Enhancing Livelihoods Through Community Development Finance

Velcro Arms, Teflon Heart

This paper was written for the Ford Foundation's Affinity Group on Development Finance to help stimulate discussion and debate among its program officers working in that field. Its authors were once, but are no longer, employees of the Foundation and they take full responsibility for its content. The authors of this paper each have over 25 years experience in community development finance. In this paper, they reflect on this experience and the lessons they have learned, and make some recommendations for the field. Four central lessons are discussed at length in this paper:

- We initially underestimated how difficult community development finance work would be, and we have not devoted sufficient attention to strengthening the number and capacity of community development finance institutions.

- We've learned the hard way the importance of commercial finance skills, as well as business-style discipline and efficiency.

- Markets work better than we thought, capital gaps are less deep and wide than initially expected.

- We should not be shy about the need for subsidy; at root our mission is social in nature and requires public subsidy in order to achieve social benefit.

These views may be controversial. However, surfacing and debate of controversial ideas is crucial to the growth and development of this work. This paper is offered in the spirit of promoting excellence of practice in this important field and helping it become ever more effective in achieving its primary objective: the alleviation of poverty.

TOUCHSTONE FINANCIAL GROUP

A Paper About Scale, Scope and Impact

Commissioned by the Affinity Group on Development Finance of The Ford Foundation

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I. Background

Like it or not, money is important. It allows us to easily exchange the product of our labor for things we are not able to produce. We can save for rainy days and borrow when our need for money exceeds our current liquidity. And money permits our collective investment in the activities of others, fueling accumulated capital pools larger than one person alone might assemble and sending a flow of money around the world searching for its best use and highest return.

To organize one's financial life, to build a more stable platform upon which to enhance livelihood, one must smooth out the peaks and valleys of life — or at least their financial consequences. Most big events, problems and opportunities alike, do not present themselves in easy monthly installments and often arrive without warning: medical crisis, death, birth, marriage, business investment or reversal, school fees or natural disaster. Such events are challenging enough to manage without the added complication of financial turmoil that often accompanies them. Aside from the kindness of family and friends, there are only two ways to handle lump financial consequences: dip into accumulated wealth; or borrow. Financial institutions and instruments are built to serve this fundamental individual and community need.

But commercial finance is often not available to poor and marginalized people and communities. This is a question of skills and understanding of low-income people as well as attitudes of financial institutions. Therefore, the practice of community development finance disseminates money, money management skills, attitudes, tools and institutions among that portion of the world's population that does not have them in sufficient measure.

Community development finance is a relatively recent term and has its roots in poverty alleviation activities that began in the 1960's in the United States and the 1970's in developing countries. Today, thousands of organizations throughout the world and well over one hundred Ford Foundation grantees can be called "community development finance institutions" (CDFIs). Such grantees are found in most every place the Foundation works. To name just a few: Self-Help (North Carolina); ShoreBank (based in Chicago and with affiliates in a number of other states); Coastal Enterprises (Portland); First Nations (working on many Indian reservations); Enterprise Corporation of the Delta (Mississippi Delta); Grameen Bank (Bangladesh); Bina Swadaya (Indonesia); Accion International (South America and several states in the United States); Alternativas (Mexico); the Kenya Rural Enterprise Programme; BASIX and SEWA in India; FADU (Nigeria); Women's World Banking (in New York, with affiliates around the world); and, the Low Income Housing Fund (United States).
In the last 25 years, community development finance (CDF) has helped community development activities to move away from viewing enterprise and capital markets suspiciously, as threatening to the goals of social change. CDFs have become mature financial institutions and have mastered the intricacies of sophisticated finance. CDFs now commonly speak of risk weighted capital adequacy, intermediation, secondary and tertiary capital markets and transaction costs. Citibank would be - and is - comfortable in these discussions. We now engage eagerly, and to mutual benefit, with commercial capital institutions, welcome them to the table, actively seek partnerships and use their tools and techniques. We have found the power of commercial finance and learned how to use it for social change.

This power derives from the CDF field's ability to combine commercial enterprise with social action. For example, as a regulated commercial bank, Shorebank in Chicago began with a dual commitment: to pursue community development; and to achieve strong financial performance that would compete well with purely commercial banks. ACCION has securitized microcredit loans and sold them in international markets, expanding the capital available to dozens of microfinance groups in South America. Self Help, based in North Carolina, is pursuing an aggressive plan to sell mortgages on the secondary market, opening up large capital flows to the advantage of low income families. BancoSol created a regulated commercial bank to take microfinance work to scale in Bolivia, and KREP is about to do the same in Kenya. MACED in Appalachian Kentucky formed a consortium of commercial banks to broaden their access to commercial secondary markets for home loans, reducing interest rates and lengthening repayment terms for their borrowers. The very number and dynamism of community development finance institutions throughout the world show we have learned how to do this.

But what exactly do we mean by "community development finance," why is it important, what has been done about it, and what do we not yet know?

II. What Is Community Development Finance?

Interest in community development finance began in the mid-1960s with the recognition that capital is a critical resource for poor people and poor neighborhoods, and that access to capital through traditional financial institutions was unequal. We believed capital access was denied for reasons embedded in racism and discrimination against the poor, especially women.

A clear case in point was the overtly discriminatory underwriting and appraisal practices of the Federal Housing Administration's (FHA) home mortgage program prior to 1950. Similar practices existed in lending by commercial banks (and some believe still do), but the FHA was distinguished by the transparency of its discriminatory policies and by its capacity to deliver
Community development finance is not the same as financing development. Rather, it denotes one way of financing development with four distinguishing characteristics:

- It focuses on increasing incomes and building assets to improve livelihoods for people in the lower half of a society's income distribution;
- It puts financial tools directly into the hands of individuals or communities who would not otherwise have such access;
- It uses commercial financial instruments, charges commercial rates and fees, and builds bridges to commercial markets;
- And, by using commercial instruments and techniques, CDF can cover a large portion of operating costs through interest, fees and other payments from customers.

