

Addressing the Capitalization and Financial Constraints of CDFI Microlenders

Brett Simmons, Revolve

Jonathan Brereton, Revolve

Joyce Klein, Business Ownership Initiative, The Aspen Institute

Abstract

Community Development Financial Institution (CDFI) loan funds face a common capitalization challenge as they seek to grow—they must raise net assets to enable the additional debt financing needed to support an expanding portfolio. Among CDFIs that focus on microlending—making small dollar loans of up to \$50,000 to small businesses—the financial challenges are even greater, as the revenue earned on these small-dollar, relatively short-term loans typically does not cover the cost to originate and service them (Klein & Okagaki, 2018, 12-14). Thus, CDFI microlenders must also raise grant (subsidy) dollars to support the increase in their lending costs as their portfolio grows.

Introduction

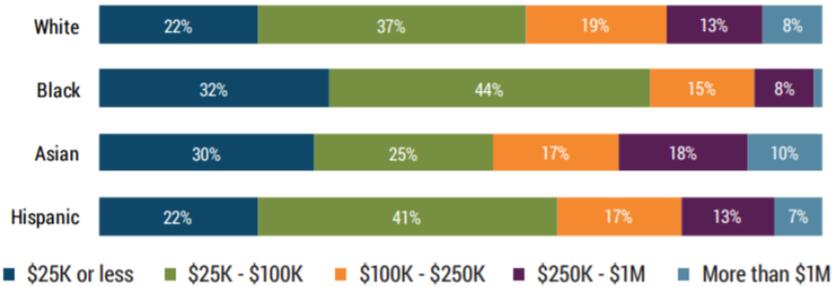
In early 2018, the Aspen Institute’s Business Ownership Initiative (BOI) began working with the members of its Microfinance Impact Collaborative (MIC)¹ to explore capitalization and liquidity strategies that could address the financial challenges associated with growth. BOI partnered with Revolve, a consulting firm with experience in the CDFI microlending sector, to support its efforts. This paper presents the results of that effort, discussing why microlending is important for mission outcomes but challenging to scale from a financial perspective, and identifying the set of capitalization strategies that the MIC members have used and explored. The paper focuses in particular on the most promising strategy identified—selling loans to banks that see value in purchasing the loans to support their Community Reinvestment Act (CRA) requirements, and identifies factors that CDFIs should consider in determining whether loan sales are a potential fit for their organization.

The Importance of Scaling CDFI Microlending

One might question the wisdom of scaling a line of business that does not allow a CDFI to cover its cost through direct lending revenues. However, microlending fills a vital role in creating opportunity and equity in LMI communities, and in meeting demand for loans among entrepreneurs who have traditionally faced barriers in accessing credit: people of color and women. Data from the 2018 Small Business Credit Survey indicates that most small business owners are seeking business credit in amounts less than \$100,000, and that the demand for smaller-dollar business loans is particularly strong among entrepreneurs of color. Specifically, the 2018 survey found that 76% of Black and 63% of Hispanic business owners

applied for less than \$100,000 in financing—compared to 59% of White and 55% of Asian business owners. Black and Asian business owners were most likely to apply for \$25,000 or less in financing (Federal Reserve Bank of Atlanta, 2019, 10).

Figure 1. Total Amount of Small Business Financing Sought (% of applicants)



Source: *Small Business Credit Survey Report on Minority-Owned Firms* (2019).

Importantly, the survey also found that Black business owners were more likely to turn to CDFIs (and to online lenders) than White- and Hispanic-owned firms, with 17% of Black entrepreneurs applying for financing at a CDFI (Federal Reserve Bank of Atlanta, 2019, 13). The COVID-19 pandemic has brought the need for reaching entrepreneurs of color into even greater visibility, with the failure of relief programs such as the Paycheck Protection and Economic Injury Disaster Loan Programs to reach the smallest businesses and Black-owned firms in particular.²

Data from the 2016 Small Business Credit Survey found that women business owners were more likely to be in the market for smaller business loans—in that year, 67% sought less than \$100,000 in financing, and 28% sought less than \$25,000. This compared to 49% and 15%, respectively, of male business owners who sought financing for their small business (Federal Reserve Banks of Kansas City and New York, 2017, p. 18). Women-owned firms were also more likely to apply to CDFIs than their male-owned counterparts (ibid, 21).

Capitalization and Financial Model Challenges for MIC Members

CDFIs lend across a variety of categories or asset classes, including business loans, consumer loans, commercial real estate, residential real estate, home improvement and purchase. Some CDFIs specialize in a single type of lending, while others lend in multiple assets classes. Between 2002 and 2015, about one quarter of loans originated by CDFIs were business loans

² According to early reporting and several national surveys of small business owners. Additional media coverage available at <https://www.nytimes.com/2020/05/18/business/minority-businesses-coronavirus-loans.html>.

(Swack, Hangen, & Northrup, 2014, 18). Microloans are defined as loans less than \$50,000, and therefore microlenders constitute a subset of CDFI small business lenders. In this paper, as well as in analysis conducted by the Opportunity Finance Network, CDFI microlenders are defined as CDFIs that hold the largest concentration of their loans in microloans (Opportunity Finance Network, 2019).

