

The CDFI program was established in 1994 as part of the Community Development Banking and Financial Institutions Act. The program had its earlier genesis from President Bill Clinton while as a candidate in 1992 visited the South Shore Bank, a specialized community development bank focused on increasing investment in neglected neighborhoods. The President's interest in creating similar efforts led to the creation of the CDFI fund in Treasury.

⁴ Opportunity Finance Network (OFN), "About CDFIs", website www.ofn.net

⁵ Opportunity Finance Network "CARS, Comprehensive Ratings for CDFI Investments", An Independent Project of Opportunity Finance Network, www.CARSratingsystem.net

The 1994 law was designed to “promote economic revitalization and community development in distressed urban, rural and Native American communities across the nation. The CDFI Fund does this primarily by awarding financial assistance to CDFI’s and insured depository institutions.”⁶

WHAT IS A CDFI?

The CDFI Certification Application⁷ defines CDFIs as follows: “A Community Development Financial Institution (CDFI) is a specialized financial institution that works in market niches which are underserved by traditional financial institutions. CDFIs provide a unique range of financial products and services, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers, flexible underwriting and risk capital for needed community facilities, and technical assistance, commercial loans and investments to small start-up or expanding businesses in low income areas. A CDFI must provide development services that support financial transactions and show that it is directly accountable to its community or its customers. CDFIs include regulated institutions such as community development bounces and credit unions, a non regulated institution such as loan funds, venture capital funds and micro-enterprise loan funds.”

To become a CDFI the entity must meet the following six certification criteria:

1. Have a primary mission of promoting community development
2. Be a financing entity
3. Primarily serve one or more target markets
4. Provide development services in conjunction with its financing activities
5. Maintain accountability to its defined target market
6. Be a non-governmental entity and not be under control of any government entity (excluding tribal governments).

CDFI PROGRAM BENEFITS

The CDFI certification is a requirement that will allow you to access CDFI program funds. These programs include: *Note: Source material for this section is from the CDFI website at: www.cdfifund.gov. The website includes annual changes in the program or special programs, for example the 2011 application process included the Healthy Food Financing Initiative that made 12 awards for \$25 million. The goal of this program is to use CDFI capacity to make investments in a range of health food projects serving food deserts including grocery stores, mobile food retailers. Farmers markets, cooperatives, corner stores, bodegas or other food related items (including health foods).*

1. Bank Enterprise Award (BEA): CDFIs can partner with a FDIC insured financial institution to seek a BEA award. This program provides incentives to institutions by providing

⁶ Abt Associates Inc., “From Insight to Impact, Assessment of the Community Development Financial Institutions Fund (CDFI) Program, Training Program & CDFI Certification – Final Report” Executive Summary, August 17, 2007, page iii

⁷ CDFI Fund Summary, Op Cit

financial incentives to expand investments in CDFIs and to increase lending, investment, and service activities within economically distressed communities over a specific time period. Activities include:

- a. CDFI Related Activities: Equity investments, equity-like loans, grants, loans, deposits/shares, and technical assistance to qualified CDFI partners
 - b. Distressed Community Financing Activities: Affordable home mortgage loans, affordable housing development loans, small business loans, home improvement loans, education loans, and commercial real estate loans
 - c. Service Activities: Deposits, community services, and financial services
2. Capital Magnet Fund (CMF): provide competitively awarded grants to CDFIs and qualified nonprofit housing organizations. CMF awards can be used to finance affordable housing activities as well as related economic development activities and community service facilities. Awardees will be able to utilize financing tools such as loan loss reserves, loan funds, risk-sharing loans, and loan guarantees to produce eligible activities whose aggregate costs are at least ten times the size of the award amount.
 3. CDFI Programs: (See next section for details on the Financial Assistance and Technical Assistance Programs)
 4. Financial Education and Counseling (FEC): Through the FEC Pilot Program, the CDFI Fund shall provide grants to eligible organizations to enable them to provide a range of financial education and counseling services to prospective homebuyers, with the goals of:
 - a. Increasing the financial knowledge and decision-making capabilities of prospective homebuyers;
 - b. Assisting prospective homebuyers to develop monthly budgets, build personal savings, finance or plan for major purchases, reduce their debt, improve their financial stability, and set and reach their financial goals;
 - c. Helping prospective homebuyers to improve their credit scores by understanding the relationship between their credit histories and their credit scores; and
 - d. Educating prospective homebuyers about the options available to build savings for short- and long-term goals

The ultimate program goals of the FEC Pilot Program are to identify successful methods resulting in positive behavioral change for financial empowerment, and to establish program models for organizations to carry out effective financial education and counseling services to prospective homebuyers.