Wealth to a vast number of Americans simply by making homeownership a realistic option. Unfortunately, the benefits of this wealth generation were largely limited to white Americans. Thus, in the formative years of the community development finance field, we focused on creating access to capital on favorable terms as a key lever to unlock the potential of female, poor and minority entrepreneurs and to revitalize neighborhoods.

Today, practitioners identify the goals of the field somewhat differently: The goal is to mobilize the investment of market capital to create income and wealth for the poor through job creation and homeownership. This does not mean 'recycling soft money' or creating parallel banking institutions. Rather, the goal is to attract market capital to our mission.

"But there is a second and equally important goal: we must deliver a message to poor kids and poor communities that there is hope, that there is a sense of possibility. We must reverse the message that these people and neighborhoods are dead ends."

There are two major categories of community development finance: strategies that work with communities to build public assets and those that finance individuals to build private assets. The former often works with nonprofit groups or governmental agencies, and includes loans for community and day care centers, rental housing or infrastructure such as water systems. And while many of the following observations can apply to building public assets, we have chosen, in this paper, to concentrate on strategies for individuals.

III. Four Community Development Finance Strategies

Community development finance institutions targeting individuals often engage in a broad array of social change activities, and their emphases differ depending on local context. However, four financial strategies are predominant:

- Microcredit.
- Savings.
- Small business finance.
- Land and housing loans.
A. Microcredit

From a global perspective, by far the most prominent CDF tool is very small loans to small informal enterprises. These short-term loans are usually repaid within one year in equal weekly installments. They most often use the solidarity group “borrower knows best” technique where a small group of peers “underwrite” loans and see to repayment with very little, if any, business assessment from the lender. This strategy was first achieved to wide notice by the Grameen Bank, but also by a privately owned commercial bank in Indonesia, Bank Dagang Bali, which began earlier than Grameen and does not use the solidarity group approach. Now, hundreds of CDFIs (mostly non-governmental organizations, or NGOs) lend to millions of people throughout the world. They routinely show repayment rates between 96 to 98 percent and charge interest rates sufficient to cover loan losses and the costs of lending. Some have reached levels of efficiency where interest and other charges cover all operating costs (except experimentation with new products) and a few are reportedly able to maintain their capital pools constant with inflation.

In recent years microcredit providers have become less directive about how borrowers use these small loans. Originally “restricted” for use in starting or expanding microenterprises, some CDFIs now allow loans to be used for housing or consumption purposes. This trend acknowledges that money is fungible within households and it is not possible for microcredit providers to effectively restrict the use of proceeds. But more importantly, it recognizes that the bigger purpose served by microcredit is to provide credit per se. Whether for business or other purposes, people benefit greatly from quick access to credit on predictable and appropriate terms.

B. Savings

In the developing world this second financial instrument was a valuable surprise. Microcredit programs began asking customers to save as a test of commitment and to build loan loss cushions to supplement solidarity group pressure to repay. At first, many thought a savings requirement would be onerous. Can the poor be expected to have surplus cash?

Yes. In fact, it turns out that the poor in the developing world are hungry for savings opportunities. Often, however, these customers and their small deposits are not welcomed by commercial banks. And minimum account balance requirements, low interest rates, bank fees, the cost of transport to and from the bank, and time away from the business all combine to make this an uneconomic activity for the small saver. So, with programs that went to the people (often on bicycles), microcredit lenders discovered borrowers and their neighbors were enthusiastic savers, depositing much more than the minimum required for credit eligibility.

As an important added benefit, the savings tool improved the prospects for growth in microcredit programs by providing a possible permanent source of private capital and income through arbitrage on customers’ accounts. This highlights one of the unique characteristics of community development
finance: programmatic and financial goals often can be served by the same
activities and without serious conflict. The growth in savings gave microcredit programs a new name: microfinance. This is more than semantics. As obvious as it seems in hindsight, we learned that savings is the mirror image of credit and is just as central to improving livelihoods. And this led us to see our work in a new way, as not so much about offering products that people needed as about how they organize their financial lives.

C. Small Business Finance

The third financial instrument of community development finance is
investment of debt and equity in small and medium size formal sector
businesses. Most entrepreneurs receiving such investments are not poor.
CDFIs make such investments because they create an asset valued highly by
the poor: a job. Most people do not want to be entrepreneurs, large or small.
Most want a job. Ranging from several thousand to more than a million
dollars and waiting ten years or longer for repayment, these investments look
very much like those in the commercial sphere. But their risk is much greater
and they are made with a clear social purpose: to stimulate economic growth
and diversification and create new job opportunities in areas of economic
stagnation and high unemployment, or to stimulate ownership of businesses by
minorities. Small business finance usually seeks "multiplier effects" in which an
entire local economy grows and diversifies as a result of the "jump start"
delivered by CDF. Among CDF strategies this is the most explicitly targeted
activity to improve a poorly performing economy.

These loans and investments address the economic ingredient most economists
name as the "shortest resource" - entrepreneurship. A chronically depressed
economy results not from a shortage of any single factor of production (land,
capital and labor) but from a shortage of the entrepreneurial talent that combines
those factors in new ways to build vibrant and resilient new enterprises. This
thinking has been taken one step further to say that economic development
should not be measured by job creation, but by venture formation (not failure)
rates and the degree of economic diversification in a local economy.

Much of the early and theoretical work on entrepreneurship and small business as an economic development strategy
was done in India and other developing countries, and
many governments in developed and developing countries
have provided direct loans to businesses or required banks
to do so. But the United States is where most small business finance
experience resides - or at least is most visible to the authors of this paper. In
the US, small business investment includes three lines of work: relatively
passive lending; development venture capital; and nonfinancial services (often
used in combination with finance.)

During the 1960's in the United States, the Small Business Administration pio-
neered passive lending in high volume. It was then taken up by a number of
federal agencies, either directly or through grants to nonprofit or quasi-govern-

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mental intermediaries, and still represents the vast majority of small business finance dollars and programs. Recent estimates indicate some $5 billion was placed in small business loan funds, and thousands of such funds can be found throughout the country.

