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A model for funding and supporting CDFIs:

Lessons from the United States

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BRIEFING

FUTURE ECONOMY

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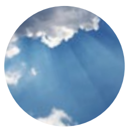


future economy

nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G7/G* summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

Summary

Community Development Finance Institutions have been at the forefront of tackling financial exclusion and supporting local entrepreneurs and communities to develop their own solutions to economic deprivation. After an initial period of public support, they now find themselves at a turning-point; though they have grown significantly in size and capacity for impact, support from Government has dried up just when such support could have far-reaching benefits. This paper sets out the case for how this could be achieved.

This year represents a significant opportunity to refocus Government policy on financial inclusion and the appropriate role of third-sector lenders such as Community Development Finance Institutions (CDFIs).

December 2007 saw the publication of the Government's new *Financial Inclusion: an action plan for 2008–2011*. Part of this plan is an assessment of the Financial Inclusion Task Force and the £120 million financial exclusion fund it monitors. In addition, renewed discussions with the banking sector will be initiated on the need for new shared goals for financial inclusion.

The action plan sets out government plans to double the capacity of third-sector lenders to provide credit to the financially excluded and to consider new legislation, such as a Bill, to further develop third-sector lenders.

CDFIs represent a key third-sector provider of finance to the excluded, both of personal and enterprise lending. Third-sector lenders can and should be counted upon to contribute to government inclusion targets.

For this to be achieved, the renewed government attention on financial inclusion and third-sector involvement must not repeat earlier mistakes of insufficient funding which was committed over too short a period and without the necessary legislative backing.

The original policies and funding supporting CDFIs in the UK drew inspiration from the United States. Using newly-released data from the US Treasury and the CDFI Data project this paper re-examines lessons from overseas, and makes the case in the UK for combined government funding and legislative intervention to enable CDFIs to contribute to the Government's own targets for financial inclusion and regeneration.

The case for a new CDFI policy framework

Public funds supporting CDFIs in the USA are far more effectively used than in the UK. This is due to an effective combination of enabling funding structures and legislation that is lacking in this country.

In the USA, consistent levels of public investment, combined with a supportive legislative framework, together trigger far more additional private funding and investment for CDFIs. In the UK, by contrast, reduced funding and uncoordinated policy severely limit the ability of CDFIs to provide capital to people and small businesses excluded from mainstream financing. With improved backing, CDFIs could contribute far more towards reinvigorating local economies and communities across the UK.

The US CDFI Fund is part of the US Department of the Treasury. This is, in itself, indicative of the importance with which CDFIs are viewed in the USA. The Fund has committed over $800 million since it began operating in 1995. It has succeeded in leveraging an additional $27 for every dollar invested through the fund by 2005. In contrast, in the UK, if the public money invested via the Phoenix Fund of £42 million plus the £11 million of transition payments had leveraged just 20 times more investment, it would have added over £1 billion of additional capital to UK CDFIs' lending. *Inside Out 2007*, the most recent CDFI Trade Association report, notes that the UK's Phoenix Fund managed to leverage £2.20 to every £1 it invested in 39 member CDFIs.

Recent financial crises both here and abroad illustrate the value of investment in locally rooted, sustainable lenders, such as CDFIs. They can play a critical role in the financial resilience of local communities and provide an alternative to exploitative and unaffordable lending.

Contrasting the scale of investment and public backing in the USA with that in the UK shows that public and policy commitments in the UK have been half-hearted at best.

In particular:

1. The relative youth of the majority of UK CDFIs, their small size and the limited level of funding and investment to date mean that they are far from ready to operate without significant ongoing government support.

2. Previous recommendations for the sector, in particular those of the Social Investment Task Force, need to be implemented in a coordinated manner.

3. Banks must be made to disclose information about their lending to reveal where financial exclusion exists so that interventions can be better targeted, allowing any public funds to be more effectively focused on financial inclusion.

4. Incentives for investment in the sector should be developed and reformed, including Community Investment Tax Relief.

5. Without a change in policy direction, the reduced policy and funding support means that CDFIs will find it more difficult to attract capital investment to those areas that need it most.

