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CALIFORNIA COMMUNITY ECONOMIC DEVELOPMENT ASSOCIATION

COMMUNITY DEVELOPMENT MICRO LOAN FUNDS

Community Economic Development Manual

Disclaimer

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COMMUNITY DEVELOPMENT MICRO LOAN FUNDS

Use of this Guide

The Community Development Micro Loan Fund Guide is intended for use by community development organizations for the following purposes:

1. Organizations wanting to learn about Micro Loan Funds
2. Organizations creating alternative lending and investment programs
3. Organizations seeking services and capital from Micro Loan Funds

NOTE: For purposes of this guide, focus will be on business lending (to start, expand or invest in business development) and to a lesser degree on personal loans (home, auto or educational loans). This guide is one of five guides discussing the following categories of lending and investment activities:

1. *Community Development Loan Funds (CDLFs): This broad category includes all loan funds that are not Credit Unions or Equity Investment funds. The information in this section includes the steps and considerations for starting a loan fund.*
2. *Microloan Funds: This is a sub-category type of loan that fund focuses on smaller loans, primarily for start up financing.*
3. *Credit Unions: This is a federal/state designation for a lending institution that meets certain capital requirements, operating guidelines and management systems.*
4. *Equity Investment Funds: Funds that provide equity investment (versus loans) into community development activities.*
5. *Community Development Financial Institutions (CDFIs): This is a Federal US Treasury designation based on organizational and lending standards that allows loan funds access to US Treasury grants through the CDFI Fund (includes most CDLFs, Microloan funds and Credit Unions).*

Organizations interested in expanding access to capital for underserved communities have focused on various forms of loan and investment funds. Microloan funds are a specific type of fund which targets small loans to entrepreneurs and individuals. Loan funds can specialize and focus lending for various products and markets (home or auto loans, business start ups or expansion) in specific neighborhoods or regions.

All of these forms of loan and investment funds are eligible to become certified Community Development Financial Institutions. This federal certification allows loan and investment access a wider menu of grants and programs designed to bring capital to low income and underserved communities.

Community Development Financial Institutions (CDFIs) is becoming the standard nomenclature categorizing all community development lending and investment entities (albeit not all such entities have obtained the official US Treasury designation, most have and will apply for the CDFI designation because it represents a recognizable industry standard). The Opportunity Finance Network is the association representing all types of lending institutions and has broadly categorized all lending institutions as CDFIs and subcategorized lending and investment institutions as follows:[1]

> *"As with mainstream lenders, a variety of institutions has emerged to serve the broad range of needs in emerging domestic markets. Although they share a common vision of expanding economic opportunity and improving the quality of life for low-income people and communities, the four CDFI sectors—banks, credit unions, loan funds, and venture capital (VC) funds—are characterized by different business models and legal structures":*

1. *Community Development Banks: Community development banks provide capital to rebuild economically distressed communities through targeted lending and investing. They are for-profit corporations with community representation on their boards of directors. Depending on their individual charter, such banks are regulated by some combination of the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and state banking agencies. Their deposits are insured by FDIC.*
2. *Community Development Credit Unions: Community development credit unions (CDCUs) promote ownership of assets and savings and provide affordable credit and retail financial services to low-income people, often with special outreach to minority communities. They are nonprofit financial cooperatives owned by their members. Credit unions are regulated by the National Credit Union Administration (NCUA), an independent federal agency, by state agencies, or both. In most institutions, deposits are also insured by NCUA.*
3. *Community Development Loan Funds: Community development loan funds (CDLFs) provide financing and development services to businesses, organizations, and individuals in low-income communities. There are four main types of loan funds: microenterprise, small business, housing, and community service organizations. Each is defined by the client served, though many loan funds serve more than one type of client in a single institution. CDLFs tend to be nonprofit and governed by boards of directors with community representation.*
4. *Community Development Venture Capital Funds: Community development venture capital (CDVC) funds provide equity and debt-with-equity-features for small and medium-sized businesses in distressed communities. They can be either for-profit or nonprofit and include community representation.*

The companion "Community Development Financial Institutions (CDFI) Guide" also touches on many aspects of loan funds and should also be reviewed. The CDFI Guide however is usually the "next step" for established loan funds. We would also recommend reviewing the "Business Technical Assistance Guide" since the two community development activities work hand in hand.