Development venture capital was first practiced in the “black capitalism” strategies launched in the 1960’s. Then in the early 1970’s it was used to address poverty reduction goals in low-income communities, and was widely adopted by community development corporations. Over the years, many urban CDCs abandoned the strategy but many rural CDCs have expanded their use of it. Today there are perhaps only several dozen CDFIs concentrating on development venture capital, but interest seems to be growing in the U.S. and throughout the world. CDFIs are attracted by the belief that such investments can spur entrepreneurship and economic growth as well as target more jobs to low-income people.

Because of these social benefits, passive lending and venture capital techniques accept below market investment returns caused by the low volume and poor quality of deal flow, more intensive monitoring and assistance, and constrained exit (or cashing-out) opportunities. Some development venture capitalists maintain that commercial returns can be achieved, but none have yet done so. But enough experience can be found to show that with sufficient and appropriate capitalization, development venture capital funds can at least cover their costs (including investment losses) while generating significant social returns in the form of new venture formation, job creation and economic diversification.

The more passive small business lending strategies may also be able to cover a large portion of costs, but many of them offer highly subsidized terms to borrowers.

While we have significant experience with provision of non-financial services to small businesses, very little has been documented or evaluated. In the 1960’s and 1970’s such services were typically concentrated in training activities, but many practitioners stopped doing this when their high costs and uncertain benefits became clear. (Many governments still offer a variety of training programs.) In the past decade, several notable innovations have appeared. One is called sectoral “intervention” in which a CDF practitioner selects a strategically important industry sector and works over the long-term to improve its growth as well as the extent to which low-income people have access to the opportunities within it. Activities include research and advocacy, but also frequently involve direct assistance and targeted investments in key enterprises.

Related to the sectoral strategy is the “flexible network” activities that first became popular in northern Italy. A CDFI works with enterprises within a certain sector, but also seeks to build strong business connections between those enterprises. The idea is that some production or market opportunities are too large for any one business, but not for a network of collaborating firms. Such collaborations also provide benefits by speeding information flows between the businesses about production techniques and markets.
Yet another extension of this small business strategy is business incubators. Initially premised on the idea that businesses could reduce costs (by sharing rent, reception areas and other support services) if they clustered together in the same building, CDFIs quickly found that it was also a more efficient way to provide management assistance and that the entrepreneurs tended to help each other as well. More recently, some CDFI incubators have found that the most power resides in combining the flexible network and incubator strategies. For example, ACENet in Athens, Ohio, built a “certified” kitchen (a costly undertaking) used by a number of small businesses to produce food products. In part because of their close association through use of that kitchen, the businesses are sharing product ideas and market opportunities. Again, CDFIs often use investment tools alongside networking.

D. Land and Housing Loans

Not only does owning land or a home bring clear quality of life benefits to a family, it is a principal source of wealth accumulation even in very poor countries. Some microfinance groups make housing loans, usually offered to long-time customers of their regular microfinance programs. Aside from the benefits to borrowers, these larger and longer term (up to ten years) loans improve the financial performance of lenders by reducing transaction costs. (This is another example of how the program and financial goals of CDFI lenders can be complementary.)

In developing countries, housing ownership presents an added benefit: income. Especially in fast growing urban areas, low-cost housing is often in very short supply and many low-income people rent rooms to others. Of course, many high-income absentee landlords do this as well, but room rental by low-income people does not present the same worries carried by “slumlords.” While slim and anecdotal, some evidence exists that the economies of room rental are quite favorable. For example, in Nairobi it seems that the cost of adding a room onto an existing house (whether stone, block, or mud and wattle), or putting up a new house all together, can be recovered within five years or less.

In the United States, much community development finance work has been to promote rental housing development, reflecting the government’s subsidization role in this market. This activity has two goals: to improve the physical infrastructure of disadvantaged communities, creating a more conducive climate for investment and growth; and, to reduce the housing burden which the poor face. Recently, however, increasing attention has been focused on promoting homeownership opportunities for poor households. Experimentation is underway with low down payment mortgage loans, which deepen the reach of homeownership opportunities to lower income families. Self Help in North Carolina, the Federation of Appalachian Housing Enterprises, the Enterprise Foundation, and affiliates of the Neighborhood Reinvestment Corporation offer examples of such work.

Over the past three decades, use of these four instruments — microcredit, savings, small business investing and land and housing loans — has taught us some important lessons.
IV. What Have We Learned?

Reflecting on our 25 years of work in community development finance we found four big lessons.

A. Our Teflon Heart

While the motivations for community development finance reside in the heart and our Velcro arms reach out to the poor and marginalized, these feelings must not apply to our methods. We have learned the hard way that underwriting, monitoring and intervention (in the case of nonperformance by an investee) must be just as tough as for purely commercial investments. CDF activities must be serious about repayment. They must establish peer pressure systems, take collateral, repossess assets, and go to court. People learn very quickly if a lending or investment program is “for real” or merely free money in a new package. We have also learned that NGOs are better able than either commercial or governmental groups to use both Velcro (welcoming the poor and marginalized) and Teflon (applying seemingly cold hearted commercial practices). In this field, that ability is fundamental.

B. The Invisible Hand Works Better Than We Thought

Early in the work of development finance we assumed that lenders and investors were missing profitable opportunities. We believed there were deep and persistent capital gaps: markets where – out of ignorance or bias – commercial financiers failed to recognize real market opportunities. So, we set out to demonstrate successful market based strategies, expecting that commercial financiers would awaken and begin serving these markets. Rather than establishing parallel institutions with a special purpose, we intended mainly to change commercial financial practices. But, we have learned something about capital markets: they don’t fail as often as we thought. Most CDFIs now consider their activities to be needed permanently. While affecting pricelies of commercial finance is still our goal, it is rarely our first priority.