In the USA, coordinated policy and ongoing secure funding has created a virtuous circle of more effective public investment and an improved environment for CDFIs. The funding system in the UK has been modelled on the US system but did not go far enough in creating a similar positive feedback loop. If this could be created in the UK it could represent a breakthrough in the fight against financial and social exclusion.

A comparison of CDFIs in the USA and the UK

nef's comprehensive review of the UK community development finance sector, *Reconsidering UK Community Development Finance*, argued that government policy and investment had not realised initial ambitions. The report recommended that the Government should consider an ongoing fund to support capacity building of CDFIs, and that current levels of public investment are insufficient. Instead, public funding of CDFI investment has been curtailed.

This briefing paper examines the public funding commitments to UK CDFIs and contrasts these with the situation in the USA. It shows that the UK goal of developing a thriving and significant community development finance sector similar to that in the USA was not matched by an appropriate commitment in terms of investment and support. Set against the public investment and enabling legislation which underpins US CDFIs, it is clear that UK community development finance needs greater support both financially and from government policy to make the kind of impact community development finance has in the USA.

The evidence from the USA, even when taking into account the significant differences to the UK CDFI sector, suggests that public funding in the UK has been too modest and was too short-term to fulfil its ambitions. The funding available was insufficient for CDFIs to become significant and sustainable institutions in the short time they were given.

It is also not a simple question of insufficient funding. The role of enabling legislation in the USA, primarily the Community Reinvestment Act (CRA), has been crucial to making public funding effective. It has enabled public funds to be better geographically targeted and consequently to attract more funding. Most importantly, it has contributed to the creation of a framework for greater private-sector investment into areas and for people who are otherwise financially excluded. The CDFI Fund, a national fund providing investment and grants, calculates that its investment attracted 27 times more funding from other investors in 2005.

The lesson for the UK is that a thriving CDFI sector needs much greater levels of public support than has been the case to date. This also needs to be part of a larger and more coherent community development finance framework. Such a framework should seek to encourage other investors to engage with the sector, and enable public contributions to stimulate more finance targeted at those who need it most. Instead the elements of such a framework in the UK have been undermined by reduced funding and uncoordinated policies.

US and UK funding levels

Funding for Community CDFIs in the UK has changed; the 2001 Phoenix Fund has been discontinued even though it had been the single most important source of funding to most CDFIs. Expectations were that CDFIs would quickly adapt and generate their own funding through revenue and other private or commercial sources. **nef**'s research showed that this change was premature; it came too soon for CDFIs to have developed the expertise or financial health necessary to operate as independent, financially viable institutions targeting a market that mainstream banks had declined to serve.

These expectations were born from the example set by the relatively mature and much larger US CDFI sector. While attempts to contrast the UK sector with its US counterpart are complicated by the different history and context in which the sectors emerged, the difference in scale at which US CDFIs operate and the greater level of public and private investment they receive are in significant contrast to the UK CDFI sector. The level of public funding required to sustain the work of US CDFIs has not been matched in the UK.

The US CDFI Data Project analysed 496 CDFIs (out of over 700 registered institutions) in 2005. Results showed that they alone held $20.8 billion in assets and $14.1 billion in financing outstanding. Those CDFIs created or maintained 39,151 jobs and financed or assisted 9,074 businesses in just one year, comparing very favourably to the UK.

Although the UK sector's achievements are significant, it is far from emulating what has been achieved so far in the USA. This is partially due to reduced public funding and diminished policy attention, as the **nef** report argues. But it is also due to the funding structure that from the outset was too short-sighted and assumed a speedier development of CDFIs than was realistically possible.

The UK Government's commitment to the sector took several forms, including establishment of the Social Investment Task Force (SITF) whose recommendations led to new CDFIs and public backing for them. This came via the Phoenix Fund and by 2003 over £42 million had been awarded to 63 CDFIs. A tax mechanism, Community Investment Tax Relief (CITR), sought to encourage investment in the sector and succeeded in raising an additional £38 million. In 2006, when the Phoenix Fund had been discontinued, a further £11 million was provided to the sector, to be distributed by Regional Development Authorities (RDAs).

