CDFIs: The Next Alternative Financial Institutions

by Tim Ferguson, Founder and Chairman of Next Street

Introduction

Next Street and our clients share a common goal of delivering transformative change to underserved communities across America. The desire to create that change at scale is one of the many reasons Next Street works with Community Development Financial Institutions (CDFIs). For more than 40 years, CDFIs have been some of the most impactful organizations across the country, bringing both affordable capital and other services to underserved markets and populations. Many within the CDFI industry will tell you that they are the original impact investors. These institutions have led the charge in how impact dollars reach the people and places that need it most and now they have an opportunity to be the next wave of alternative financial institutions.

I have been in the financial services sector for thirty-eight years. During that time, we have seen private equity and hedge funds grow to have trillions in assets under management and gain acceptance as a core investment asset class. We have also seen the emergence of passive/index investing which now accounts for over a quarter of all invested assets worldwide. Firms such as Vanguard and Blackrock have built multi trillion-dollar platforms in the last thirty-five years from nothing. Their leaders saw an opportunity, executed well and built significant firms as a result. The question is: will there be similar opportunities in the next thirty-five years? What are the most likely characteristics of those that will succeed? And does this represent an opportunity for the CDFIs to become the next alternative financing entities?

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The Opportunity

There is a growing segment of investors that are demanding that their capital be invested for both financial and social return. This is likely to lead to a fundamental change in the way people invest. In the last few years we have seen an explosion of money invested into ESG (Environmental, Social and Governance) products in the public markets and the launch of several large private equity impact funds such as TPG Rise and Bain Capital's Double Bottom Line. There has also been the carving-out of funds for impact investment from foundations, such as Ford, and several community foundations based on demand from their own stakeholders. It has been widely reported that this shift is being driven by the changing investment demands of millennials and women.

Over the next 30 years some $30-40 trillion of wealth is expected to be transferred from the boomers to the next generations, predominantly the millennials[i]. Public surveys conducted by the large wealth management platforms suggest that the next generation of investors wants their capital invested into "products" that have a "social conscience," i.e. both a financial and social return. This is reinforced by the recognition that inequity in our society is at its worst point in decades, with data showing that 10% of the adult population owns 88% of the world's wealth[ii], and a desire on the part of the next generation to see their capital used to transform some of our societal ills.

The impact investing market place is still nascent, although for the reasons stated above, there is positive momentum. Based on 226 impact investing organizations queried in the latest Annual Impact Investor Survey from the Global Impact Investing Network, there is at least $228[iii] billion invested for impact, which is a tiny percentage of the world's total invested assets of more than $75 trillion.

One of the barriers to growth is that there are very few intermediaries who have the capacity to deploy large amounts of capital with both financial and social returns in the private markets. In addition, the infrastructure, particularly how to screen and monitor investments for both financial and social returns and their associated risks, is still in its infancy.

This represents an opportunity for CDFIs, whose mission-orientation positions them well to become the intermediaries of choice in this market. They will, however, face competition from mainstream investment banks and wealth managers as they seek to fulfill the demand for investments with both financial return and social impact. At the same time, these more traditional firms have little experience investing in the undeserved communities that the CDFIs know so well and they are also likely to face internal inertia towards growing their efforts in such markets.

Although CDFIs have a competitive advantage, they are also likely to face competition from a new generation of Fintech companies, such as Neighborly, who are rethinking the way that place based investing is done. It is also likely that investment professionals with main stream investing experience who have "jumped the gap" to work in social enterprises may combine their expertise to create new investment management platforms that combine both financial and social returns. We have seen one or two such platforms, such as Generation Investment Management, emerge over the last fifteen years.

To succeed in building the next alternative financial institutions, here is what CDFIs will need to do:

Become Market Makers

CDFIs should view themselves as a conduit between a broad base of investors (beyond the traditional CRA banks and government) and those seeking capital in their communities. For example, community foundations are increasingly being asked by their donors to find opportunities to enable them to place larger amounts of capital that can have both a financial and social return. Today, most of the assets in Donor Advised Funds (DAFs) are invested in traditional investment vehicles, a concentration that presents an opportunity for CDFIs to provide diversity. They will need to become more transaction oriented to meet the needs of this audience. Some, such as IFF, are creating market making/capital market functions that will play this role. There is a real opportunity to connect the dots with investors like community foundations, and a successful market making function will also play this role. The ability to creatively structure transactions, akin to the capital markets desk in an investment bank, will also be a critical feature of the market making function.

Reach a New Level of Scale

To tap into the capital in the mainstream that is seeking both financial and social returns the ability to deploy at scale, even in the private markets, will be important. Investments of a few hundred thousand dollars at a time will not meet the demands of investors. This capacity will take time to develop but having investment opportunities that are in the tens of millions of dollars will be important if the industry is to become an intermediary of choice for impact investors and their advisors.

One of the reasons capital is sitting on the sidelines is the perception that there are no deals to be done. Some CDFIs are trying to find solutions to the challenge of getting to scale. Community Reinvestment Fund is building a second look lending platform known as Connect2Capital and Opportunity Fund has an innovative referral partnership with the Fintech platform Lending Club.

The successful rating by S&P of some CDFIs such as Capital Impact and Reinvestment Fund has made investment opportunities available to investors who without a rating may not be prepared to invest. This has also benefited the issuers with a more effective cost of capital. Continued access to the traditional capital markets will help CDFIs scale as mainstream Investors understand the attractive risk that these institutions represent and their ability to deliver both social and financial returns.