Deal flow has been much more sparse, the need for training and technical, management and marketing assistance much greater, and loss/delinquency rates much higher than originally expected. Simply making capital available does not work in and of itself. The problem is much more the insufficient readiness of marginalized people and communities to use capital or the high cost of getting it to them.

This conclusion that CDF is building permanent institutions working parallel to commercial finance plays somewhat differently within the four chief CDF tools.
Microfinance

In developing countries, microfinance has generated very large volumes and good performance of CDFIs, but their performance still is not up to commercial standards. Even in the few cases where NGOs have created commercial banks to take over this work, the portfolios transferred to those banks were created with heavy subsidy. The cost of reaching microentrepreneurs is too high to generate the returns needed by commercial lenders. The one exception seems to be Bank Dagang Bali. While this raises powerful questions, it remains conspicuous by its lack of company around the world.

But even more telling is the concern that microenterprises are not growing as much as we originally hoped, with very few (probably less than one-tenth of one percent) graduating to a size where they can be financed commercially. What does this mean? Can’t one assume that a high repayment rate means that borrowers are doing well with their microloans and that, therefore, capital market failure really was the problem? No, or at least not as much as we thought.

One of the labels applied to microcredit programs is “borrower knows best.” This signifies that the lender applies little if any assessment or assistance to the enterprise or individual asking for a loan. This works well and is crucial to keeping transaction costs low. But we are now learning that the reason repayment rates remain high is not primarily because borrower’s businesses are succeeding. Repayment is driven by peer pressure, but even more by the desire to remain in the system - to preserve access to borrowing and savings opportunities. Further, with the very small size of these enterprises and their limited overhead costs, fixed assets or significant raw material inventories, repayment can be achieved even when the enterprise fails. The cost of liquidation is near zero. In fact, “fail” means something entirely different in this context. It really means that the entrepreneur discovers the business is not sufficiently profitable to be worth his or her time, or similarly, that another enterprise is found which looks to offer better returns.

This lesson raises the uncomfortable question of how are the borrowers really doing? If they don’t already “know best” then what should we be doing to improve their ability to start and expand their enterprises?

The category of activities that responds to this question is called non-financial services, and includes training, marketing and accounting assistance, technology transfer, and provision of business sites, all usually provided at below cost. But after thirty years of discouraging results (costs were high and impact hard to see), it is not at all clear how to provide these services. The borrower-knows-best approach was welcomed in no small part because it allowed us to avoid solving the high cost/questionable “return” problem of non-financial services. But it now looks like market failure is not the principal issue and passive provision of capital will not take us as far as we want to go.

This point is more sharply drawn in the United States. Microfinance CDFIs are finding that the demand for technical assistance is far greater than the demand for capital. The Self Employment Learning Project reports that fully two thirds
of microenterprise clients came to the program requesting technical assistance in running their businesses, while only one third came seeking capital. This results from a combination of two factors: the informal economy in the United States is small and microenterprises must withstand heavy competition from formal sector enterprises; and capital is available to many microentrepreneurs through credit cards, pawn brokers and friends and family. The low lending volume and heavy demand for management assistance has led to the conclusion that microfinance cannot stand alone but must be one window among several within a CDFI.

Small Business Finance

For small business investment (in the U.S. as well as developing countries) the problems with the capital market “failure” hypothesis show up in the extensive work needed to find and manage good deals. As noted earlier, the loan funds that passively provide capital (and often only debt) are often only priced far below market. We suspect this means that these loans are not solving a capital gap but are displacing loans that would otherwise have been made by commercial lenders. Further, loss rates have been high within these funds, indicating that borrowers needed more than just capital. For development venture capital, a CDFI must be more of an entrepreneur than a passive investor, and after 25 years we cannot find one example where this has been done at commercial rates of return.

Like microfinance, development venture capital seems to be a case where specialized noncommercial institutions are needed because returns are not sufficient to pull commercial institutions into this work.

Land and Housing Loans

For land and housing, the blockage is more related to the failure of governments to remove discriminatory practices from land allocation and tenure policies and mortgage lending. Discrimination based on gender or ethnicity is clearly a case of market failure, but it is not clear whether the most effective response is a CDF strategy. On the one hand Self-Help has made impressive in-roads with its mortgage lending strategies to minorities and in working with banks to improve their practices. On the other hand, perhaps the most powerful impact on “redlining” came as a result of the advocacy strategy that led to the Community Reinvestment Act.

To be sure, market failure is the problem in other cases as well. For example, in Appalachian Kentucky bankers were not able to use secondary markets and therefore offered housing loans only on very restrictive terms. MACED developed a program that demonstrated the use of secondary markets and made a large difference in their lending practices.

In Chicago, Shorebank showed that there were true gaps in mortgage lending for single family home ownership and lending to small businesses to buy and renovate distressed properties. Shorebank proved this was commercially profitable, and now (after 15 years) other lenders are competing in its market. However, Shorebank’s early expectations that banks would respond to the
general proposition of banking in poor communities and neighborhoods has proven elusive.

Yet, market failure is much less a part of the problem than we first thought. Much more prevalent are situations where CDF returns are far below commercial levels and where, therefore, parallel institutions are needed. This builds directly on our third big lesson.

C. Community development finance does not offer commercial returns

Especially in the last decade, one increasingly hears claims that at least some part of community development finance can achieve market rate returns. This is perilous because it is both true and not true. The true part is that some activities can, in fact, be profitable. The untrue part is that this is a meaningless statement. That a small part of a bundle can be sold at a profit does not mean the entire bundle is profitable.14

Our argument against the profit potential of community development finance is based on the fact that we have yet to see a community development finance bundle that is profitable at commercial levels. Shorebank has managed to achieve operating results that compare well with its commercial counterparts, but the commercial bank portion of its bundle is integrally complemented by other, noncommercial parts of its bundle. BancoSol is profitable, and KREP’s bank will likely be, but both of these benefited enormously from their inheritance of a large working portfolio of loans and savings developed with significant subsidy from their nonprofit founders. Some community development venture capital funds are promising to achieve market returns, but have yet to do so. While the Kentucky Highlands Investment Corporation, one of the pioneers of development venture capital, has a net worth that exceeds the total amount of grants it has received, its overall return is still far below commercial levels.