5. New Markets Tax Credits: CDFIs are eligible to compete for New Markets Tax Credits (NMTC). Through the creation of a Community Development Entity (CDE), credits are allocated to eligible non housing real estate development projects in eligible locations. Community benefit and job creation are the primary goals of the program. The New Markets Tax Credit Program (NMTC Program) was established by Congress in 2000 to spur new or increased investments into operating businesses and real estate projects located in low-income communities. The NMTC Program attracts investment capital to low-income communities by permitting individual and corporate investors to receive a tax credit against their Federal income tax return in exchange for making equity investments in specialized financial institutions called Community Development Entities (CDEs). The credit totals 39 percent of the original investment amount and is claimed over a period of seven years (five percent for each of the first three years, and six

percent for each of the remaining four years). The investment in the CDE cannot be redeemed before the end of the seven-year period. *NOTE: The NMTC program has become a very important tool for Community Economic Development. Please review the separate Guide on New Markets Tax Credits for more details.*

6. Native American CDFI Assistance Program (NACA): Focused program supporting activities for Native American communities: The CDFI Fund's Native Initiatives are designed to overcome identified barriers to financial services in Native Communities. These initiatives seek to increase the access to credit, capital and financial services in Native Communities through the creation and expansion of CDFIs primarily serving Native Communities
7. Certification for Community Development Entities (CDE): A CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investments, or financial counseling in low-income communities. Benefits of being certified as a CDE include being able to apply to the CDFI Fund to receive a New Markets Tax Credit (NMTC) allocation to offer its investors in exchange for equity investments in the CDE and/or its subsidiaries; or to receive loans or investments from other CDEs that have received NMTC allocations
8. Certification for CDFIs: CDFI certification is a designation conferred by the CDFI Fund and is a requirement for accessing financial and technical award assistance from the CDFI Fund through the CDFI Program, Native American CDFI Assistance (NACA) Programs, and certain benefits under the BEA Program to support an organization's established community development financing programs

CDFI Financial Assistance and Technical Assistance: To be eligible for an FA award, a CDFI must be certified by the CDFI Fund before it applies for the award. Prospective applicants that are not yet certified must submit a separate certification application to be considered for FA during a funding round.

Both certified and non-certified CDFIs are eligible to apply for TA awards. However, non-certified organizations must be able to become certified within two years after receiving a TA award. The TA awards will cover expenses needed to build the capacity of organizations to become eligible for CDFI designation.

Technical Assistance (TA): TA grants allow certified CDFIs and established entities seeking to become certified to build their capacity to provide affordable financial products and services to low-income communities and families. Grants may be used for a wide range of purposes. For example, awardees can use TA funds to purchase equipment, materials, or supplies; for consulting or contracting services; to pay the salaries and benefits of certain personnel; and/or to train staff or board members. The CDFI Fund makes awards of up to \$100,000 under the TA component of the CDFI Program

Financial Assistance (FA): The CDFI Fund makes awards of up to \$2 million to certified CDFIs under the FA component of the CDFI Program. A CDFI may use the award for financing capital, loan loss reserves, capital reserves, or operations. FA awards are made in the form of equity investments, loans, deposits, or grants, and the CDFI is required to match its FA award dollar-for-dollar with non-federal funds of the same type as the award itself. This requirement enables

CDFIs to leverage private capital to meet the demand for affordable financial products and services in economically distressed communities.

CDFI Program Activities: The CDFI Fund publishes annual reports on who received awards. The information is summarized and is presented by CDFI name and by State they are located in. The summary shows the geographic target of the funds (can vary from neighborhoods, to counties to multi-state geographies), and what type of lending and investment the CDFI targets (micro loans, business loans, home loans, real estate loans and/or loans to non-profit organizations).

The following summarizes activities for the 2011 awards.