Regrettably, the SITF recommendation that bank disclosure should be encouraged, meaning that lending patterns would be published to reveal areas of acute financial exclusion, was not implemented though in the USA this factor has been a key link between legislation and more effective use of public funding.

Public funding for CDFIs in the USA is channeled through the CDFI Fund, a national public fund created in 1994 and in operation since 1995. By 2006, it had awarded US$820 million to CDFIs in the USA.[1] The CDFI Fund also administers the New Markets Tax Credit which is used to attract private sector investments, which total US$12.1 billion. Data from the US Department of the Treasury suggest that, by 2005, CDFIs were succeeding in increasing public money administered through the CDFI Fund by almost 27 times, attracting an additional US$1.4 billion from US$51 million of initial funding. Each $1 of public money was being matched by $27 of additional investment from other sources.

The key question is: 'how comparable and relevant are these US figures to the UK?' The importance of the USA to the development and expectations of the UK sector means that we must also understand how they differ, so that a more realistic set of expectations for CDFIs', the Government's and other stakeholders' responsibilities can emerge.

The US context

Direct comparisons of US and UK funding data are not possible, but important lessons about a positive approach to public funding can still be drawn. The US CDFI sector has been in existence for much longer than its UK counterpart. It has achieved greater scale and offers a wider range of financial services and products. CDFIs in the USA evolved serving highly specialised and niche target markets. Nevertheless, most US CDFIs are not yet entirely financially self-sustaining and the sector faces similar challenges as the UK, including how to improve capacity and sustainability. The US CDFI sector is still a minnow when contrasted with the mainstream domestic financial sector.

A key difference in US community development finance is that the majority of CDFI finance, whether lending or equity investment, is used on housing-related activities. These are primarily mortgage products and housing or property development loans. This asset-based model allows greater scale and lower costs through secured lending. It has been a critical component of the growth of the US CDFI sector, but is largely lacking in the UK. Hence, CDFIs in the USA can balance unsecured loans with secured ones, whereas CDFIs in the UK have in most cases no collateral whatsoever.

The US sector is also more diverse than the UK, comprised of four distinct types of CDFI:

1. Community development banks

2. Community development credit unions

3. Loan funds

4. Venture capital funds

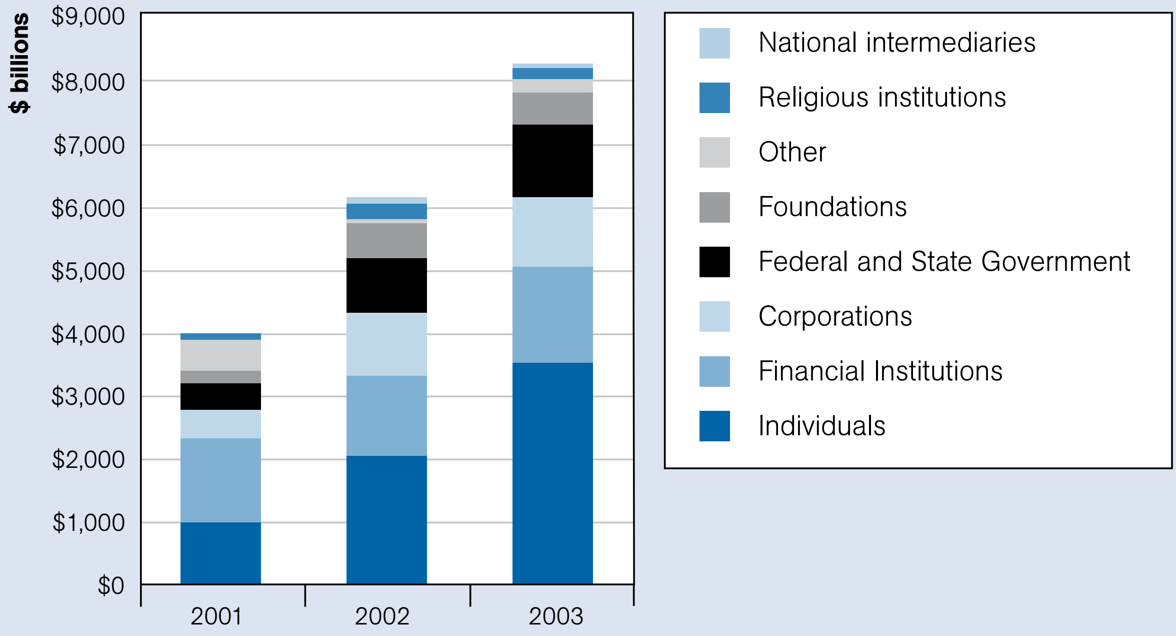
The CDFI banks and credit unions in the USA are regulated financial institutions and as such can take deposits from their members. The banks are the largest type of CDFI and are for-profit, averaging $105 million in assets. The loan funds are far more numerous but smaller, averaging $6 million. These are the most similar in structure to UK CDFIs.