CDFI microlenders range in scale from those that originate just a few loans per year to those that originate thousands. The MIC members are distinct from the large majority of CDFI microlenders in the scale of their microlending activities and their plans to significantly scale their portfolio of loans below \$50,000. As they have developed plans to scale their lending in this size range, each is cognizant of the significant financial challenges that growth entails. Despite these commonalities, the MIC members have diverse financial profiles. At the time this research effort commenced, portfolios under management ranged from \$6M to more than \$130M. Products remain diverse in terms of business and borrower characteristics, underwriting approach, terms, use of extensions and modifications, collateral liens secured, etc. Cumulative (vintage) losses range from 6-8% on the low end to in excess of 12%. Most cover just over 40% of their expenses through earned income while some achieve over 65% coverage. Three of the MIC members have hit their net asset limit of 20%. All have introduced larger, more profitable loan products in addition to their microloan products in order to increase self-sufficiency.

While they all require debt to lend and donations for operating subsidy and net assets, the relative priority of each need varies depending on the MIC member. The diversity among the lenders presents a challenge when crafting collective strategies. Ultimately, however, that diversity is a benefit in terms of mission outcomes as lenders look for ways to serve previously unreached clients. Previous efforts to more closely align or standardize loan parameters and underwriting have met resistance. Inasmuch as diversity leads to valuable mission outcomes the best capital strategy would seek to adapt to existing diversity.

Despite the diversity in the underlying portfolios and the scale of these lenders, they face common financial challenges. To expand their portfolios, they must:

Secure grant dollars to increase their net assets. Net assets are recommended at a level of 20% relative to liabilities by the CDFI Fund at the Department of Treasury (also responsible for CDFI ongoing certification) and some large lenders to MIC members require 25%.

Raise additional debt financing (dependent upon the above step of securing net assets to meet the underwriting and covenants requirements of their lenders). As portfolios grow, often this means an increase in the cost of debt, as CDFIs exhaust the lowest-cost sources of capital. It also often means that CDFIs must build the staff capacity to manage a significant number of lender relationships. Each of the MIC members is managing relationships with between 15-30 lenders.

Raise additional operating grants to support the costs of originating and servicing smaller loans that are not profitable. MIC members have found that even as they introduce efficiencies that improve the percentage of their costs recovered from interest and fees, rapid portfolio growth can mean that the total dollar amount of grant funds they must raise each year continues to grow.

While most CDFIs use a business and financial model that results in the first two financial challenges as they seek to grow, the third challenge is much more common among CDFIs that are seeking to scale loan products that are smaller, shorter-term, and somewhat higher-risk (e.g., unsecured). In fact, there has been a longstanding saying within the CDFI industry that CDFIs are “profit making but not profit maximizing.” But the reality of this statement varies depending on the types of products that the CDFI is offering. The experience of MIC members has been that in order to grow, microlenders must build a large and strong fundraising operation as well as an effective lending operation. There is no profitmaking.

Strategies Used by MIC Members and Their Constraints

While there are various funding vehicles that microlenders use for lending capital, all involve some form of debt and so bring related constraints. These vehicles include:

CRA motivated debt. Banks provide loans at below market interest to CDFIs and receive CRA credit as Community Development (CD) loans. Typically, these have been less than \$2M each, for terms less than 5 years, are unsecured and have carried interest rates around 3-3.5%. Some MIC members have taken similarly structured debt but have given a security interest. Managing a growing set of relatively small, shorter-term loans as portfolios increase contributes to the cost of expanding a CDFIs portfolio.

SBA microloan program. The SBA provides loans to CDFIs (and other lending intermediaries) but requires that a cash reserve of 15% be maintained throughout the period of the debt. This debt is secured by the loan receivables generated with the funds and the cash accounts. Operational grants are also provided to aid in the cost of delivering technical assistance to borrowers. The microloan program places a limit on the interest spread that intermediaries can charge to borrowers, which limits the CDFI’s ability to cover its lending costs. The microloan program also places geographic limits on the market served by its intermediary borrowers, which can limit its utility to lenders moving into new geographies.

Equity Equivalent (EQ2) investments. These are investments in the form of debt that are deeply subordinated, requires only small interest payments, and typically have maturities that are extended in perpetuity. While equity-like, it is still debt and must be shown as such on the balance sheet.

Individual investors. Most impact investors are seeking to take minimal risk and to generate positive returns. Interest rates tend to be relative to other investment strategies for individuals and therefore are quite high relative to CRA-motivated bank debt. Rates vary from 4-7%. Individuals also desire the ability to withdraw funds after short periods of time, requiring the microlender to hold additional cash and have a predictable supply of additional debt.

LLC investments as net assets. Several large microlenders dealing with net assets constraints have utilized an innovative method to recognize EQ2-like investments as net assets. To do this, they create an LLC with investment from a bank or other party and typically a 10-year term on its formation documents. The microlender makes a small investment but has a controlling interest in the LLC and can therefore consolidate the \$1M investment on its balance sheet as an asset. Nonetheless, given the LLC term, the note must still be repaid as if debt. This structure has primarily been used by microlenders with growing portfolios that are able to generate the grant funds necessary to increase their net assets (see also: Edgcomb, 2009).

New Strategies Examined by the MIC

Given the amount of debt microlenders already have and their reliance on philanthropy for net assets, solutions to their capitalization and liquidity strategies in other forms are desperately needed. In exploring new solutions, a logical place to turn is the largest asset that the microlenders hold: their microloan portfolios.

Banks commonly sell loans to diversify their assets and reduce leverage. These methods include whole loan sales, shared participations in loans, and different variants of securitization. Several large CDFIs focused on single-family housing sell mortgages to raise capital. Most fintech companies sell portions of their portfolio through loan sales and securitization. None of these methods are extensively used by microlenders.