Due to recent economic and financial turmoil, commercial lenders and investors have tightened lending requirements, resulting in a "credit crunch" where credit needs are greater than resources. This economic landscape has resulted in commercial financial institutions relying more on community loan funds as the mechanism to better serve niche market needs. Financial institutions now invest and lend more aggressively to financially sound and stable loan funds. Loan funds have built a strong reputation by understanding local credit nuances and needs resulting in sound lending and strong loan portfolios

[1] Opportunity Finance Network, website: www.opportunityfinance.net

Loan funds come in many sizes and focus on a myriad of community development credit needs. Community based loan funds are integrated with training and business technical assistance programs. Together these resources enhance and support the small business industry, a very important part of community development and stabilization. Business programs, services and loan funds are usually managed by the same organization that provides comprehensive business assistance. Loan funds, however can stand alone and become a centralized funding mechanism in partnership with other local and regional business support programs and organizations.

For successful loan funds, the CDFI designation is very important and allows lending programs 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.

The CDFI designation is determined through 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. *NOTE: Because the CDFI designation is so important, it will be referred to throughout this guide and will be summarized at the end. The "Community Development Financial Institutions Guide" should be referred to for details on the CDFI Fund and its programs.*

Loan and investment funds play an integral role in a community economic development strategy. Loan funds 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). Capital enhances economic stability while creating jobs and opportunities for community residents. Creation of personal and community assets is a keystone in building and strengthening communities. Loan funds also bring communities a higher level of technical expertise in business and finance, increasing the potential for sustained community stability and growth.

Financial institutions have become more effective in meeting customer demands in low income and disadvantaged communities through channels created by loan funds. Financially successful funds generate income to cover organizational operating and overhead expenses and can bring additional income to support other community credit needs, such as business technical assistance programs and expansion of lending services (such as auto loans, microloans, home or business loans). A stronger and financially viable lending business enhances the overall success and longevity of your community development organization while supporting community credit needs.

Loan funds play a very important role in community development (revitalization and stabilization). The effects are substantial and include:

For the Organization:

1. Generates additional income for the program
2. Supports and allows for the creation of complementary programs, services and projects
3. Expands staff capacity and 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. Creates personal and community assets
4. Enhances the local economy by supporting important segments of the economic infrastructure including business, residential and industrial sectors
5. Effective means of supporting entrepreneurial development in neighborhoods and creating needed community goods and services.

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.

COMMUNITY DEVELOPMENT MICRO LOAN FUNDS

Micro loan funds are a specific category of community development loan funds. According to the Opportunity Finance Network, "Community development loan funds (CDLFs) provide financing and development services to businesses, organizations, and individuals in low-income communities. [Loan and investment funds] are defined by the client served, though many loan funds serve more than one type of client in a single institution. CDLFs tend to be nonprofit and governed by boards of directors with community representation."[2]

CDLFs are not regulated entities and deposits or investments into funds are not guaranteed; however most adhere to a standard created by two major entities. The first is a federal program through the Community Development Financial Institution (CDFI) Fund. The Fund has established guidelines to become a CDFI (and be eligible for program grants). The second has been established by the Opportunity Finance Network (OFN). OFN is a non-profit association whose membership requires that prospective members meet performance standards that are appropriate for their particular operating context.

OFN standards are based on:

1. Mission and Impact: Primary mission to "strive and to have a positive impact on low income. Low-wealth and other disadvantaged people and communities"[3]
2. Finance Led Strategy: Lending activity history of over two years, be a non-governmental entity and provide affordable, responsible financial products and provide financial services.
3. Commitment to Performance: Meet certain loan and risk management policies and procedures, have audited statements and meet certain capital and portfolio ratios and requirements.
4. Support OFN's Mission

OFN also provides extensive technical assistance and access to information and data to assist in the start-up, operation and management loan funds.