The amount of capital available to US CDFIs is of a different order to the UK. Figure 1 shows the source and amount of capital available to US CDFIs from 2001 to 2003, excluding the credit unions which are not considered CDFIs in the UK context. It shows that the scale of US investment capital sources are measured in billions of dollars, much larger than in the UK which had provided only a total of £181 million in loans by 2004.

The relatively small proportion of federal and state funding in the USA is noteworthy. In 2003, it is less than that provided by financial institutions, and only slightly larger

1 One must account for the fact that the term CDFI refers to a broader range of institutions in the USA.

Figure 1: Sources of investment capital to US CDFIs 2001-2003 ($billions).



Source: CDFI Data Project

than investment from corporations. Government funding in 2003 represented 14 per cent of the overall total of over $8 billion in investment capital (Table 1). Individuals represent the largest source of investment capital due to the size of deposits held with the few, large CDFI banks.

The 1990s were the key growth decade for CDFIs in the USA, with the largest increase in the number of new CDFIs, particularly in the number of loan funds which have the greatest similarity to UK CDFIs.

The growth of US community development finance was not simply a result of either increased funding or new legislation, but a product of both.

New CRA legislation strengthened the reporting of lending patterns by banks led to the subsequent responsibility banks took on as investors and partners to CDFIs. The establishment of the CDFI Fund bolstered this by providing grants and technical assistance awards, administering the New Markets Tax Credit and investing significantly *and* requiring matched funds for every investment. CDFIs were supported and improved as both partners and catalysts for investment. This process was reinforced by the emergence of trade associations and new networks that have made considerable progress in the professionalisation and implementation of best practice in operational and reporting terms.

The US Department of the Treasury, which houses the CDFI Fund, has for the first time published a detailed report on the recipients of funds. In combination with the data collected by the CDFI Data Project, it has become possible to trace the importance and catalytic role that appropriate public funding can have on community development finance.

The importance of public support for the US CDFI sector: the CRA and the CDFI Fund

The climate in which CDFIs operate in the USA has been created through the combination of legislative support and funding designed to stimulate further investment. This combination allowed for more effective use of public funds as a tool to leverage extra investment into areas of financial exclusion.

Though CDFIs in some form have been in existence in the USA since the early part of the last century, the emergence of the sector into a broad and diverse body resulted directly from the legislative support it received. In 1977, the CRA was passed and this laid the basis for much greater investment by banks or other depository financial institutions into areas of low or moderate income and marked by financial exclusion.

The CRA was founded in recognition of mainstream banks' obligations to the communities they operate in. It required monitoring and public accountability of banks and depository institutions' financial provision to their community. It provided an enforcement mechanism to ensure that banks would disclose their lending, which has been substantially strengthened over time.

Selected timeline of the CRA:

- 1977 – Act passed to provide credit to underserved segments of the US population, in particular low-income and minority groups who had been excluded, or 'red-lined', by banks.

Table 1: Investment capital sources (US$ billions).