In the case of whole loan sales there is generally a transfer of the servicing agreement and a notification to the customer that the note is no longer owned by the original lender. Microlenders are typically working with entrepreneurs with more limited banking relationships, who know and trust the microlender as a nonprofit. For most microlenders, this wholesale transfer of the relationship is problematic. In many cases it may result in reduced repayment rates and client success. As such, whole loan sales with transferred servicing was not deemed viable.

Instead, ideas were explored where the client relationship could be maintained by the microlender while still achieving capitalization without additional debt. The two initial approaches explored were securitization and loan sales (through loan participations).

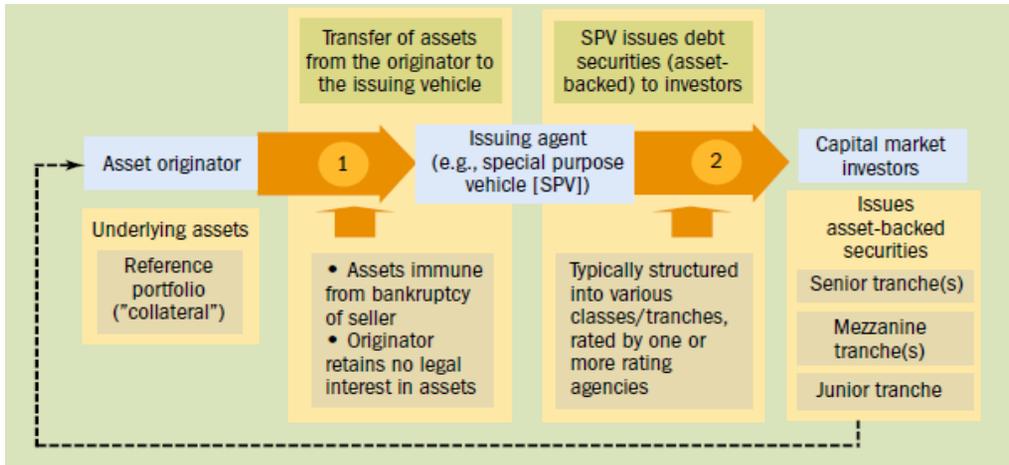
Securitization

Securitization is the creation of a security backed by the future cash flow on a pool of loans. Buyers of the security receive interest and principal payments from that cash flow. The Intersect Fund, a former MIC member, completed a small private placement securitization but is the only MIC member to have attempted something similar to a standard securitization.³ Private placements are often not rated by a third-party agency and therefore have fewer buyers willing to consider the risk. As a result, the prices can vary widely, and the available capital is more limited.

³ The Intersect Fund was created in 2009 in New Brunswick, NJ and operated through 2018, at which time its proprietary technology platform was acquired by DreamSpring and some of its outstanding portfolio was acquired by Accion East.

Securitization is expensive. In order to create and market a publicly-traded security backed by its underlying loan pool, a lender needs significant legal, accounting, and financial (ratings agency) support. These third-party costs can be considerable.

Figure 2. How Securitization Works



Source: Jobst (2008).

For any pool there will also be some defaults. To deal with defaults a lender must typically pledge more loans than the actual total sold (so a \$100M sale might have \$110M of loans backing it) in order to overcollateralize the cash flow. Investors require this strengthening. Additionally, while CRA benefits encourage banks to charge CDFIs a reduced interest rate despite the risk inherent in the loans made by the CDFI, a securitization investor requires that the return mirror the risk of the underlying investment and therefore would demand at least 5-8% coupon rates. A pool consisting predominantly of CRA-eligible small business loans could potentially seek a lower rate, but overcollateralization requirements are unlikely to change. All these factors result in an expensive vehicle in terms of assets pledged along with high ancillary costs related to ratings and legal services.

Nonetheless, for many growing lenders without a long track record (such as fintech lenders) securitization at a large scale remains cheaper than issuing corporate debt or raising equity. It also has significantly less impact on the balance sheet. These firms complete securitizations at a large enough scale that the cost is small relative to the total transaction. Scale gains can start at transactions as small as \$25M but are most beneficial at \$100M and above.

Importantly, firms doing securitization also typically have a large pool of fairly similar loans in terms of size, risk profile, term, and structure. Without this homogeneity, securitizations further balloon in price because risk analysis is more difficult, and the legal structure becomes more complex.

Without a large pool of similar loans, securitization is unlikely to be viable. The MIC members potentially have enough total portfolio to do securitization on paper, but after accounting for commonality of loan structure and overcollateralization, it becomes clear that securitization is a tool reserved for future scale levels when more loans are available. A highly sophisticated bank investor in need of major CRA benefit could potentially negotiate a private placement with a group of MIC lenders at lower legal cost by avoiding a formal rating agency review; however, obtaining bank internal approvals for such a transaction and addressing all safety and soundness concerns may be insurmountable obstacles. As scale grows the cost of other funding vehicles currently in use will likely go up and the cost of securitization will become relatively more attractive.

Institution Level Loan Sales (via Loan Participations)

Institutional loan participation sales are a strategy that has been used by five MIC members. In these scenarios, a lender sells a 90-100% nonrecourse stake in an individual loan in exchange for the principal, some portion of the interest, and some fees. Structures vary, but the basic idea is that a participation sale more easily allows the lender to retain servicing and the customer relationship without any interruption, notification, transfer of collateral, etc. A participation structure also allows for shared risk on a portion of the sale, for instance, leaving 10% of the loan on the books of the CDFI to maintain proper incentives regarding servicing and collections. In addition, it allows the lender to turn future cash flow (repayments) into immediate cash to be lent. As a result, the lender can serve more customers without raising additional net assets and taking on additional debt.