Lending and Investment 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 management terms and concepts 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 cost of funds and what the rate of return is for your funds (average interest rate you are charging).
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: Expenses include business operations (loan and portfolio management), business management and marketing, office and staff costs. These are expenses that should be paid from the income derived from the "interest rate spread". If

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[2] Opportunity Finance Network, Website: www.opportunityfinance.net
[3] Ibid

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 consists of a mix of loans investments and grants, and a portion (or majority) of the bad loan needed to be repaid to a lender or investor, you would draw the funds from a loan loss reserve. If one loan 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 need a higher loan loss reserve. High loan loss reserves do not benefit your fund since they are dollars that are set aside and are not "working" as outstanding loans or generating interest income.

   In financial institutions and in larger funds, loans in portfolio are rated. Those with greater risk or in various stages of 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 have greater relative operating costs because handling and processing costs for each transaction is about the same whether the loan is for $500 or $5,000,000.

Start-up or Expansion / Becoming a Micro Loan Fund

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

1. Start-up loan fund:
   A. As a new fund
   B. Through a partnership
2. Existing, slightly experienced loan fund
3. Existing, experienced loan fund

Start-up Fund: Starting a loan fund is very difficult due to costs. Funding is needed for business operations and for the loan fund. A lending track record is needed to attract financing or to become eligible for a technical assistance grant through the CDFI Fund.

The following is a suggested guide for organizations that have clearly identified needs and 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 potential ways of becoming a CDLF, 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, consider the following steps:

1. Fund Initiation: Secure seed funds to allow for staff or consultant assistance for the following: (funding could be lower if your staff has the time to conduct the preliminary research)
   A. Concept Paper: Creation of a one to two page summary that includes a summary description of your organization, needs, size, management, and potential resources available for the business and fund.
   B. Community Support: Obtain support from entities that represent 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 develop 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 especially if you are trying to create a large fund. 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 to penetrate markets by effectively partnering with community organizations that represent and serve these communities. You must make the case, present need, and indicate how your organization's role will enhance the effort. (See Development Tips at the end of the Guide)

   Your organization must assess how the proposed program costs will benefit the overall 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 the 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. Board: Creation of the Board of Directors is a very important step that builds the foundation for a successful loan fund.
   A. Proper balance between mission (helping improve distressed communities) and risk (lending guidelines and requirements) is maintained by board representation.
   B. Fundraising: Fundraising is a critical need for loan funds and having representatives from entities that either funds/invests in loan funds or are in peer industries that can support loan fund activities is critical.
   C. Management: Expertise in lending, business or law provides the necessary input and oversight of lending activities and overall success.

5. Loan Committee: The loan committee should in many ways mirror the balance of the board of directors but have focus on management issues. The committee must have members versed in understanding of the lending guidelines and policies of the fund. Experienced lenders can typically be recruited from financial institutions that invest or lend into the fund.
6. Start Up Lending Activities
7. 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.*

<u>*Strategy 2: Partnership*</u>: If there are other loan funds or 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 potentially obtain CDFI certification at a later date). Some of the strategies include:

1. Expansion of Service Area: If it is possible, an existing loan fund or CDFI could expand its 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 for creating a fund, you may want to consider creating one and having the CDFI or neighboring loan fund manage it. 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 you will need if you create your own fund.

The partnership structure is important if you are considering operating a small loan fund or provide smaller loans. Remember, the management and handling costs for a small loan are the same as for larger loans. In addition, the larger the loan pool (and the greater the amount of funded loans) generates 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. Another strategy to lowering operating costs is to partner with other organizations that could handle marketing, training and technical assistance.

Existing 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) through the US Treasury's CDFI Fund. 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."[4]

Existing or experienced loan fund: If you are currently operating a loan fund, you should consider applying 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 plans) for your CDFI. You can also apply for a Financial Assistance Award that provides capital for your new or expanded loan fund.

Development Tip: Manage Expenses: Managing your income and expenses is essential for your long term survival.