	2001	2002	2003
Individuals	$0.9885	$2.0680	$3.5327
Financial institutions	$1.3363	$1.2774	$1.5387
Corporations	$0.4451	$0.9965	$1.1000
Federal and state government	$0.4190	$0.8593	$1.1501
Foundations	$0.2137	$0.5557	$0.5233
Other	$0.4762	$0.0831	$0.1837
Religious institutions	$0.1014	$0.2252	$0.1837
National intermediaries	$0.0340	$0.1179	$0.0837
Total	$4.0142	$6.1831	$8.2959

Source: CDFI Data Project

- 1990 – Amendment to the CRA passed requiring the provision of additional types of data from banks, including lending patterns.

- 1994 – Amendment creating an explicit and objective tool for the evaluation of banks' performance in serving their geographical community.

The CRA provides a foundation for tracking and identifying financial exclusion and is the basis for an enduring partnership with banks. It means that key regulatory decisions, such as approval of mergers and acquisitions, can be influenced by banks' CRA rating performance. It requires geographic disclosure of lending which reveals areas of exclusion and mobilises action to address this, including permitting banks to invest in CDFIs as part of their CRA commitment.

Under the 1994 amendment, investment in CDFIs was made a qualifying factor for the evaluation tool used to rate banks. Banks and other depository institutions are consequently the second-largest source of investment capital in CDFIs.[2] The amendment meant that legislators now had a stick to use alongside the carrot of public funds.

The CRA creates the basis on which other stakeholders, principally banks, can work with CDFIs. However, the CDFIs themselves have to be viable partners. This has been enabled by ongoing public funding.

The other critical change in the USA in the 1990s which spurred growth was the introduction of the CDFI Fund. A key element of its funding is that it requires one-to-one matching of its investment funds. It also enables CDFIs to use the funding as security against which to borrow. Finally, it is capital that can be used to partner with investors to provide critical gap financing or subordinated debt to ensure additional investment. Calculated in this way, the US Department of the Treasury estimates that the leveraging of these 'Financial Assistance' awards has risen from a factor of 20 ($20 to every $1 awarded) in 2003 to a factor of 27 in 2005. As noted earlier, the Phoenix Fund investment in 39 CDFA members leveraged £2.20 for every £1 invested.

The CDFI Fund

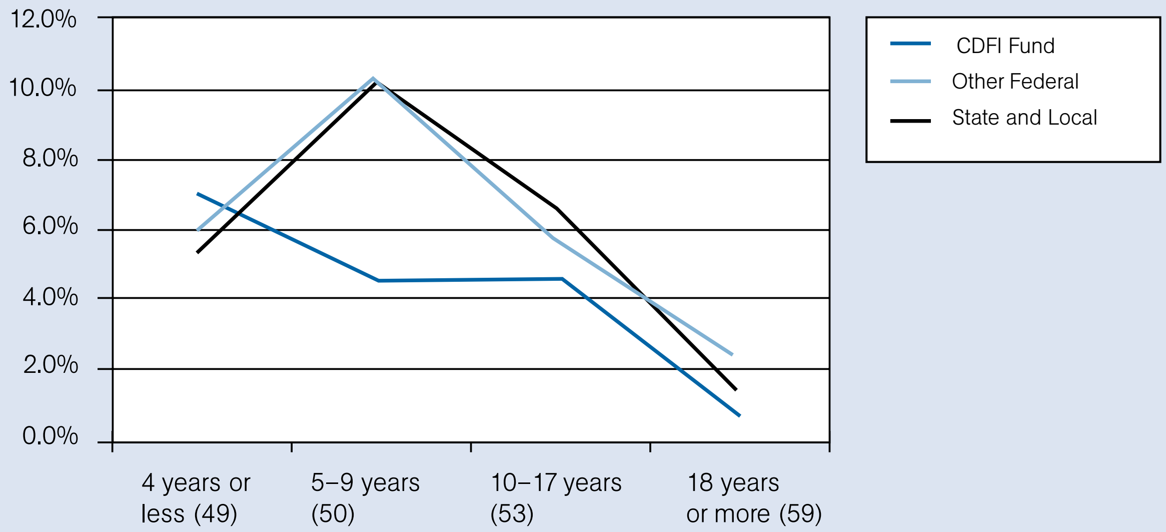
The US Department of the Treasury this year released *Growth, Diversity, Impact: A Snapshot of CDFIs in FY 2003*. This provides the opportunity to examine the importance of the Fund to CDFIs and enabling greater investment.