Loans sales benefit CDFIs that are growing their portfolios from a balance sheet perspective, by providing liquidity while reducing rather than increasing their net asset ratios. Importantly for microlenders, however, loan sales also offer financial benefits from an operating perspective—by both increasing revenues and decreasing expenses. Although the extent of these benefits varies depending on the characteristics of the loan assets that are sold and the pricing paid by the purchaser, they can be quite substantial even if a premium is not achieved.

Figure 3 illustrates the financial impact of loan sales from an operating perspective for two hypothetical CDFI microlenders. The scenario modeled illustrates transactions to sell a portfolio of \$5M in loans.

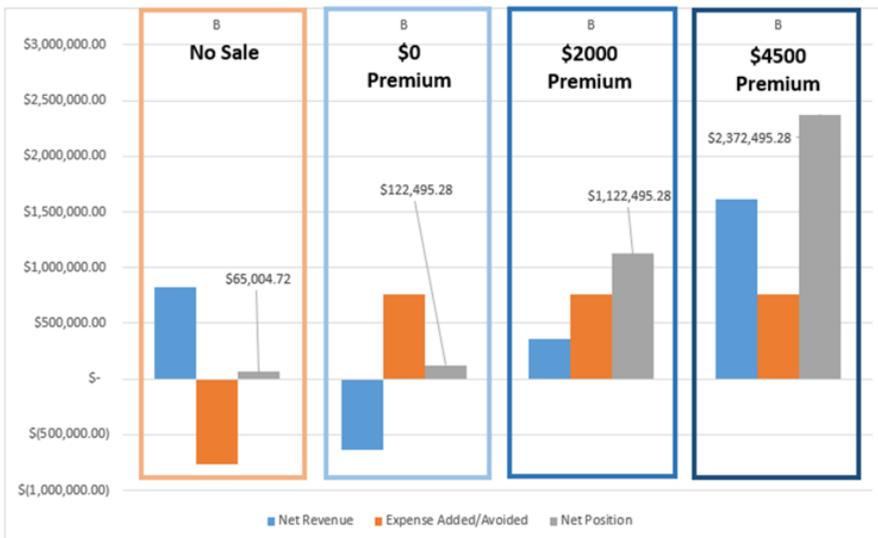
They are similar in a number of ways—total size of the portfolio, average interest rate, average contract term, average actual term, and cost of capital. When selling these loans, both would receive a monthly servicing fee of \$15 per loan. The yield on these portfolios varies substantially based on two key variables highlighted in yellow: the average size of loans sold and the organization's historic loss rates for vintages of loans. The resulting yield is 7% for CDFI A, but only 0.11% for CDFI B. This will affect their willingness to sell at different price points.

Figure 3. Impact of Loan Sales on CDFI Financials

CDFI A	
Portfolio Participated (\$)	\$5,000,000
Average Loan Amount (\$)	\$25,000
Average Interest Rate	13.0%
Avg Contract Loan Term (Months)	36
Avg Actual Loan Tenure (Months)	25
Monthly Servicing Fee (Per Loan)	\$15
Average Long-Term Default Rate	7.0%
Average Cost of Capital	3.0%



CDFI B	
Portfolio Participated (\$)	\$5,000,000
Average Loan Amount (\$)	\$10,000
Average Interest Rate	13.0%
Avg Contract Loan Term (Months)	36
Avg Actual Loan Tenure (Months)	25
Monthly Servicing Fee (Per Loan)	\$15
Average Long-Term Default Rate	13.0%
Average Cost of Capital	3.0%



When a bank is considering a loan purchase, it will examine the yield to determine its potential upside from the transaction, but it will also consider value from supplementing its CRA lending test performance. Scenarios A and B are intentionally quite different in terms of these two outcomes, but both reflect realistic CDFI microlender portfolios. The \$5M portfolio from CDFI B offers a much lower yield, but because of the smaller average loan size, offers a much higher value in terms of CRA credits, as the purchase involves 500 loans rather than 200. CDFI A has created a portfolio generating a high return but has originated larger loans to achieve that return. Because banks are typically seeking to acquire a higher number of transaction units, as opposed to a greater outstanding dollar balance, from a CRA perspective a portfolio with fewer units will have lower value.

Among the MIC members that have sold loans, the volume and experience vary. Accion Chicago has completed more than \$10M of loan sales to banks that are primarily CRA motivated. In these cases, the banks have been willing to lose money on the immediate transaction because they can purchase a small loan (average size of \$10,000), receive the same CRA benefit as a larger loan, and purchase the exact number of loans they need to improve their CRA profile.⁴ The value is driven by the alternative cost to supplement CRA as opposed to the immediate return from the transaction. In these cases, bank purchasers were willing to pay a per-loan premium substantially above par. The overall outcome is an improved net margin for Accion and improved CRA performance for the bank.

Opportunity Fund has sold more than \$70M in loans, although the majority of these have been trucking loans that are larger small business (not micro) loans. These loan sales have been motivated by Opportunity Fund's need to generate liquidity to meet the rapidly growing demand for its loans. For the larger transactions completed by Opportunity Fund, the per-loan premium paid by purchasers has been much lower than that received by Accion Chicago. However, for a rapidly-growing lender, the alternative was either to raise new net assets needed to leverage new lending capital—which can be slow and an expensive process if one accounts for the staff resources dedicated to securing grants—or to slow its lending growth, which could have led borrowers to seek alternative and higher-priced capital.

Loan sales are the best fit for CDFI microlenders that face financial needs associated with large-scale portfolio growth. A CDFI that has a small portfolio, is far from its net asset ratio cap, and has a set of local banks willing to lend it money and donate should likely avoid loan sales because the cost in terms of staff time and capacity is not worth the balance sheet benefit.