Unquestionably, community development finance institutions should continue to emphasize their practice of maximizing income while maintaining the priority of their social goals, as well as their search for new ways to use the high performing portion of their portfolios to tap commercial capital markets. That is where the money is (including savings of low-income customers) and it brings necessary discipline to the work. But let us not go too far and expect the entire bundle of community development finance to be fueled by private sector capital and the returns it demands.

The CDF field is a continuum or spectrum. At one end are those activities where commercial rates of return are possible without sacrificing social return (market failure) and at the other end are those activities where significant subsidy will always be needed (parallel institutions or markets.) And here is the big rub: it is in the most difficult places, with people who face the greatest obstacles, where commercial markets are least likely to reach and where CDF most squarely lands in the subsidy end of the
spectrum. We risk losing sight of our mission if we believe that CDF strategies must eventually pay for themselves and shed subsidy. This would drive the field from its mission.

It would be wonderful to be proven wrong on this point, but we doubt it will happen and suggest that we do not try. We take undue risks if we run to the extreme of maintaining that community development finance can earn commercial rates of return: either investors will be disappointed and sour on community development finance; or community development finance will move away from targeting the poor as its main customer base in order to deliver on its financial promises to investors.

D. We haven’t fully priced for risk and cost; we haven’t created a financial system

Efficient credit systems are organized with the following six key characteristics: origination, underwriting, funding, servicing, credit support and liquidity. In the past, all of these functions were performed by a single organization – usually a bank – and were most often localized. However, as commercial credit systems have matured, expanded and become more efficient, different functions are now performed by different institutions. Each takes the piece of the bundle best suited to its abilities and risk/return targets, and the players trade services with one another. Together, these relationships form a credit system which handles high volumes, achieves high levels of efficiency and allows the tapping of a large variety of capital sources. They maximize access to capital and minimize its cost.

Perhaps the most important feature of the modern system is asset backed securities. Backed by all kinds of debt – mortgages, credit card debt, automobile loans – these securities spread risk across a large number of loans. They are then sold in large unit sizes to private investors. Through this securitization process, two important goals are achieved:

- The credit system can expand its marketplace to make riskier loans (for example, personal loans through credit cards).

- The system generates liquidity by selling these securities, which allows the originator to re-lend, multiplying its volume with the same capital base.

In fact, the private system is so efficient that even risky credit card debt, which carries loss rates far higher than a bank would normally accept, can be securitized and sold on the private market. The originating debt is priced to cover its risk, generally at high interest rates of 15% or more; the risk is spread across a large number of loans, and investor confidence is stoked by the combination of volume and reliable data on risk and return experience.

In the world of community development finance, however, we have yet to
create a system of credit. Community development lending tends to be characterized by low volumes, with large numbers of risky loans, organized in a highly fragmented, usually local fashion. There are few uniform standards of underwriting in the field, little data on risk and return, and no significant outlets to increase liquidity, enhance volume and defray risk. We do not price our capital fully for the risk and costs associated with our work, crucial to carving out those portions that could be sold in different capital markets. With a few scarce exceptions, we have not yet learned how to do this, or we have not yet faced a "capital crunch" sufficient to demand we do it. In short, our lending remains inefficient.

One practitioner recently said, "We've focused all our attention on capital: how we raise money from the Ford Foundation, from the Federal government. But money is not the problem. There's plenty of money to finance this work. What we're really missing is a system organized to handle the risk and cost." Until efficiency is improved, until cost and risk are truly accounted for in our investing, the field will lack access to capital pools large enough to serve the full market for CDF. For example, we have learned that small businesses are relatively insensitive to the cost of capital. A recent paper makes the case that a $100,000 working capital loan could carry a nine point fee. While this seems high, the cost to the business is negligible, only increasing monthly debt service from $2,224 to $2,451. In sufficient volume such fees would fully fund a loss reserve, technical assistance and a fee to the originator, all of which would then allow the loan pool to be securitized so that capital is raised efficiently.

The point here is to optimize the field's performance and reduce the need for subsidy. However, we must also recognize that there is a point beyond which such optimized tools cannot go and it is necessary to go there to achieve our social mission, to reach the poor and poor communities. Subsidy is a necessary part of achieving our mission. Nevertheless, we believe it is possible to do more to improve our practice, reduce the need for subsidy and expand our reach.

E. In Summary

CDF is much more difficult than we thought. Deals are not out there just waiting for a capital pool to be set up. Whether for real estate, development venture capital or microfinance – placing and recovering capital in low-income communities requires very high levels of skills, discipline, internal management systems, and "development services" to find the deals, put them together and help them succeed. These costs will not be entirely recovered, but the field can do more to price its products to reflect these necessarily high transaction costs. Loans that need such work will never be made by commercial financial institutions. That is the margin in which CDFs work and the reason why they are not temporary institutions demonstrating market failure, but a set of permanent institutions parallel to commercial capital markets.
V. Recommendations for the Field

This section of the paper is divided into the three categories of its subtitle: scale, scope and impact, in reverse order.

A. Assess Impact

This first recommendation builds on our conclusion that CDF strategies can not be commercially profitable. If financial returns are not sufficient to justify CDF and attract private capital, then we must also measure social returns. We recommend the field aggressively tackle the question of measuring impact.

Strategies, products, and techniques evolve from experience, but only if there is good knowledge about costs and impact. We are quick to note that the Self Employment Learning Project (SELP) is well along in the assessment process for microenterprise programs in the United States. The knowledge generated through SELP has accelerated the evolution and maturation of microfinance practice here, and those involved also point out the role that funders played in stimulating the need for assessment. A somewhat skeptical donor audience created a “need to know” climate, which encouraged reflection among practitioners. Funders play a vital role in encouraging self-questioning, knowledge building, and change.