The CDFI Fund consists of four programs, including Financial Assistance (FA), Technical Assistance (TA), a Bank Enterprise Award and a program for Native American organisations. It also administers the New Markets Tax Credit. The FA program makes equity, loan and deposit investments plus grants to new and existing CDFIs. The recipients must match awards by at least a factor of one. To date, $520 million have been awarded. The TA program provides grants focused on capacity-building. A significant portion of the grants awarded has been to start-up CDFIs, 139 of 563 awards which total $36 million. The data set for Fund recipients is distinct from that used by the CDFI Data Project, but the overall trends are consistent in both.

The CDFI Fund is a minor proportion of the investment capital under management for CDFIs. Capital from the Government represented only nine per cent of the capital

2 The largest source is individuals who hold money on deposit with community development finance banks or credit unions, which are also classed as CDFIs in the USA.

Figure 2: Government sources of capital as percentage of total capital under management, by age of CDFI.



Data from US Department of the Treasury (2007); Growth, Diversity, Impact: A Snapshot of CDFIs in FY 2003.

under management of all US CDFIs in 2003. Examining only loan funds shows that the CDFI Fund represents only two per cent of their investment funding in 2003, which with other national and local sources of funds amounts to 10.2 per cent of their sources of capital for investment. This is less than half of the capital contributed from corporations (including financial instituions).

Over time, the proportion of CDFIs' dependence on government funding has decreased, as is shown in Figure 2. As CDFIs mature, threre is a greater diversification of the sources of capital that CDFIs benefit from. In the 2003 Treasury study, more than 60 per cent of the youngest CDFIs, but less than 20 per cent of the oldest CDFIs, rely on only one or two sources of capital. For CDFIs that are 4 years old or younger, the CDFI Fund represents 6.9 per cent of the sources of capital under management. For those between five and nine years, and 10 and 17 years this falls to 4.6 per cent and drops to just 0.6 per cent for those older than 18 years.

Despite the decreasing dependence on public funds, the need for what are termed 'contributed funds' – for example, grants or philanthropic support, endures. Only the large CDFI banks, and some older credit unions, achieved self-sufficiency according to the Treasury data. This is measured as revenue sufficient to cover operating costs.

The evidence suggests that the CDFI Fund has managed to avoid creating a culture of 'total grant dependency'. CDFIs are decreasingly dependent on such support over time, but do not appear to release themselves entirely of the need for grant or philanthropic funding. Hence it points the way to the design of a funding tool that is a positive stimulus to further investment and CDFI growth. The evidence from the **nef** report indicates that a need for such funding still exists in the UK, both for investment capital and for the kind of support provided by the TA Fund for capacity-building in the USA.

Unlocking wider support in the UK – what the US evidence suggests

- Public funding to the UK CDFI sector is still necessary and appropriate.
- Funding needs to explicitly address capacity issues in addition to providing investment capital.
- Funding needs to support CDFIs for a much longer period than the Phoenix Fund allowed in order to support CDFIs' growth and capacity.

The CDFA reports that the £181 million lent by CDFIs up to 2004 leveraged an additional £285 million. The total funds provided by the Phoenix Fund and the later transition funds are just over £50 million. It is clear that the potential scale of leverage and involvement of other investors is simply not realised in the UK context. Meanwhile, CDFIs are finding it harder to access funding for core operational work, capacity building, staff training and other key activities. Generating revenues sufficient for sustainable activity is still a long way off for most UK CDFIs.