1. 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.
2. Loan losses decrease the size of your loan pool and lower your potential income
3. Reserves impact your business success. These are funds set aside that do not generate income.
4. Your lending guidelines and approvals also impact your success. The greater risks your fund incurs; the greater the potential losses.
5. The expenses for marketing, processing and managing a small loan are the same as expenses for a larger loan.
6. Partnering and sharing of loan management and portfolio management functions are an excellent means of managing and reducing expenses.
7. 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.

[4] CDFI Fund Website, Op Cit

MICROENTERPRISE LOAN FUNDS

Microenterprise development is an economic development strategy that traces its roots from successful traditional credit and savings programs established by rural and urban poor communities in many countries throughout the world. Over the last 20 years, this strategy has been refined and targeted to disadvantaged communities lacking access to traditional lending and savings resources. Key traits of this "sub-market" include poor savers and borrowers without a verifiable income and a lack of savings or other tangible collateral, in an environment with no or very little access to credit.

Microenterprise development is an important strategy because it generates income through the creation of businesses (jobs) at the grassroots level. The ultimate beneficiary is the community where typically both the entrepreneur and the service provided directly support the stabilization and growth of distressed communities.

Microenterprise programs provide access to capital in sub-markets traditionally overlooked by conventional financial markets. Whether the program provides $100 or $35,000 loans, capital is needed to initiate successful business enterprises and ensures start up and operations are adequately funded through the most tenuous part of the business cycle.

Many of the basic strategies of microcredit are attributed to Nobel Laureate Muhammad Yunus who founded the Grameen Bank in 1976. Many institutions in countries throughout the world incorporated successful strategies developed by the Grameen Bank that delivered credit (small loans) to individuals in poor communities. Besides delivering credit and savings programs, microcredit and lending is an economic development strategy that:

1. "Fosters small business creation and growth among disadvantaged populations without access to conventional resources and,
2. Increased economic self-sufficiency of low and moderate-income people though self-employment"[5]

International developing countries measure microloans in "hundreds of dollars or even less"[6] while the United States defined business loans up to $35,000. The scale may be different but, the focus on impoverished communities is the same

Microloan activity in the United States is substantial. FIELD, a microenterprise policy project of the nonprofit Aspen Institute, conducts periodic surveys of groups that serve microenterprises, called microenterprise development organizations (MDOs). "MDOs are nonprofit organizations that serve as banks, private equity funds, and financial planners, such as lending, capital investments, budgeting, and financial advisory services. In addition, they provide a range of business-specific technical training, coaching and mentoring, counseling, legal assistance, and other types of nonfinancial services. Some MDOs exist solely to conduct microenterprise development activities, and some are part of larger organizations with broader missions."[7]

The FIELD survey conducted in 2009, using data as of 2008 estimated the scope of microenterprise development.

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[5] Shorebank Advisory Services, "Microenterprise Loan Funds", May 1996, page 1
[6] FDIC, "Microenterprise Development: A Primer" FDIC Quarterly, Vol 5, No. 1, 2011, page 36
[7] Ibid, Page 37 www.fidc.org

- 696 MDOs in the United States served more than 274,000 individuals. (NOTE: In 1995 the estimate of MDO's was a little over 200)[8]
- More than 300 of these MDOs engaged in micro lending and originated over 9,000 loans totaling more than $100 million.
- MDOs held an estimated $174 million in outstanding loans and $235 million in microenterprise capital.
- The most common services provided by MDOs were "microloans," business loans of $35,000 or less, and general technical assistance; more than 90 percent of MDOs provide these services.[9]

"Over a five-year period, clients of MDOs have reported that their businesses have had positive effects on household income and their communities, such as the following:

- The median revenue for business owners increased 60 percent, from about $50,000 at program intake to just over $82,000.
- The median "draw" or the amount business owners take for personal compensation, more than doubled, from about $11,000 to $25,000.
- The median contribution of draw to household income increased from 52 percent to 71 percent.
- For the approximately 40 percent of business owners who employed workers other than the owner, the number of paid workers more than doubled, from 2.1 workers per business to 5.6.[10]

The average cost to service a microenterprise is about $2,700, and MDOs recoup only approximately one-fifth of their costs through interest and fees on loans and other income sources. MDOs derive the remainder of their annual funding from a mix of public and private sources."[11]