Also, several microfinance groups have done some impact assessment and USAID and other international donors have such studies in their files or are now planning them. But so far this is largely ad hoc. Systematic assessment is difficult to find. What does exist is more oriented to specific donor decisions about funding than toward wide learning in the field.

A fter more than a quarter century of CDF we don’t yet have enough objective information on impacts. So far, we have focused on output measures such as loans made, repayment rates, and sustainability ratios. Perhaps the very nature of development finance and its ability to yield attractive (if not commercial) output numbers, has pushed us away from a focus on impact. While output and process measures are necessary, they are by no means sufficient. For example, can one assume that a high repayment rate means that borrowers are doing well? No. As noted earlier, repayment is driven by peer pressure, but even more by the desire to remain in the system. If we do not assess impact we run the danger of accepting positive output measures as indicators of success, when there is a far more important story to be told. Further, a focus on outputs risks skewing the field away from its fundamental mission. You get what you measure, and so far we have not been measuring the most important part of our work.

What difference would this make? It would give CDF practitioners the information they need to understand if process measures and other “impact proxies” are showing the full picture, and then to challenge assumptions, stimulate new
thinking and help the field evolve to serve impact as well as efficiency goals. And we must be willing and able over the long term to gather the subsidy that is needed for CDF to work at the most difficult end of the spectrum: with the poor and marginalized. If we do not gather sufficient subsidy, those people will be left out once again. To gather and maintain that subsidy, we must be able to make the social impact case. Not only must we reach optimum levels of efficiency and sustainability, but we must also compute and communicate the social return. This is our biggest challenge—but it is also our biggest opportunity. CDF is well suited to be one of the only fields to address both commercial standards and public policy standards.

While it may be driven by funders, assessment must be first and foremost beneficial to the ones being assessed. If tailored to practitioner utility, it could yield:

- Collaborative evolution—helping practitioners learn about the true costs and impacts of their work.

- Organized access to public and private capital markets; and, 

- Help in making the subsidy argument.

We have also taken this opportunity to catalogue a few of our favorite questions—particularly in the developing country microcredit field—which could be addressed in an effort to undertake impact assessment.

- What do we know about how often in developing countries microentrepreneurs take kids out of school to help with the business, especially when it is expanding?

- While most microfinance customers are women, what do we know about who really controls assets and income for women’s businesses? Does the presence of more assets and income in the household lead to more equitable decision making in the home? And what is wrong with men? Why don’t they make good borrowers?

- What is the effect of specially formed borrowing groups on other community organizing activities? To what extent do they displace traditional groupings which may have been more inclusive and also focused on a broader range of community issues?

- There is a growing consensus that microfinance groups mostly are reaching economically active people in densely populated areas. Is this true? What will it take to reach deeper and farther? Does village banking have promise here?

- We are seeing only limited growth and expansion of microenterprises. And the "displacement question" has not yet been answered: If 100 women expand their businesses selling vegetables, has the informal market for vegetables expanded as well or do their new sales come at the expense of women already in the business?

- For development venture capital, who is getting the jobs and can we yet discern any "ripple effects" in jump starting stagnant local economies?
ELP is one model for a peer assessment and learning system. It is helping the microfinance field in the U.S. to evolve, adapt and consider new ways of organizing itself so that it can become more successful. This type of assessment could expand to developing countries and to other sectors within the field, such as the Community Development Venture Capital Alliance. There are other ways to approach this: the National Community Capital Association, the Manpower Development and Research Corporation, the Aspen Institute and others all provide models within our field. Some are capital driven, some are learning driven. Some are trade associations and others are like secondary markets. Whatever vehicles are chosen, by soliciting interest in and finding assessment activities the major donors to CDF will send a clear message that measuring impact is important. But what will create the incentives within donors to demand such assessment?

The first step is to help the field create its own self-assessment mechanisms. The big advantage to self-assessment is that it creates a relatively safe environment and one in which peers are asking themselves and each other the tough, but constructive, questions. By definition, learning involves surprise and pain, and a safe place is crucial. Also, the people best positioned to ask the “right” questions and probe answers are practitioners themselves. A next step may be to broaden the audience for this learning. Could several donors and some of the more understanding and active commercial partners of CDFs come together to advance understanding of impacts? Could the Ford Foundation and other donors create an incentive fund to support 6 to 10 assessment initiatives, and then bring those groups together now and again to discuss process and impact lessons?

Whatever next step is chosen, the Affinity Group for Development Finance could play an important role by establishing the clear expectation within the Ford Foundation that it is time to begin impact assessment and by adopting specific plans to bring this about. Accountability can be an uncomfortable thing. Impact assessment will not come about until the sources of the money (donors) demand it. But we think we have found an open door. When the authors were interviewing a dozen or so of the most effective CDFs for this paper, we found universal agreement that it was time to address the big questions facing the field. We found our colleagues in a reflective mood and suggest we open this door all the way and walk right in.

B. Scope

The four basic instruments of CDF cited in this paper are just the beginning and many practitioners are experimenting with new tools and techniques. And the field has demonstrated a number of times that techniques or products developed in one location have considerable relevance in other places. To take advantage of these two factors the Affinity Group on Development Finance could establish within the Foundation and in collaboration with practitioners and other donors, a more explicit focus on supporting experimentation and learning and disseminating findings. We recommend that the field begin a learning collaboration and a tracking system to follow experiments and disseminate lessons learned. Also, it might bring needed visibility and
legitimacy to such experimentation if a special grant fund were established to support especially promising tests of new products and strategies. What are some of these new products now being tested or under consideration?

Agricultural Lending in the Developing World

At least in developing countries, the vast majority of people still look to agriculture as their main source of income. While some customers of community development finance institutions use their loans for farming enterprises, agricultural lending is not yet well understood and far from reaching its full potential. Agricultural enterprise carries some key differences from small scale manufacturing, services or retail. The “business cycle” tends to be longer, and an annual or even semi-annual rate of capital turnover does not fit with microcredit programs serving other types of microenterprise with their daily or weekly turnover rates. Governments and donors have devoted billions of dollars to agricultural credit schemes, and almost all have fallen to high loan losses and diversion of capital. But we believe that the CDF field has learned a number of lessons that could be applicable to agriculture lending.