1. 155 organizations received \$142 million (all grants)
2. 118 FA and 37 TA awards were made
3. 125 loan funds, 25 credit unions, three venture capital funds, and two depository institutions/holding companies received awards
4. 69 served major markets, 39 served minor urban markets and 47 served rural areas

Financial Assistance Awards:

1. 267 CDFIs applied requesting over \$448 million
2. 118 received \$139 million
3. 94 loan funds, 20 credit unions and 4 awards went to others
4. Core CDFIs (received previous FA grants) received 86 awards with 32 going to Emerging CDFIs (new or previously received TA grants)
5. Awardees were headquartered in 35 different states
6. Type of services included:
 - a. 32% provided affordable housing products
 - b. 29% provided small business loans
 - c. 21% provided consumer finance loans
 - d. 14% provided micro enterprise financing
 - e. 3% provided commercial loan products

Technical Assistance Awards

1. 114 applicants requested over 10.8 million
2. 37 awards were made for a total of \$3.15 million
3. 31 loan funds, five credit unions and 1 other received grants
4. Awards ranged from \$13,456 to \$100,000
5. Use of the funds included:
 - a. 48% for Personnel
 - b. 26% Professional Services
 - c. 9.3 % Fringe Benefits
 - d. 4.1% Equipment
 - e. 3.8% Training
 - f. 2.7% Materials/Supplies
 - g. 2.6% Travel
 - h. 2.6% Other

CDFI DESIGNATION REQUIREMENTS:

The following outline summarizes the key elements in the application to become a CDFI. You can locate the full CDFI application on the CDFI Fund website.

Becoming a CDFI:

1. A CDFI is a specialized financial institution that works in market niches that are underserved by traditional financial institutions.
2. Provide a unique range of financial products and services in economically distressed target markets such as:
 - a. Mortgage financing for low income and first time homebuyers and non- profit developers
 - b. Flexible underwriting and risk capital for needed community facilities and technical assistance
 - c. Commercial loans and investments to small start up or expanding businesses in low income areas
3. Could include regulated institutions such as community development banks and credit unions and non regulated entities such as loan and venture capital funds

CDFI Eligibility: This is the first step you need to establish eligibility to apply for Technical Assistance or Financial Assistance Awards. You must submit a CDFI Certification Application to the fund for review. You must:

1. Be a legal entity at the time of certification application
2. Have a primary mission of promoting community development
3. Be a financing entity
4. Primarily serve one or more target markets
5. Provide development services in conjunction with financing activities
6. Maintain accountability to its defined target market
7. Be a non government entity and not be under the control of any government

2011 CDFI Award Categories:

1. Financial Assistance: Certified CDFIs may receive awards in the form of grants, loans, equity investments, deposits and insured credit union shares
 2. Technical Assistance: Non certified CDFI's may apply for TA (not both) to build organizational capacity. If you have not been certified, TA could help you get certified. These funds do not require matching funds.
 3. Healthy Foods Financing Initiative: Awards to CDFIs to address the need for healthy foods in their markets (USDA and HHS support)
-

CDFI Application for Technical Assistance Awards: This award allows you to build your organizations systems and capacity to apply for the Financial Assistance Awards. Required information includes:

1. TA Proposal
 - a. How will it help meet business plan proposal
 - b. How will it help build your capacity
2. Use
 - a. Training, travel and supplies/materials
 - b. Professional services (consultants for lending policies and procedures, market analysis, evaluate existing services and programs and develop and deliver training to potential borrowers.
3. Economic Distress Priority Points
 - a. Level of distress (qualitative and quantitative) in target market
 - b. Priority points: ID 5 priority counties
4. Financial Products and Financial Services
 - a. List products and needs addressed
 - b. Examples of past customers and impacts
 - c. Returns and leveraging
5. Services to the Targeted Market
6. Market Demand
7. Organizational Capacity
 - a. Track record (products and services)
 - b. Growth (demand)
 - c. Impact
 - d. Leveraging
 - e. Projected activity and results
 - f. Management team (key staff)
 - g. Systems, policies and procedures for underwriting, portfolio review, financial accounting and MIS systems.
 - h. Financial capacity (portfolio health, viability, capitalization and performance)
 - i. Capital measures and ratios

CDFI Application for Financial Assistance Awards: This award is a grant that can be used for organizational systems improvement as seed capital (or expansion capital) for your loan fund. It is a grant and therefore comes to you a 0% interest. Information required includes:

1. Target Market:
 - a. Customers
 - b. National Markets: Where have you provided Financial Products over the last 5 years
 2. Financial Assistance Plan (For FA)
 - a. Organizations impacts to date in the target market
 - b. Business plan once award is received
 3. High Impact Narrative
 - a. How, timeline, objectives and impact
 4. Economic Distress and Priority Points
 - a. Level of economic distress (areas within larger geography)
-