That said, a CDFI with significant growth goals for its microloan portfolio may model out a period when a base level of loans and grants will no longer suffice. If that threshold is within a five-year horizon, beginning the preparations to sell loans can be an important strategic move, as it will significantly reduce the burden associated with taking those steps in a condensed time window. Avoiding a condensed time window is critical as it will allow the CDFI the time

⁴ The CRA small business lending test is based on the number of small business loans originated, not the volume. Therefore, banks seeking to strengthen their CRA rating often prefer to buy larger numbers of small loans (which offer relatively low risk from a dollar perspective) to a smaller number of large loans.

to find banks that see the CRA benefit and realize that higher prices also aid the community (by subsidizing the provision of small dollar loans). For example, Revolve has in some cases quickly found banks (often those that sit on the board of a CDFI and therefore know it well) that are willing to purchase loans at lower prices. In other cases, it has taken a year or more of outreach and many meetings to find a bank willing to pay a high price.

A sufficient time buffer will allow a CDFI to strategically weigh the tradeoff between the investment of its time and the price it receives, relative to the opportunity cost in terms of staff time. Typically, a new lender with fewer bank relationships will take longer to find a first buyer who can pave the way for future transactions. Because the characteristics of the individual CDFI and its relationships/reputation are so important to sales, it is very difficult to predict how large the administrative and staff costs may ultimately be. Thus, it is important for CDFI to be strategic in how they allocate time to grow loan sales. At the same time, it is worth noting that many of the steps needed to prepare for loan sales will strengthen a CDFI's lending operations.

Loan sales can be difficult to complete and time consuming. The experiences of the micro-lenders above, and the work to date on this issue completed by Revolve and BOI, identifies key factors—in essence, risks to the bank purchasers—that CDFIs should assess and be able to overcome as they contemplate approaching banks to sell loans. These factors, listed below, are the primary driver of whether this strategy has the potential to be a good fit for a CDFI:

Institution-level risk

Banks will want to know whether the CDFI has the financial and management strength to support loan purchases. More specifically, they will want to be convinced that the CDFI has the systems and strength to effectively underwrite and service the loans that the bank will purchase, and the financial strength to survive until the purchased loans are paid off. It can be difficult to reach the necessary level of comfort. Experience suggests that the following factors can play a role in helping banks to assess and overcome concerns about institutional risk:

- A bank's internal knowledge of and experience with CDFIs.
- External validation of a CDFI's balance sheets and accounting systems, such as via AERIS, annual audits, or other systems.
- The length and scale of a CDFI's lending experience. A CDFI with experience on thousands of loans with good data and a long track record help.
- The CDFI's relationship and engagement with local banks. CDFIs with boards of directors that have significant bank representation, or that have longstanding relationships and reputations among the banking community will be better positioned to sell loans.

CRA risk and knowledge

The second pre-transaction risk is with CRA itself. Bank expertise regarding the various options for meeting CRA obligations varies widely. In local community banks, the CRA officer role often rotates among bank staff, meaning that institutional knowledge is continually lost. For larger banks, CRA officers are often chosen for their community connections related to grant disbursement and the CRA investment test. As a result, they may lack familiarity with data for their CRA lending test, which is often reviewed within the lending function of the bank. This fragmentation of responsibility for the various aspects of overall CRA performance makes it difficult for banks to see how certain units in certain assessment areas may have an outsized impact on overall CRA performance relative to other strategies. This is likely due to the common CRA strategy of “loan, grant, repeat” to CDFIs and nonprofits. Strategies (outside of community development loans) that contribute to the CRA lending test are often left to the bank’s commercial or mortgage bankers, not the CRA officer. Loan purchases often require decisions and buy-in across bank silos and business lines; so, the CDFI must be able to explain the community benefit clearly to the CRA officer and make the financial case to the bank CFOs and CLOs. It is the combination of these variables that shows the value in these transactions. Without agreement across the bank, it is difficult for one part of the bank to see how these transactions are advantageous. As one might imagine, implementing loan sales will typically fall to a CDFI’s CFO, who must then gain the CRA knowledge necessary to get past the initial pitch to the bank. Finally, the CFO must have considerable bandwidth. When first establishing a track record with loan sales, conversion rates of bank’s pitched will likely be under 10%. After establishing a group of buyers, the required bandwidth substantially decreases.

Transaction risk

Finally, there is the risk involved in the loans themselves. Banks will conduct due diligence on a portfolio to reach its own judgement on the loan default risk. Among the MIC members, the experience with due diligence experience ranges from having a local bank president sit down to review loan files in the CDFI’s offices, to having bank underwriters getting comfortable with detailed spreadsheets of data and the CDFI’s internal risk measures. Importantly, banks are looking for commonality and potential red flags. A bank will look at the organization and completeness of the CDFI’s loan files as key indicators of whether it can be trusted to manage the servicing and to have underwritten the loans in a manner the bank can understand. The files also indicate whether the CDFI is dealing with some regulatory issues a bank must confront. Getting past this review is typically challenging, as a bank will not have a credit box that would include the vast majority of CDFI microloans as underwritten. Banks that approach CDFI loans through the lens of their own credit policies will struggle to become comfortable; a CDFI must be proactive in describing its own credit box, approach, and track record in ways that differentiates itself from the bank but provides comfort with the risk and performance of the loans to be purchased. It may take time for a bank purchaser to become comfortable with the heterogeneity and varying risk levels in a

CDFI's portfolio. In Revolve's experience, banks initially gravitate towards loans originated in a CDFI's lower risk tiers, and to lower-balance loans, if they can have both. Starting with a more homogenous pool helps the bank get comfortable. Over time, the pool of lower-risk, lower-balance loans will shrink while the bank simultaneously gets used to the credit risk. Although buying a \$500,000 pool of 50 loans with even a 10-12% loss rate is a small absolute risk relative to a bank's overall small business portfolio, especially given the number of units it will obtain for CRA purposes, it still often takes time for the bank to get comfortable. Starting with selling more homogenous, lower-risk pools helps begin that process.