Microlending is a niche business. MDOs target specific demographic profiles or the geographic niche of a segment of the non-bankable market. Access has been denied for various reasons including:[12]

- Small credit needs
- Poor or no credit history
- Limited or no collateral
- Insufficient cash equity
- Inadequate business experience
- Socio-economic, ethnic, cultural or gender obstacles

Niches of microloan business activities include:[13]

- Poverty alleviation programs use credit as one of many tools to assist poor and low-income borrowers to overcome social and financial hurdles and generate additional sources of income through full or part-time microbusinesses.
- Self-employment programs help early stage entrepreneurs stabilize their businesses and establish a steady source of employment for themselves and/or their families

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[8] Shorebank Advisory Services, Op. Cit.
[9] FIELD, "Microenterprise Census Highlights FY 2008 Data", July 13, 2010
[10] FIELD, "Microtest Measures 2008 Data" www.fieldus.org
[11] FDIC, op. cit.,page 37, www.fdic.gov
[12] Ibid, Shorebank Advisory Services
[13] Ibid, Shorebank

- Growth and emerging microbusiness programs help microbusinesses to increase sales and employment and to transition into being small businesses with access to other financing resources.

Microloan funds and lending are typically not stand alone activities. A loan fund can be a program or service of a non-profit organization or a separate organization, but its effectiveness depends on complementary services needed to prepare and teach individuals the steps to save and use the capital they now have access to.

The Aspen Institute (FIELD) presented information as part of their Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination titled "Financial Literacy and Credit Building Services in Microenterprise".[14] The presentation included information on effective comprehensive services that support and enhance microlending activities.

Comprehensive Services:

- Financial literacy training/financial education: classes or workshops that provide information on budgeting, savings, personal financial management, financial products, etc.
- Financial coaching/advising: one-on-one assistance on budgeting, savings, personal financial management, financial products, etc.
- Credit counseling: one-on-one assistance focused on dealing with a crisis and/or an individual's debt situation, typically provided by licensed credit counselors.
- Credit-building loans/financial products: financial products, including checking and savings accounts, prepaid accounts, term loans or credit cards, offered by the organization or with a financial institution, that seek to help an individual to manage cash, debt and/or improve their credit profile.
- Credit education/credit coaching: one-on-one counseling or technical assistance focused on building basic credit knowledge and helping individuals build positive skills and behaviors.

In addition their survey showed the percentage of MDOs providing specific services:

- 15% Credit building products in partnership
- 25% Links to checking or savings accounts
- 33% Credit counseling
- 46% Credit Reporting
- 52% IDA's
- 52% Direct credit building projects'
- 58% Financial education information
- 75% Financial coaching / advising
- 77% Credit education / coaching
- 87% Financial literacy training / financial education

Organizational Structure:

Although most microloan funds are operated by non-profit organizations, they can also be part of municipal governments. They may vary in size from several thousand to several million dollars.

[14] FIELD, "Financial Literacy and Credit Building Services in Microenterprise", Aspen Institute, September 2010, www.fieldus.org

Funding comes primarily from philanthropic sources and from the public sector. These resources are very important because most microloan funds do not generate adequate income to support the extensive services (business management, marketing, accounting, tax reporting, etc.) needed to support the success of entrepreneurs.

The FIELD study report noted that only one-fifth of program expenses are derived from program revenue (interest income and fees), therefore ongoing organizational support (funding) is essential. Microfunds generally do not have the loan fund size needed to generate the higher revenue needed to support and manage the greater number of smaller lending transactions.