- b. Economic data; credit, capital and financial need
- 5. Financial Products and Financial Services
 - a. List products and needs addressed
 - b. Examples of past customers and impacts
 - c. Returns generated by products and services
 - d. How funding is being leveraged
- 6. Service to Target Market
 - a. Development services summary
 - b. Linkage to products
 - c. Other services
- 7. Market Demand
 - a. Quantify demand for products and services
 - b. Market studies
 - c. Other resources
- 8. Organizational Capacity
 - a. Track record (products and services)
 - b. Growth (demand)
 - c. Impact
 - d. Leveraging
 - e. Projected activity and results
 - f. Management team (key staff)
 - g. Systems, policies and procedures for underwriting, portfolio review, financial accounting and MIS systems.
 - h. Financial capacity (portfolio health, viability, capitalization and performance)
 - i. Capital measures and ratios

Comprehensive Ratings for CDFI Investments (CARS): CARS, the CDFI Assessment and Ratings System, was launched in 2004 as an independent project of Opportunity Finance Network. It is “the only ratings system to provide a comprehensive, third-party assessment of both impact performance and financial strength and performance [of CDFIs] CARS helps investors confidently assess CDFIs that match their social objectives and risk parameters”⁸. The analysis includes an assessment by an experienced professional expert in underwriting CDFIs. The analysis includes assessment of financial and programmatic performance and review of loan portfolios, risk management systems, staff and board.

The analysis creates a single standardized rating system to assist investors from sources such as foundations, corporations or individuals to uniformly decide where they will invest their funds based on impact and risk tolerance. Many institutions solely rely of the CARS rating and require applicants to participate in CARS.

Business Plan and Growth Strategy: The CDFI application process essentially lays out the majority of items needed for a sound business plan. Key elements that are not part of the application include:

⁸ OFN, CARS, Comprehensive Rating for CDFI Investments, Op Cit

1. **Market Analysis:** Identification and analysis of competition and determination of market size and needs

In most cases, the competition is nonexistent. This is the primary reason why an organization would seek to create a loan fund/CDFI. This analysis is important in identifying the credit gaps that you are trying to fill, while understanding why other institutions have not attempted to meet this need. It also allows you to identify potential partners, such as those that may refer business to you or where you might need to refer clients with needs that your fund does not address. This process also helps you identify sources that may be interested in matching grant funds.

2. **Financing Plan:** Financial analysis of the existing and proposed loan portfolio and cash flow for your business operations

You should also identify additional sources of financing that could be leveraged for your fund. If you are awarded a technical assistance grant or a financial assistance grant, you should be ready to leverage these funds with other public and private sector resources. Initially a concept paper and the later business plan are key elements needed to attract investors.

Program Feasibility Concepts: Operating a loan fund is a business. Loan funds can generate income for organizations if they are operated properly and have the right level of activity. Key terms and concepts that need to be managed include:

1. **Cost of Funds:** Your loan pool may include various sources of grants and investment funds. Some will come in at different interest rates. The blended rate is the average rate for your loan pool. If you received all grants the rate would be “0” but if you received an investment or loan, the rate might be 2-5%.
2. **Interest Rate Spread:** The spread is the differential between your cost of funds and what rate of return is (average interest rate you are charging) for your funds.
3. **Breakeven:** This is the minimum rate (above the cost of funds) you need to charge to cover your expenses.
4. **Fund Expenses and Overhead:** Business operations (loan and portfolio management), business management, marketing, office and staff costs are expenses that should be paid from the “interest rate spread”. If your income does not cover expenses, you will need to secure ongoing funding for operations.
5. **Loan Loss:** This is the expected rate of losses in bad loans. All funds have provisions for loan losses and the more aggressive the fund is (willing to take more lending risks) the greater the losses could be. Successful funds estimate loan losses well below 5% (which at one time was a standard commercial lending loss expectation).
6. **Loan Loss Reserve:** Loan loss reserves are funds set aside that may be needed to repay any loans or investments made to your fund. If your fund consisted of a mix of loans investments and grants, and a portion of the fund needed to be repaid to a lender or investor you would set aside funds in a loan loss reserve. If one of the loans you made went bad and your fund lost \$25,000 you would need to tap into the reserve to repay the lender or investor. The riskier your lending is or if you have had historically high loan losses, you would reflect a higher loan loss reserve. High loan loss reserves do not benefit your fund since it is set aside and is not “working” in the market and generating interest income.

In financial institutions and in larger funds, loans in portfolio are rated and loans with greater risk or are in distress (late payments) will have a higher percentage set aside for potential loan losses.

7. Feasibility: Income needs to exceed expenses. The larger the lending pool (and level of funding you have out to borrowers) the greater your potential returns are. Similarly, smaller sized funds have a more difficult time generating income to cover expenses. Smaller loans also increase operating costs (handling and processing costs for each transaction is relatively the same whether the loan is for \$500 or \$5,000,000.