Loan volume

Experience to date with loan sales indicates that banks want loans in their assessment area that check as many CRA boxes as possible. The first priority is whether the loan is in an LMI census tract and whether it is made to a borrower with less than \$1M in gross annual revenue. Furthermore, experience shows that banks want loans with an average size below \$20,000 in order to maximize the CRA benefit for the dollar invested in loan sales. Units matter disproportionately to dollars from a CRA lending test credit perspective. Thus, once the bank's focus area is clear, a CDFI needs to assess whether it has sufficient loans to make an impact on a potential bank buyer's CRA rating. If the bank makes 500 loans a year and needs 50 loans every year that meet all the above characteristics to improve its numbers with regard to loan distribution, some CDFIs will be hard-pressed to provide the needed volume. There is very little positive impact to the bank from buying fewer loans than it needs to move the needle on its CRA rating. Generally speaking, lenders with less than 200 loans in their portfolios may struggle to provide buyers the predictability they require.

With regard to the issue of financial need and loan volume, one special note pertains to lenders with significant concentration in the SBA microloan intermediary program. Loans funded with these dollars become collateral for the SBA debt. As a result, any effort to sell those loans requires approval from the SBA. Attempts to get such approval have led to challenges: the SBA has indicated a willingness to consider approving loan sales that are large in scale, are done by intermediary lenders that have drawn most of their funds from the SBA, and are imminent. In the latter case, it appears approval will only occur if a bank buyer has already been found. Most bank buyers presented with this scenario are unwilling to expend the time to review files and audit the organization if the eventual sale is dependent on the SBA's approval. This is especially true as the SBA has not been willing to approve pilot efforts that may reassure banks that approval will be granted. As such, CDFIs wanting to sell SBA microloans likely need to sell loans disbursed using other funds first and then create a transaction specifically aimed at gaining longer-term SBA approval.

Practices, Processes, and Capacities Required to Sell Loan Participation

Participation sales require an initial setup and outreach effort and then ongoing operational and account management with the bank buyers. The loan sales process should start with a review to ensure the lender has policies that mimic the core aspects of the Bank

Secrecy Act. For most CDFIs this is a small burden. More importantly, the lender needs to review its documentation process, underwriting, and document retention to ensure it consistently adheres to its own policies. In some cases, lenders need to tighten internal controls before pursuing loan sales.

Lenders then need to start outreach. For lenders looking for a price above what they would receive from holding the loan, it is essential to orient outreach efforts to banks around a CRA justification and a targeting of banks based on that CRA logic. Only banks struggling with consistently originating loans eligible for the CRA lending test will be willing to pay extra for smaller, relatively higher risk loans. This hurdle of CRA knowledge can be substantial and time consuming to acquire. Most microlenders currently lack the depth of CRA knowledge to sell loans along these lines.

For lenders willing to sacrifice some income for the immediate liquidity, the sales pitch is more straightforward and is largely driven by market conditions, price and risk. To add additional CRA benefit, outreach should be targeted to banks struggling with customer acquisition. This can be determined by loan to deposit ratios and often through board member knowledge.

After a buyer is found, the loan sales strategy shifts to an account management process. Bank buyers will need a point of contact to deal with servicing questions and to convey monthly reports. It is best if one person handles this effort for all banks. This is especially true as volume grows. Banks willing to pay the highest price for loans will do so because of the speed with which they can meet their CRA targets. They will buy more over time if the same amount of volume is consistently available. For the CDFI, a balance must be struck between short-term and long-term sales. Banks are willing to become more dependent on buying from the CDFI, and therefore buying more loans overall, if the lender has volume available when they need it. Conversely, if the CDFI does not have loans available when the bank needs them, the relationship will be damaged, and the bank will need to make other plans to address the shortfall. The lender must become adept at managing this tradeoff if they intend to make this strategy work as a tool for long-term growth.

All of the above requirements relate primarily to personnel. The system requirements are not beyond what a traditional servicing process can handle. The primary investment is therefore a personnel opportunity cost: selling loans will take time and focus away from other activities and a concerted sales and operations effort from senior leadership at the organization. Once established, it may take an additional 0.5 FTE to maintain the bank relationships.

Steps in the Loan Sale Process

1. Model potential financial impact from loan sales and decide to proceed.
2. Review portfolio from a CRA perspective: reviewing existing loans at microlender and determine value based on CRA consideration for each loan.
3. Conduct operational evaluation and revised practices as needed: the microlender must be able to meet a bank's needs to understand and be comfortable with the CDFIs underwriting, cumulative losses, ability to meet bank compliance needs, its operational preparedness for banks replicating loan files and managing payments to banks.