Organizational and Program Considerations:

1. Operations and Management: The following are systems, tasks, responsibilities needed to be resolved prior to initiating a fund:
    a. Market Analysis: Analysis of the market you are serving
    b. Business Plan: Summary of the business, including all of the items mentioned in this outline
    c. Management Plan: Roles and responsibilities of staff
    d. Personnel: Analysis of technical capacity and staff needs
    e. Fundraising: Sources for start up, loan fund capital and operating costs
    f. Investment Policy: Where and how unused funds are used
    g. Marketing: Who is being marketed, how and where
    h. Outreach: Partners to be enlisted to assist in marketing
    i. Loan Application Review: Who will review the application to make sure the information is complete
    j. Loan Analysis / Underwriting: Who will review, underwrite and prepare the credit memorandum for review, and what are the standards that apply to the analysis
    k. Credit Review: Who will be on the loan committee? Care should be taken to "balance" the committee with experienced lenders and community representatives.
    l. Technical Assistance: Where will business technical assistance resources come from if borrowers encounter problems?
    m. Loan Management: Who will conduct and monitor billing?
    n. Portfolio Management: Who will manage the portfolio, and what standards and requirements will be applied to the portfolio?
2. Key Loan Considerations:
    a. Loans: Depending on community needs, small business loans can range from $100 to $35,000.
    b. Use of Funds: Working capital, equipment or other asset acquisitions
    c. Terms: Depends on the size and use of funds, but usually have a short term that can range from months to 5 years
    d. Rate: Most microlenders have rates above conventional market rates
    e. Collateral: Usually required, but is typically not a secondary source of repayment
3. Program Considerations:
    a. Pre-assessment: Assessing the need for training and/or technical assistance
    b. Pre-qualification: Many programs require participants to attend classes or obtain technical assistance for issues identified in the pre assessment
    c. Business Plans: This is typically a pre-qualification requirement and a very important exercise to measure business progress and success. Organizations providing this

training or technical assistance will have a better understanding of the business and higher likelihood of success.

d. Loan Monitoring: Requirements for business operations and financial reporting (monthly, quarterly or semi-annually). Frequent monitoring and maintaining contact with the borrower is important to spot early issues that can potentially be rectified.
e. Collateral: Level of collateral to be required and an important measure of the commitment of the borrower.
f. Character: In lieu of a guarantor, co-signer or reference, some successful programs require applicants to identify individuals to vouch for the applicant

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS (CDFIs)

Microlending programs, most CDLFs and credit unions are eligible entities under the CDFI program. *NOTE: (Please refer to the Community Development Financial Institution (CDFIs) Guide for specific details).*

The key programs include CDFI Certification, Technical Assistance (TA) Awards and the Financial Assistance (FA) Awards. These programs are designed to enable CDFIs to leverage private capital to meet the demand for affordable financial products and services in economically distressed communities.

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"[15] 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 operating a successful loan fund or conducting lending activities. Therefore, we highly recommend that organizations closely study the application guidelines found at www.cdfifund.gov.

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).*

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.

[15] Community Development Financial Institutions Fund "CDFI Certification Application", Department of Treasury, June 2007, pg 4

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 supports your organization towards building systems and capacity to apply for the Financial Assistance Awards.

CDFI Application for Financial Assistance Awards: This award is a grant that can be used to improve organizational systems and as seed capital (or expansion capital) for your loan fund. This is a grant and can be used for your loan fund at 0% interest.

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

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. Some of the larger lending institutions may be national but they may not serve all communities with the same lending products.

Communities could be served by CDFIs with lending products that do not meet local needs. Many CDFIs serve only one segment of lending activity such as businesses, real estate or personal, which may not match with needed credit service in a given area.

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

SOURCES OF FUNDS:

1. Federal, State and Local
    a. Small Business Administration
        i. Microloan Program: Funds to nonprofit community-based MDOs with loans capped at $35,000 recently increased to $50,000 pursuant to the Jobs Act. The average loan is $13,000. For FY 2010, $25 million was allocated to the program.
        ii. Program for Investment in Micro-entrepreneurs (PRIME): In 2010 there were 92 grants made from a $8 million dollar pool. Grants up to $250,000 can be awarded to MDOs to fund direct assistance to customers of funds or to build the MDOs own resources or capabilities.
    b. Department of Treasury: CDFI Fund
        i. CDFI Certification: Certification Program for loan funds to become eligible to apply for CDFI programs
        ii. Technical Assistance: 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 including 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
        iii. Financial Assistance: Awards of up to $2 million are made 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.
        iv. Other Programs: Other CDFI Fund programs include:
            1. Bank Enterprise Award (BEA): This program provides financial incentives to institutions to expand investments in CDFIs and to increase lending, investment, and service activities within economically distressed communities over a specific time period.
            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. Financial Education and Counseling (FEC): Through the FEC Pilot Program, the CDFI Fund provides grants to eligible organizations to enable them to provide a range of financial education and counseling services to prospective homebuyers
            4. New Markets Tax Credits: 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. This is in exchange for making equity investments in

businesses and commercial projects that creates jobs in low income communities. *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.*