START UP OR EXPANSION / BECOMING A CDFI

The following section will discuss various strategies and steps that should be considered if you are a start up CDFI or if you are expanding to become a CDFI. We will look at the following:

1. Start Up CDFI: Two Structures
 - a. As a new fund
 - b. Through a partnership
2. Existing, Slightly Experienced Loan Fund
3. Existing, Experienced Loan Fund

Start Up CDFI: For those who do not have a loan fund or lending program you first need to create a loan fund to build the lending track record and organizational experience. This initial loan fund will subsequently seek CDFI certification. Once certified, you are eligible to apply for the CDFI Fund's programs. *NOTE: For more information on creating loan funds, please see the "Loan Fund Guide"*

This is the most difficult starting point because many CDFI and lending resources require experience. The following is a suggested guide for those organizations that have clearly identified need with strong support to create a fund. Support from your organization and board is critical. The fund should be targeted to a specific market segment: micro businesses, small businesses, affordable housing or consumer financing. There are two methods of becoming a CDFI, one starting from scratch and one through partnerships.

Strategy 1: New Fund (If your plans call for the creation of a new fund or start up). A significant amount of funding and predevelopment work is needed for developing the business plan, marketing and management plans. Consider applying for a CDFI Technical Assistance Grant. You will also need funding for operations and for the loan fund. If this is the case, you will need to consider the following 3 steps:

1. Fund Initiation: Secure seed funds to allow staff or consultant to assist in the following:
 - A. Concept Paper: Creation of a one-two page summary that includes a summary of your organization, need, size, management and potential resources available for the business and fund.
 - B. Community Support: Obtain support from entities that represents your target market
 - C. Public and Private Sector Support: Identify support from entities that represents your target market

- D. Identify potential sources for predevelopment funds
 - E. Seek grants (or plan to self finance)
2. GO/NO GO: The information researched above will allow you to update the concept paper. This will allow your organization to decide if the creation of a loan fund makes sense and is feasible. Securing predevelopment funds will be essential. The concept paper will be the basis of the business and marketing plan.
- Determination of the scope, size, and direction of your loan fund should provide a good indication of feasibility. Sources of initial capital are secured through foundation and corporate grants and, in some instances, from local government programs, especially if there is a targeted market with tremendous needs.
- Financial institutions often provide corporate grants that allow them to penetrate markets by effectively partnering with community organizations that represent and serve these communities. As in all program proposals, making the case, presenting need, and indicating how your organization's role will enhance the effort must be made. (See Development Tips at the end of the Guide)
- Your organization must assess how the proposed program costs will benefit the overall community economic development strategy of the community and organization while assessing impacts to individual CED projects and programs. The creation of a loan fund offers substantial benefits to the community and its economic well being.
3. Pre-development Activities:
- A. Business Plan/Market Analysis: Conduct a market analysis and develop a business plan for the fund.
 - B. Management Plan:
 - 1.) Fund Management: Included are the documents that define lending parameters, lending guidelines, requirements and application process.
 - 2.) Loan Management: Included are the loan management functions (loan approval process, closing, documentation and loan management (billing/collections) process).
 - 3.) Portfolio Management: Guidelines and standards on risk management (loan loss tolerance, reserves and risk rating of loans).
4. Start Up Lending Activities
5. Application for a CDFI certification. Once you receive certification you are eligible to apply for a Technical Assistance Grant (to conduct or upgrade your business plan) or for a Financial Assistance Award (grant for your loan pool). *NOTE: You can apply for a Technical Assistance Grant to start a CDFI and loan pool from scratch, but these are in very high demand and are very difficult to obtain. The more experience you have the greater the possibility of receiving a grant.*

Strategy 2: Partnership: If there are other CDFIs operating in your area (or nearby), you may want to consider partnerships that will leverage their expertise with your understanding of local needs. This strategy allows you to build capacity and expertise and maintain a goal of creating your own loan fund and obtain CDFI certification at a later date. Some of the various strategies include:

- 1. Expansion of Service Area: If it is possible, an existing CDFI could expand their coverage area to include your geography. You could become a marketing arm for their products

and services and possibly provide space, coordinate meetings or provide language services.

2. **Creation of a Dedicated Fund:** If there is significant interest and resources in creating a fund, you may want to consider creating a fund and having the CDFI or neighboring loan fund manage the fund. There are significant ongoing expenses for operations and all “back-room” operations (loan servicing and management). Your organization could participate in developing the lending guidelines and standards, or possibly be on the loan committee for the fund. This intermediary step allows you to gain experience that will allow you to create your own fund.