Home Ownership Lending in the Developing World

A few community development finance institutions have begun (mostly in the past decade) to offer an explicit housing loan product, but real estate lending is usually for only the best customers and is not widespread. Again, such lending has marked differences from that for microenterprises: they are larger loans that require much longer repayment periods. But unlike enterprise loans, real estate has value beyond the abilities and actions of the borrower. Certainly it is costly for a lender to take possession of the real estate that collateralizes a loan, but it can be done and there is no obvious reason why the economics of this type of lending would not be quite attractive.

Not only does the purchase of a home provide for a basic human need, it creates a valuable asset of long-term utility in terms of income and wealth creation. It is cheaper in the long run and offers the likely opportunity for capital appreciation. If the poor are not able to participate in the long-term, world-wide appreciation in property values, then they are missing out on a very big economic opportunity. And in the urban centers of developing countries this argument can be extended another crucial step: low-cost rental housing is in such high demand that a slum dweller can quickly earn back the cost of adding a room.

In developing countries, a focus on housing squarely engages a community development finance institution in the intersection of human rights and economic development issues: specifically, the issue of land ownership, allocation and tenure. This intersection is a very tricky one, and the understandable reluctance of CDFIs to engage in strong advocacy work may be the major factor that has so far discouraged their large-scale entry into land and housing loans. Another factor may have been the difficulties encountered by “sites and services” schemes which were intended for low- and moderate-income people but most often benefited higher income groups. But some early experimentation with community land trusts promises to mitigate these
worries, and in any case some CDFIs are finding that many low-income people have land but do not have the capital to build or improve their home.

Insurance

Insurance allows people to join others with similar risks, and then quantify and spread those risks out into easy (or at least predictable) monthly payments. This is another way in which people organize their financial lives. Do the poor have effective access to insurance? Surely not. We suspect unequal access has much to do with attitudes and practices of commercial insurance carriers that make it difficult for the poor to purchase it, as well as limited experience with and understanding of insurance on the part of the poor themselves. This sounds very much like what is beneath microcredit and savings. In recent years, we have heard a few stories about small initiatives (often sponsored by religious institutions) to test group insurance schemes. It is time to look for experience and explore how the lessons learned in microfinance can be applied to insurance.

The Intersection Between Public and Private Assets

One possible new tool takes us on the road to “public assets.” The poor and poor communities have assets. The community foundation movement in the United States is predicated on the belief that all communities have assets but may lack the capacity to develop, manage and use them: a public park or small rural water system fallen into disrepair, or a volunteer fire department that needs a new truck, or scattered public bank accounts lying fallow. Many of these same challenges and opportunities are found in developing countries: a self-help water system that cannot bill its customers because it could not afford to purchase water meters; or, a local child development center that does not have the skills to attract and manage endowment funds raised from local businesses. Aren’t these all questions of financial organization and couldn’t community asset development benefit from the lessons learned by the CDF field in building private assets?

C. Scale

What must community development finance do to dramatically expand its scale of work, to truly cover its market? For microfinance, the portion of the field now working at the largest volumes, CDFIs are probably reaching 10 million out of a total potential customer base of some two or three billion. This is a great start, but represents only a fraction of one per cent. And it is clear that donors do not have sufficient resources to address this unmet demand, even with the entrance of the World Bank into microfinance. Small business investing and lending for housing and land are at much lower levels of output and face the same question: Where will the capital come from? This is a question of how CDFI products are priced, and of the human and institutional capacity of CDFIs.
Price Properly for Risk and Cost

Even though we maintain that CDF is not commercially profitable, it is still important that its products are priced at the highest level consistent with reaching our social goals. We must struggle to leverage as highly as possible the subsidy available to CDF, and we believe the field should consider whether it is doing so. Even with interest rates far in excess of bank prime rates, microfinance institutions in the developing world still face huge demand for their products. This implies that the price of capital is not yet a problem. In the U.S. as well, it is now generally accepted that the cost of capital is not a sensitive factor for small businesses. Yet, many small business investment activities take the risks of equity investing but not the returns. Pricing fully for risk and cost would allow the field to optimize its products and performance and maximize its access to commercial capital markets.

Build Institutional Capacity

The authors do not believe a shortage of capital is the biggest constraint facing the CDF field. We suggest that while the growth of CDFIs has been solid, especially in developing countries, the field is not seeing the formation and maturation of as many institutions as are warranted by what has been achieved. This is a very big question to which we do not yet have good answers.

Our best guess is that the emergence and development of CDFIs is complicated by several factors. First, we hark back to our recommendation that the field improve its attention to assessing and documenting impact. CDFIs will not evolve as quickly without clear feedback on performance. Further, a peer review and self-assessment mechanism should speed and deepen learning. And with impact information, the argument for subsidy will be strengthened.

Second, because of the complexity of CDF, forming a new CDFI is a daunting challenge. And once formed, a CDFI faces a long gestation period before it reaches scale and sophistication. Many of today’s leading CDFIs did not reach those levels for nearly a decade or more from their birth. Further, a new CDFI must jump start its financial management and planning far beyond that of most nonprofits, and struggle to find the expertise or funds to do so. This capability is a precondition to success.

Third, we wonder if the compensation packages offered the founders or leaders of CDFIs are sufficient. By definition, CDF work requires a high level of skill in both social action and commercial finance. One difficulty is that people with strong commercial finance experience are highly paid. Another is that the CDF field might not present a sufficiently attractive “career ladder” to convince someone in the commercial sector to take the risk of leaving it for a CDFI.