4. Target banks and conduct outreach: identify potential purchasers based on their CRA lending challenges and existing knowledge of and relationships with CDFIs; make sales pitch based on CRA benefits.
5. Complete a non-disclosure agreement with the bank: necessary to protect CDFI borrower data.
6. Submit loan information to bank for review, which typically includes:
 - a. Credit box summary. (Can review full policy if desired. More of a steering document.)
 - b. Light review of individual loans in spreadsheet form.
 - c. Share electronic sample files with all loan documentation.
7. Bank determination/decision to proceed with pricing as stated per loan: begin to review legal agreement.
8. Bank selects loans:
 - a. Bank receives more in-depth view of loans in their stated assessment area with key underwriting data also now included.
 - b. Bank chooses which loans it wants to see full files on.
 - c. Bank reviews files, chooses files, and replicates chosen files on its systems.
9. Perfect transaction and close: using targeted close date, determine amounts outstanding, anticipated interest, and premium.
10. Servicing: lender collects payments and remits interest and principal to the bank while withholding the servicing fee.

Scaling Loan Sales among CDFI Microlenders

Revolve and BOI's experience with loan sales has helped to identify three key issues that could facilitate greater use of loan sales by CDFI microlenders (via either securitization or loan participations). These relate to third-party ratings, servicing, and centralizing expertise and management of loan sales.

Third-party Ratings

In the process of exploring the feasibility of securitization and institutional participation sales, it becomes clear that the presence of a third-party rating may be essential to reach scale. In the world of securitization, third-party ratings are common and required. In the world of participations, even bank to bank, third-party rating is unusual and likely contribute to the market remaining small and focused on one-off transactions. It is more common to sell 5-10 loans than 500 because the buyer is in many cases repeating the underwriting process to get comfortable with the transaction. This is in contrast to sales of consumer loans and mortgages that can rely on FICO and other data to allow thousands of loans into a single tranche of a securitization without assessing each loans risk directly. Alternatively, a bank may come to rely on a trusted broker who knows its risk preference. For sales to meet the

needs of large-scale microlenders seeking to grow, streamlining the review of hundreds of small loans is essential.

The most promising way to accomplish the streamlining is an accepted rating process that is quick and clear. A rating tool could be created or adjusted from an existing lender. However, such a tool would likely be heavily influenced by the lenders, which will create a perception of bias. A better solution may be to find an approach already used and accepted by banks. Various systems exist or are in development that may eventually serve this role.

Servicing

The second commonly occurring issue is loan servicing. In securitizations it is common to have a third-party, backup servicer included in the terms of the agreement. This backup ensures that any risk to the first servicer does not jeopardize cash flow of the entire pool. Some participation agreements also require a backup servicer or, in the case of multiple lenders contributing to a single pool, a master servicer to compile all the incoming information and be prepared as a backup servicer as required. It is likely that for large-scale sales or securitizations purchasers would value at least a master/backup servicer and in some models, may value direct servicing support. In this case, CDFIs could still retain the relationship with the client but pass off the tasks more directly tied to risk (or perception of risk) for the bank buyer. Third party servicers operate across the country and Revolve and individual CDFIs are engaging with them to identify their ability to execute the servicing requirements of microlenders.

Creating a market maker

Given the capacity and time requirements necessary to implement institutional loan sales—developing related expertise, balancing the trade-offs between volume and pricing, providing the required volume of loans, and the potential value added by third-party service providers—we believe there is value in centralizing knowledge and management of loan sales in an entity that could in effect be a “market maker” for loan sales.

A market maker would serve as a warehouse of loans from multiple lenders. It would work with the CDFIs to complete initial due diligence and ensure they are prepared to sell. After that initial process, the market maker would buy all of the loans that a lender would like to sell within a set credit quality standard. This would address the liquidity needs of the CDFIs, enabling them to originate new loans without raising net assets or additional debt. The market maker would then manage the process of finding buyers for the loans and achieving the best price possible while balancing volume needs long-term for the bank buyers. When the market maker achieves a premium, it would pass that premium back to the original lender, providing resources to support the CDFI’s ongoing costs of originating and servicing microloans.

A market maker would also be valuable from the banks’ perspective. In the course of its work to support loan sales, Revolve met with several banks that had approached CDFIs to try to purchase small business loans. The banks expressed a common frustration that their

overtures to the CDFI were declined or ignored, despite the CDFI's likely need to sell loans. It seems likely that the CDFI's response stemmed primarily from a lack of capacity and knowledge. Many nonprofits struggle to allocate time to strategic initiatives that are outside of the norm of the day-to-day. For that reason, many banks have expressed a desire to work with a motivated third party that would facilitate transactions for the CDFIs.

Although a market maker would have a similar capital structure to the CDFI lenders—leveraging its net assets with debt—if the secondary market is functioning well and most of the loans it purchases can be sold relatively quickly, it would not need a significant asset base. For example, while the fund might have \$50 million in assets under management, most of those assets would be held by the bank purchasers, and the fund itself could function with \$5-10M in assets. Therefore, its capital raising needs would be limited. In fact, a large warehouse line might be sufficient to manage transactions.

Of course, if sales become slow, the market maker could quickly balloon in size, but counterintuitively, that ability to grow is an asset. Sales are most likely to become slow during a recession, when small business lending is contracting at banks. The experience of the MIC members is that recessions create growth as businesses turn to them to fill the void in lending created by bank retractions. Yet, in a recession many high-volume CDFIs will not have the balance sheet to take on debt to grow. In that instance, a market maker that has maintained a small debt load and low net asset ratio can become a vehicle to take on debt a CDFI is not otherwise positioned to borrow, passing liquidity to the CDFI through loan purchases.

In May 2020, Revolve and BOI partnered to take this learning to the next phase, creating a new nonprofit, the Entrepreneur-Backed Asset (EBA) Fund, that is working to create an efficient and scalable secondary market for CDFI microloans. Its initial focus is on purchasing loans from the members of the Microfinance Impact Collaborative. As of October of 2020, EBA Fund had purchased \$1.9 million in loans from four of the MIC members. Of the loans purchased, 79% were loans originated to entrepreneurs of color.