The partnership structure is important if you are considering operating a small loan fund or provide small loans. Remember, the management and handling costs for a small loan is the same as for larger loans. In addition, the larger the loan pool (and the greater the amount of funds you have out) generates the more interest income used for operations and management. For these smaller pools, it may financially wise to have another institution service and manage your loan fund.

For smaller funds another strategy to lower operating costs is to partner with other organizations that might handle marketing, training and technical assistance.

Slightly Experienced Loan Fund: If your organization has some experience in lending or wants to build a lending track record, you can immediately apply to become a Certified Development Entity (CDE). Although the definition focuses on New Markets Tax Credits, a CDE’s activities meet CDFI standards and provide an established certified lending track record for organizations. As a CDE you will be able to apply for CDFI certification and a Technical Assistance Award. The process to become a CDE is straightforward and relatively simple.

As defined on the CDFI website, “a CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investments, or financial counseling in Low-Income Communities (LICs). Benefits of being certified as a CDE include being able to apply to the CDFI Fund to receive a New Markets Tax Credit (NMTC) allocation to offer its investors in exchange for equity investments in the CDE and/or its subsidiaries; or to receive loans or investments from other CDEs that have received NMTC allocations.”⁹

To become certified as a CDE, an organization must submit a CDE Certification Application to the Fund for review. The application must demonstrate that the applicant meets each of the following requirements to become certified:

- Be a legal entity at the time of application;
- Have a primary mission of serving LICs; and
- Maintain accountability to the residents of is targeted LICs.

Existing or Experienced Loan Fund: If you are currently operating a loan fund you will need to simply apply to the CDFI Fund for certification. The certification process is straightforward (check at www.CDFIfund.gov). Once you receive certification, you are eligible to apply for a Technical Assistance Award (to allow you to create the business, marketing and management

⁹ CDFI Fund Website, Op Cit

plans) for your CDFI. You can also apply for a Financial Assistance Award that provides capital for you new or expanded loan fund.

Summary Steps to Becoming a CDFI: To gain CDFI designation the steps are relatively simple. The work is in the planning and application process.

Process:

1. Technical Assistance to developing the organization and program structure
2. Obtain Community Development Entity (CDE) designation
3. Financing participation /partnership (strategy to gain experience)
4. Application for Technical Assistance Awards
5. Developing the CDFI organizational and program structure
6. Apply for CDFI status
7. Request for CDFI funding
8. Other investments and matches
9. Make loans
10. Manage loans

DEVELOPMENT TIPS:

Some key development tips to remember include:

1. If you are starting a new fund, do the initial investigative research and concept paper to determine if the project is feasible. The concept paper will also become your base tool for to discuss the concept to potential funding and resource partners and becomes the basis for your business plan. As you gather data your concept paper should be continually updated and will become the basis of your business plan.
2. Instead of starting your own fund, consider partnerships to bring the resource to your community or to create a specialized fund that can be managed by an existing CDFI or loan fund. This may be an intermediary step for you to gain experience if you later want to create and manage your own fund.
3. Become a Community Development Entity (CDE) and get CDFI Certification. This is especially true if your organization has a lending program.
4. The CDFI designation only allows you to apply for CDFI Fund resources and they are very competitive. It is important to build your capacity and track record.
5. Once you get a designation make sure conventional lending institutions are part of you planning/development process. Enlist them as supporters (on your board, advisory board or project committee). Remember, the conventional financial markets have realized the importance and successes of CDFIs and seek CDFIs to place investments.
6. Manage Expenses: Managing your income and expenses is essential for your long term survival.
 - a. Partnerships with other related lending entities allow you to expand your market and cut down on your own expenses in the areas of marketing, loan processing and loan management.
 - b. Loan losses decreases the size of your loan pool and lowers your potential income
 - c. Reserves impact your business success. These are funds set aside that do not generate income.

- d. Your lending guidelines and approvals also impact your success...the greater risks your fund incurs; the greater the potential is for losses.
 - e. The expenses for marketing, processing and managing a small loan are the same as expenses for a larger loan.
 - f. Partnering and sharing of loan management and portfolio management functions are an excellent means of managing and reducing expenses.
 - g. If you already have loan processing and management experience, you may want to market this capacity and generate additional income by managing funds for partner organizations.
7. Additional Capital: The CDFI Financial Assistance Award is a grant that can start your lending program, but you should look at it as an opportunity to locate additional matching funds to expand your loan pool.