We know that CDFIs need substantial grant funding in order to test strategies, handle normal organizational development challenges and provide the equity base for debt financing that is most commonly available for CDF work. We also know that this grant funding is difficult to find, but is that a problem of availability or low effective demand? How often do the Ford Foundation, or other major funders willing to provide early stage support to a CDFI, turn down a compelling proposal because of lack of funds?
We don't think the field knows enough about the emergence, start-up, growth and development of CDFIs. Nor do we know enough about how funders can be of most assistance in that process. One way to approach this is to collaborate with a set of CDFIs to look in depth at their capacities and constraints, address them and then track progress. A number of other Ford Foundation supported institution building programs might hold lessons for such a program, among them: the National Arts Stabilization Fund; Leadership Program for Community Foundation and the Rural Development and Community Foundation Initiative; and the work of the Enterprise Foundation, LISC and local funding collaboratives to build the capacities of community development corporations.

VI. Conclusion

Community development finance is the intermediation mechanism by which capital and financial instruments reach the poor and poor communities. This is perhaps the most fundamental and concise, albeit mechanical, definition of community development finance. CDF makes available to poor people and communities those financial instruments, mechanisms and skills commonly used, and often taken for granted, by other segments of society and which are fundamental to effective organization of one's financial life. In the process of intermediation, capital is obtained from those who have a surplus of it, distributorial value is added, and the capital is then provided to those who can use it well but don't have enough of it. Intermediation pervades capital markets and has been largely responsible for their astronomical growth in recent decades. CDFIs do the same thing, but with the added challenge and benefit of intermediating in public as well as private markets.

In this paper we have discussed our views of the important lessons learned over the last 25 years in the field of community development finance:

- We initially underestimated how difficult this work would be, and therefore have perhaps not devoted sufficient attention to strengthening the number and capacity of CDFIs;

- We’ve learned the hard way the importance of skills, discipline and efficiency;

- Commercial markets work better than we thought, and capital gaps are less deep and wide than initially expected; and,

- While we can improve our pricing, at root our mission is social in nature and requires public subsidy in order to achieve social benefit.

We’ve described our opinion of ways the field can improve its outcomes. Our first suggestion is to accept the challenge of assessing progress on the
social goals that define this field: who have we helped and at what cost. We suggest that more can be done to stimulate experimentation, and to optimize the pricing of our tools so that the need for subsidy is minimized. But we also recognize that our case must be one which fundamentally compels the commitment of public or charitable resources. And finally, we wonder if CDFIs were developing as quickly as seems warranted and, if not, what does this mean?

As for any product, capital and financial instruments are of limited value if they can not be easily "purchased" from those who have them and just as easily "sold" to those who want them. CDFIs build systems that widen access by the poor and marginalized to the fundamental utility of finance. This simply, yet magnificently, allows access by the poor to the tools already available to everyone else and that are necessary to organizing one's financial life. That is what community development finance institutions have done so well, and the measure of the task before them.

FOOTNOTES

1 We first heard the phrase "organizing of financial life" from Albert Kimanthi Mtna, Managing Director of the Kenya Rural Enterprise Programme.

2 It is worth noting that in many parts of the developing world, those in the lower half of the income distribution have only in the current or recent past generation been faced with learning how to function in a monetized economy. Even some 50 year old hillbillies in Kentucky can remember when their families saw money as unusual and largely unneeded.

3 The past discriminatory practices of the FHA are described in detail in Black Wealth/White Wealth: A New Perspective on Racial Inequality by Melvin L. Oliver and Thomas M. Shapiro (Routledge, 1995).

4 This formulation is from Alan Okagaki.

5 Thanks to Vijay Mahajan for offering this crisp sentence during the meeting of the Ford Foundation's Affinity Group on Development Finance in November, 1996.

6 Throughout this paper, the term "improving livelihoods" is used in a broad way to include three of the principal economic means by which people manage and improve their lives—assets, borrowing and income—and with a focus on broadening and strengthening those means among people who possess them in limited amount. Of course, community development finance is not the only, or necessarily the best, way to improve livelihoods in any given set of circumstances. The question of when to choose community development finance techniques is left to another paper.

7 However, community development finance groups still face the danger that their own institutional strengthening goals will conflict with their programs goals. This point is discussed later in this paper.
Savings are usually deposited by NGO leaders in commercial banks because local banking regulations do not allow NGOs to hold deposits. This restriction prevents savings from being used for relending or arbitrage and is one factor motivating CDFIs to establish commercial bank affiliates to take over microfinance work.

Defining “micro” and “small” businesses is more difficult than it appears. In this paper we use “small business” to mean those that are formally structured (complying with legal and tax requirements), have or intend to have employees, and acquire and use nonliquid assets, but are not able to attract venture capital and have not issued publicly tradable stock. In other words, “small” businesses lie between microenterprises and those business that can access commercial equity markets.

There is a large body of research on the role of entrepreneurship and small business in economic development. A vibrant economy secretes enterprise opportunities and skilled entrepreneurs, and by perceiving opportunities and starting risky new enterprises those entrepreneurs are the principal engine of economic growth and resiliency. But how does one build a vibrant economy in places where few people have the experience needed to become successful entrepreneurs?

For one example, see the unpublished paper “Of These Hills,” a review of the accomplishments and lessons from Kentucky Highlands Investment Corporation, by Thomas F. Miller.

Loans are also made, especially in the United States, to develop rental housing, but that activity belongs in the “public asset” category of community development finance which is not addressed in this paper.

Interestingly, this is exactly the same motivation that helps higher income people place a high priority on meeting loan payment terms. A middle class person wants most of all to keep a clean credit history so they can get that next credit card or mortgage.

A community development finance bundle is here defined as the entire set of activities necessary for a CDFI to create effective access by the poor to the means of organizing their financial lives. These include savings and credit and investment, but also research and development and experimentation with different methods and products, special efforts to reach the very poor, advocacy, and education or training of customers concerning the intricacies of saving and borrowing as well as marketing or management.

This concept is attributable to the Loan Pricing Corporation, a national banking research firm and is cited in “Privatizing Development Credit: A Modest Plan,” by Capital Access Group, LLC of Arlington, Virginia.

This perspective is attributable to Paul Pryde of Capital Access Group, LLC.


Thanks to Rita Hilton, senior economist at the World Bank.