The Role of Loan Sales in the COVID-19 Context

The COVID-19 pandemic will have a deep and likely long-term impact on small businesses and the institutions that finance them. Many small businesses have been deeply affected by the mandatory closure of many types of firms; others that were not required to close and those that have reopened are affected by the need to adapt operations to new health and safety requirements and the general drop in demand. The duration and therefore the full impact on small businesses from measures needed to respond to the pandemic, and the recession it has created, is unknown.

What is clear is that the emergence of the COVID-19 pandemic has had a significant impact on the portfolios and liquidity needs of CDFI business lenders. As the pandemic hit, CDFIs offered deferments or other forms of debt relief to their borrowers that reduced their operating liquidity. CDFIs also must increase their reserves to reflect the higher risk among loans originated prior to COVID. These combine to create serious financial challenges for those lenders that were already at or near the net asset levels mandated in loan covenants with their creditors.

Many CDFIs have stepped up to lend as part of relief and recovery programs such as the Paycheck Protection Program and local and state government supported programs. In most cases they were able to access dedicated sources of liquidity for these programs, but often the fees and other funding available for the programs will not cover the full costs (operating and capital) of making those loans. For example, a lender making a \$15,000 PPP loan will generate only \$750 in revenue, which is not sufficient to cover the full cost of originating and servicing that loan.

In this context, selling loans to remove them from a CDFIs balance sheet is an important tool for addressing the liquidity and leverage crises that many CDFI micro and small business lenders will face. Given the risk levels of the loans, the entities that purchase them must be structured to absorb losses and/or allow for loan restructures that provide relief to small business borrowers. Revolve and BOI have been working on two efforts to advance loan sales as a response to COVID-19. The first involves a short-term shift in the goals of EBA Fund to ensure its financial model and capital structure allow it to absorb some of the losses that will occur in loans purchased at the current time. Over time, as the economy recovers, EBA Fund can pivot to a capital structure and pricing that reflects the risk levels of loans made in a non-pandemic context. The second effort is a proposal developed with partners in the CDFI industry that encourages the Federal Reserve to use the tools it has to provide liquidity to financial markets in order to establish entities that can purchase and restructure loans to businesses in industries most deeply affected by COVID-19 (Bynum, Klein, & Ogden, 2020).

Conclusion

Asset sales have been a critical driver in scaling growth in a number of financial products and asset classes. It has been a more difficult process in the small business lending market, given that it is more difficult—and also less desirable—to use credit scores alone to assess the risk of these transactions (Bhide, 2018). And CDFI micro and small business lenders have yet to achieve the level of scale necessary to make securitization a cost-effective tool.

However, the work of Revolve, BOI and MIC members has demonstrated that loan sales can be a tool for addressing all three of the key financial challenges that have limited the growth of CDFI small business lenders. This is because microloans in particular have a value from a CRA perspective that means that for some purchasers the value of purchasing loans goes beyond the direct financial return on the portfolio itself. In addition, it is possible to bring tools to bear that can increase knowledge of the risk and return associated with the underlying loans, as well as to increase the efficiency and pricing of the transactions themselves. With the necessary tools, information, and infrastructure, loan sales represent an important change in the underlying financial and business model for CDFI microlenders that could be a missing driver to greater scale and impact.

References

- Bhide, A. (2018). Why We Need Traditional Banking. *National Affairs*, 34. Retrieved from <https://www.nationalaffairs.com/publications/detail/why-we-need-traditional-banking>
- Bynum, B., Klein, J., & Ogden, T. (2020). The Most Vulnerable Small Businesses and Communities Will Be Left Behind Without Targeted Action: The Fed and Treasury Can Make Sure They Are Not. The Aspen Institute. Retrieved from <https://www.aspeninstitute.org/blog-posts/the-most-vulnerable-small-businesses-and-communities-will-be-left-behind-without-targeted-action-the-fed-and-treasury-can-make-sure-they-are-not/>
- Edgcomb, E. (2009). The Organizational Foundations of Sustainability. *FIELD Forum*, 23. The Aspen Institute. Retrieved from <https://assets.aspeninstitute.org/content/uploads/2009/05/FieldForum23.pdf>
- Federal Reserve Bank of Atlanta (2019). *Small Business Credit Survey Report on Minority-Owned Firms*. Retrieved from <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf>
- Federal Reserve Banks of Kansas City and New York (2017). *Small Business Credit Survey Report on Women-Owned Firms*. Retrieved from <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-WomenOwnedFirms-2016.pdf>
- Jobst, A. (2008). Back to Basics: What is Securitization. *Finance & Development*, 45(3). International Monetary Fund. Retrieved from <https://www.imf.org/external/pubs/ft/fandd/2008/09/basics.htm>
- Klein, J. & Okagaki, A. (2018). *The Price of Access: How Scale-Focused Microlenders are Pricing for Growth*. The Aspen Institute.
- Opportunity Finance Network (2019). Opportunity Finance Institutions Side by Side, Fiscal Year 2018 OFN Member Data Analysis.
- Swack, M., Hangen, E., & Northrup, J. (2014). *CDFIs Stepping into the Breach: An Impact Evaluation—Summary* Report. The Carsey School of Public Policy, University of New Hampshire. Retrieved from <https://www.cdfifund.gov/Documents/CDFIs%20Stepping%20into%20the%20Breach%20Impact%20Evaluation%20Report.pdf>