It is important to determine who in the marketplace has interest in supporting your lending activities.

Your board, advisory board or project committee should have members that represent financial institutions, local businesses and corporations, and local government and community leaders. They can become your spokesperson(s) and can convene meetings with their peers to market interest in your fund.

Engagement and discussions with the banking regulators; Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of Currency (OCC) and Federal Reserve Bank (FRB) regarding your fund is a very important step. These institutions can be an important resource for knowing who might be interested in supporting lending activities or are interested in your community. They are also a great resource for convening meetings with financial leaders to generate interest in your fund.

OTHER NOTES:

Service Gaps: One criticism of CDFI lending programs has been the “uneven landscape” that results in gaps in service. Most effective CDFIs operate in small geographies (communities, cities and counties) while larger entities might serve states or multi-state areas. A few might be “national” such as some of the larger lending institutions; however they may not serve all communities with the same lending products.

Despite the number of CDFI operating across the country, there are many areas not being served by any CDFI or might be served by ones without the needed lending product. Many CDFIs serve only one segment of lending activity such as businesses, real estate or personal, resulting in not having a needed service in any given area.

This does however presents an opportunity for a CDFI to expand or for a new CDFI to grow, especially if there is substantial need and interest amongst the residents and constituency affected by the lack of capital.

Final Note:

Although becoming a CDFI is a natural step for loan funds, becoming a loan fund is not easy and requires a strong commitment from the organization and the members of the development

team. The goal can be accomplished with the support of the community, local government and interested financial institutions. It is most important to have staff dedicated to the project and if they do not have the expertise, locate resources to support and guide the effort.

This document is intended to be a guide that outlines some of the key issues and identifies possible solutions and steps. It is not intended to be your source since every project has its own issues, concerns and peculiarities and its own unique solutions. The document is not intended to encourage any organization into project development but only to lay out some of the key steps and issues once the decision is made to proceed.

APPENDIX A - FOR MORE INFORMATION: Resources Websites:

Opportunity Finance Network: (www.ofn.org) “Opportunity Finance Network (OFN) is a national network of community development financial institutions (CDFIs) investing in opportunities that benefit low-income, low-wealth, and other disadvantaged communities across America.

OFN Members are performance-oriented, responsible investors that finance community businesses, sparking job growth in the areas that need it most, and delivering both sound financial returns and real changes for people and communities.

Our Network has originated more than \$23.2 billion in financing in urban, rural, and Native communities through 2009. With cumulative net charge-off rates of less than 1.4%, we have demonstrated our ability to lend prudently and productively in unconventional markets often overlooked by conventional financial institutions.”

Coalition of Community Development Financial Institutions (CDFI Coalition): (www.CDFI.org) “Formed in 1992 as an ad-hoc policy development and advocacy initiative, the Coalition of Community Development Financial Institutions (CDFI Coalition) is the lead national organization in the United States promoting the work of community development financial institutions (CDFIs). Through its member organizations, the Coalition represents CDFIs working in all 50 states and the District of Columbia. This national network of CDFIs includes community development loan funds, community development banks, community development credit unions, microenterprise lenders, community development corporations and community development venture capital funds. The CDFI Coalition coordinates industry wide initiatives to increase the availability of capital, credit and financial services to low-income communities across the nation.”

Community Development Financial Institutions Fund: (www.cdfifund.gov) “Through monetary awards and the allocation of tax credits, the CDFI Fund helps promote access to capital and local economic growth in urban and rural low-income communities across the nation.

Through its various programs, the CDFI Fund enables locally based organizations to further goals such as: economic development (job creation, business development, and commercial real estate development); affordable housing (housing development and homeownership); and community development financial services (provision of basic banking services to underserved communities and financial literacy training).

California Association for Micro Enterprise Opportunity (CAMEO): (www.microbiz.org) “CAMEO’s mission is to promote economic opportunity and community well-being through Micro Enterprise development.

Our member organizations provide entrepreneurs with small business financing such as loans and credit, technical assistance and business management training.

As California’s statewide Micro Enterprise association, CAMEO is the voice for Micro Enterprise in California. We expand resources and building capacity for its member organizations – over

160 lenders, training programs, job creators, agencies and individuals dedicated to furthering Micro Enterprise development in California

National Community Reinvestment Fund (CRF,USA): (www.crfusa.com): “Community Reinvestment Fund, USA (CRF) helps change the lives of people living in economically distressed communities across the country. We supply capital to local community development lenders so they can meet goals like these:

- Grow small businesses
- Increase affordable housing
- Create and preserve jobs
- Build child care centers
- Develop community facilities

At the same time, we enable financial institutions, socially-motivated investors, and accredited individuals to reach their social investment goals.