- An enabling environment needs to be developed via legislation to enable partnerships between banks and CDFIs.
- Lending disclosure remains a critical first step in creating a climate conducive to CDFI growth; a key but unfulfilled recommendation of the UK SITF.

A key recommendation of the UK SITF – disclosure of lending – has not been realised but has been a critical aspect of the enabling legislative environment in the USA. **nef**'s 2006 report: *Full disclosure: why bank transparency* *matters,*made this case. Local area disclosure by banks was the first step in enabling a broader and deeper community development finance sector to emerge in the USA. This developed into a mechanism for partnerships and investment into CDFIs from banks and depository institutions. In the UK, banks have been invited to voluntarily disclose local lending patterns but have largely failed to do so.

- CDFIs are still at too early a stage to absorb fully the costs of large-scale partnership with banks or other potential investment partners.

Expecting banks to develop deeper relationships with UK CDFIs without an additional incentive structure is unrealistic. A major UK high street bank that conducted pilots for CDFI partnerships found that CDFIs lacked the infrastructure to manage relationships systematically with branch managers. A systematic rolling-out of training and awareness to bank branch managers would be costly and counter-productive as few UK CDFIs are able to absorb commercial lending. Loans were difficult to manage and complex, and with little communication from CDFIs to branches their value was difficult to communicate more broadly within the organisation and to branch managers.

A funding mechanism that requires CDFIs to match funding could also avoid the development of grant dependency. The experience of the CDFI Fund suggests that, properly administered, supportive public funds can be a catalyst to greater investment when placed in a broader, enabling framework that addresses other key issues of capacity, disclosure and effective investment incentives, including the Community Investment Tax Relief.

Recommendations

1. Further support for CDFIs' capacity and growth, which had been the role of the Phoenix Fund, needs to be explored. This must include obligations for bank disclosure which is one of the SITF's original recommendations, as well as a continued commitment to support CDFIs with public investment.

2. Matching investment and other incentives need to be developed to enable investors to engage with the CDFI sector more sustainably and to leverage more funds into CDFIs and through them.

3. Incentives structures, such as the Community Investment Tax Relief, need to be reformed so that they are sensitive to a broader framework of community development finance engagement which can involve a greater number of investors.

CDFIs in the UK are in need of *greater* and *more sustained* government support than their US-based counterparts. These recommendations do not represent an argument saying UK CDFIs should expect to operate in a context identical to the USA. In several key respects, UK CDFIs will always operate differently; in particular due to the critical role that property and real estate financing play for CDFIs in the USA.

Policy has been less supportive in the UK and more short-term, and the support that has been provided has been discontinued or reduced. This needs to be recognised and redressed with greater funding, implementation of key recommendations such as lending disclosure, and more legislative support for CDFI partnerships with other stakeholders, including financial institutions.

The US example shows that in the UK greater public funding combined with more appropriate legislative support is a prerequisite if CDFIs are to achieve their core purpose: encouraging investment and attracting capital to those who need it most.

Project Description

This study was carried out by Sargon Nissan at **nef** (the new economics foundation) with support from the Hadley Trust. The research was based on data from the CDFI Data Project in the United States, the United States' Treasury CDFI Data Fund and the sector data for UK CDFIs provided by the Community Development Finance Association in its latest *Inside Out* Reports.

This research is part of a series of papers and reports on the UK CDFI sector, following from last year's review of the sector; *Reconsidering UK community development finance*. A follow-up report to this work will be released in the coming months.

THE HADLEY TRUST

A short bibliography of some of **nef**'s key work on community finance, enterprise lending and financial inclusion:

Small is Bankable, 1998

Profiting from Poverty, 2002

Community Banking Partnership: A national demonstration project, 2004

Basic bank accounts: The case for a universal service obligation, 2005

Full disclosure: why bank transparency matters, 2006

Reconsidering UK community development finance, 2007

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Further information

This briefing paper is part of an ongoing series of papers and reports by **nef** (the new economics foundation) looking at the current state and future of CDFIs in the UK. Our 2007 report on the sector, *Reconsidering UK community development finance*, can be downloaded from our website: **www.neweconomics.org**

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