5. Native American CDFI Assistance Program (NACA): Focused program supporting activities for Native American communities
6. Certification for Community Development Entities (CDE): 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.

c. United States Department of Agriculture:
   i. Rural Microenterepreneur Assistance Program (RMAP): Maximum loan: $500,000. Low interest, 20 year loans with 2-year deferral of payments, to capitalize a revolving microloan fund. The microlender must establish & maintain a 5% loss reserve from their own funds. Loan proceeds are to be used for relending as fixed rate microloans (≤ $50,000) to rural microentrepreneurs.
   ii. RMAP Enhancement Grants ($25,000 maximum size) to allow a microlender to increase its capacity to serve rural microenterprises. Enhancement grant awards are *not* tied to the operation of an established RMAP loan fund. RMAP grants cannot provide more than 75% of the cost of the project.

d. Health and Human Services, Office of Community Services, Community Economic Development: Community Economic Development Grants: discretionary grant funds to Community Development Corporations (CDC) for well-planned, financially viable, and innovative projects to enhance job creation and business development for low-income individuals. Up to $800,000 is available for projects that include revolving loan funds, real estate development and business start up and expansion.

e. Department of Housing and Urban Development:
   i. Community Development Block Grants (CDBG): Microloan funding is an eligible activity under the CDBG progam. Use of funds is determined by citizens input into the CDBG process by the participating jurisdiction (local or state government). Many jurisdictions have allocated funds for MDO support and all types of small business activities.
   ii. Community Service Block Grants (CSBG): Loan funds are also supported though CSBG funding through eligible state and local jurisdictions. Most of the local jurisdictions are community action agencies or a local government affiliate that determines use of CSBG funds.

2. Foundations and Private Sector:
   a. Grants: Foundations have been a strong supporter of microenterprise lending and development. Most of the support is conducted on a relationship basis.

DEVELOPMENT TIPS:

Consider what community needs are and design the lending or investment activity appropriately. Consider what resources you have or can access to help determine size and scope of your program. 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 be your base tool to present 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. This information 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. They are very competitive. It is important to build your capacity and track record.
5. Once you get a CDFI designation make sure conventional lending institutions are part of your planning/development process. Enlist them as supporters (on your board, advisory board or project committee). Remember, conventional financial markets have realized the importance and successes of CDFIs and seek CDFIs to place investments.
6. Your board of directors and loan committee are very important to the growth and success of your loan fund.
    a. Board: Creation of the Board of Directors is a very important step that builds the foundation for a successful loan fund.
        i. Proper balance between mission (helping improve distressed communities) and risk (lending guidelines and requirements) is maintained by board representation.
        ii. Fundraising: Fundraising is a critical need for loan funds and having representatives from entities that either funds/invests in loan funds or are in peer industries that can support loan fund activities is critical.
        iii. Management: Expertise in lending, business or law provides the necessary input and oversight of lending activities and overall success.
    b. Loan Committee: The loan committee should in many ways mirror the balance of the board of directors but have focus on management issues. The committee must have members versed in understanding of the lending guidelines and policies of the fund. Experienced lenders can typically be recruited from financial institutions that invest or lend into the fund.
7. 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 decrease the size of your loan pool and lower 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.

8. 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 who 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 are a very important activity. 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 great resources for convening meetings with financial leaders to generate interest in your fund.

Final Note:

Community development loan funds can specialize in its market and services. Microloan funds target small loans for entrepreneurs. Becoming a loan fund is not easy and requires a strong commitment from the organization and the members of the development team. With experience the natural progression is to gain CDFI certification and access its many resources. With this added capacity, organizations can become equity investors or can expand their services to the entire community by creating a credit union. 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"