CRF operates the leading national secondary market for community and economic development loans—a market CRF pioneered. We purchase economic development and affordable housing loans from community development lenders. We then pool them into asset-backed debt securities and New Markets Tax Credit (NMTC) investment funds, which we privately place with institutional investors”

FOR MORE INFORMATION: *Websites, Organizational Examples*

National Specialized Fund:

Low Income Investment Fund (LIIF): (www.liif.org): “LIIF is a community development financial institution (CDFI) that provides innovative capital solutions that support healthy families and communities. As a CDFI, LIIF invests in projects that have high social value but may not be able to access the services offered by traditional financial institutions. In this way, LIIF connects low income communities with the capital markets. LIIF offers a wide range of products, including community capital loans, New Markets Tax Credits, grants and technical assistance. LIIF’s mission-driven approach combined with its market and industry knowledge have distinguished it as a CDFI that creates flexible, affordable financing solutions that work for community organizations and investors. In 2011, LIIF invested over \$1.1 Billion.”

NCB Capital Impact (NCB, formerly the National Coop Bank): (www.ncbcapitalimpact.org) “As a national nonprofit organization and a certified Community Development Finance Institution, NCB Capital Impact improves access to high-quality health and elder care, healthy foods, housing, and education in low-income communities.

Our impact is built on a diverse and extensive network of alliances, our depth of experience, and a cooperative approach. We partner with public and private organizations that are like-minded in mission, and dedicated to long-term success. NCB Capital Impact has deployed \$1.6 Billion in loans, investments and assistance.”

Regional CDFIs:

Clearinghouse CDFI: (www.clearinghousecdfi.com): “At Clearinghouse CDFI we believe in providing equal access to credit in neighborhoods of all income levels and ethnicities. We spend the time and energy required to find creditworthy borrowers whose projects create assets in the community. These borrowers, because of their unique circumstances, are rejected or not even considered by traditional lenders.

Community development lending must be profitable in order to be sustained. As with conventional lenders, we carefully evaluate each applicant’s ability to repay the loan. Unlike traditional lenders, we do not have predefined loan programs. We analyze each loan application individually. Every loan we make benefits the community in a measurable way.

Clearinghouse CDFI is a Community Development Financial Institution serving low-income communities and families throughout the State of California. Through our two lines of business, Core and NMTC lending, we have funded \$760 million in loans and equity investments in low-income communities. Our 1,232 loans have assisted borrowers such as nonprofits and other community development groups to create 3,005 affordable housing units, enable 846 first-time homebuyers, create 4,270 construction and permanent jobs, and serve 215,000 clients of low-income communities annually.”

Coastal Enterprises Inc (CEI): (www.ceimaine.org) “CEI in 2012 is a Maine-based organization with strategic expansions outside of Maine, serving more rural communities directly or through alliances and having an ever greater impact on poverty, which is documented with data. The organization has a high financial sustainability ratio, thanks to new and expanded sources of funds through private giving, public funds, and income from funds and venture capital. CEI has a metric for looking at the balance of the 3 Es—economy, equity and environment—through all initiatives, and has a group in place measuring impact, scanning for opportunities, and developing policy.”

Community Based Funds:

Fresno Community Development Financial Institution (FCDFI): (www.fresnocdfi.org) “Fresno CDFI is a comprehensive financial services, training, and asset development institution for low- and moderate-income residents and businesspersons. Since our inception in May 2008, our professional, seasoned, and multi-lingual staff – experienced in micro-finance, credit counseling, business plan development, and advocacy for low-income families – has helped hundreds of entrepreneurs realize their dreams. We serve a 9-county region in Central California.”

People Incorporated Financial Services: (www.peopleinc.net) “People Incorporated Financial Services was created in 2001 to address business development financing needs throughout Virginia. This People Incorporated affiliate administers the microenterprise development and small business financing activities for People Incorporated

As a Community Development Financial Institution certified by the U.S. Department of Treasury, People Incorporated Financial Services offers loans, development services and financial products

to small and emerging businesses. People Incorporated Financial Services works to strengthen local economies in 17-jurisdiction service areas.

People Incorporated Financial Services has extensive experience providing small business and microenterprise development and lending services in low-income communities, and is the only CDFI headquartered in rural Virginia. Since its inception in 1992, the People Incorporated Financial Services loan portfolio has grown to include 308 microenterprise and business loans, which to date have created 475 jobs and retained 180 more.”