Establish a Financial and Social Risk Framework

Perhaps one of the biggest challenges will be to rethink the way risk and investment opportunities are assessed. Traditionally, investors have focused almost exclusively on financial return and over decades norms for both the assessment of the investment opportunity and the associated risk have developed. Social returns have not been studied so exhaustively; nor is there any one approach.

The whole area of social impact measurement is relatively new and usually not coupled with financial returns. In addition to financial capital, investors are likely to want to understand returns for other capitals. CDFIs that wish to be the intermediary of choice will need to develop alternative models for both the assessment of the opportunity and the financial and social returns as well as the management of the risk.

An example of an organization that is using this type of approach is the F.B. Heron Foundation. They are developing a framework known as Net Contribution that assesses the contribution of an individual enterprise across multiple capitals including: financial capital (enterprise sustainability/profitability), human capital (impact on employees, customers, suppliers, "people"), natural capital (impact on the environment) and civic capital (impact on society – local, national and global).

Net Contribution is a framework that can create a deeper level of understanding and shared language to integrate various forms of capital across investments and between different stakeholders. With a focus on both the positive and negative return streams that every enterprise, policy decision, or regulatory framework creates, this approach could both unlock a level of understanding that reconnects stakeholders to their purpose and enable a diverse group of investors with their own unique goals, capital sources, and constraints to invest together. Rethinking how we talk about investment returns will be necessary if traditional capital is to flow to the markets and communities CDFIs care about.

Provide Integrated Capital

CDFIs for the most part have been providers of traditional debt capital constrained by the requirements of their primary funders - the banks and the Federal Government. This is further exacerbated by a credit box that is bank-like and as a result does not meet the needs of many prospective borrowers. Demand in the communities which CDFIs serve is for a continuum of capital; by which I mean everything from patient to flexible capital. The ability to combine different types of capital should result in the needs of the market being met much more effectively. CDFIs will also need to acknowledge that "concessionary" capital alone will not suffice. Impact investors will want both a financial and social return and as the market becomes more sophisticated, they may trade/prefer one in favor of the other.

Seek New Technology and Talent

CDFIs that aspire to be the next alternative financing entities will need to harness technology to do so. Some of the platforms that are being built, such as CRF's Connect 2 Capital, are good first steps. However, there is so much that is new and there are no obvious answers. For example, how could block chain be utilized to provide access to opportunities in specific places but still allow the aggregation of assets to allow economies of scale? Building technology-based platforms is both expensive and requires talent.

Attracting and retaining outstanding talent will be a prerequisite for those CDFIs that want to be the next alternative financing entities of choice. This will necessitate thinking about not just the mission, but also the economic model and how people are remunerated. Skill gaps will need to be filled and attracting the requisite talent is unlikely to come just from those already within the CDFI industry. Thinking broadly about where people may come from and not assuming candidates need a traditional CDFI background will be important.

The opportunity is there but the question remains: Will CDFIs seize the moment?

Conclusion

CDFIs are well-positioned to be the next alternative financing entities of choice for those seeking to place their capital in investments that have both financial and social returns. CDFIs knowledge of the communities in which they operate positions them well to be the intermediary of choice. However, CDFIs will need to think more broadly about their financing capabilities and really understand what it will take to deploy capital and services at scale, which suggests that a focus on both the right talent and technology will be prerequisites for success. Determining how to get closer to self-sustaining business models will also be important if CDFIs are going seize the moment.

I am encouraged by the ambition and aspiration of some of the leading CDFIs to take advantage of the shifting demands of some investors. Although the money is moving slowly there is acknowledgment that to some extent, they need to make their own futures. That has driven some to obtain S&P ratings and to take a deep look at where and how else they can access other sources of capital.

For the banks, if they want to meet their obligations (not just CRA but those for the core business lines too) in Low- and Moderate-Income Communities (LMI) they will need to consider different risk profiles and how they might help their CDFI partners to build the necessary risk and operational infrastructure. For the foundations who have generally been smaller grantors to the CDFI industry, broadening their activities for small businesses in underserved markets in the US with grants to build infrastructure and the deployment of PRIs and MRIs would begin to make a difference.

There is almost no doubt in my mind that we are at the cusp of a significant change in the way that we think about how capital is invested and for what returns. Investors are increasingly seeking to have their assets produce both financial and social returns, as is most evident in the rise of ESG principles in the public markets. Some CDFIs are well positioned to become the alternative financing intermediaries of choice over the next decade. Like private equity firms and hedge funds over the last two decades, CDFIs have the opportunity to manage significant amounts of money that investors want to place into the communities that have been their focus for decades. The opportunity is there but the question remains as to who will succeed in making it happen.

[i] *The "Greater" Wealth Transfer: Capitalizing on the Intergenerational Shift*, page 1 (Accenture 2015) https://www.accenture.com/t20160505T020205Z__w__/us-en/_acnmedia/PDF-16/Accenture-CM-AWAMS-Wealth-Transfer-Final-June2012-Web-Version.pdf#zoom=50

[ii] *Global Wealth Report 2017*, page 11 (The Research Institute of Credit Suisse) http://publications.credit-suisse.com/tasks/render/file/index.cfm?fileid=12DFFD63-07D1-EC63-A3D5F67356880EF3

[iii] *Annual Investor Survey 2018, page 3* (Global Impact Investing Network) https://thegiin.org/assets/2018_GIIN_Annual_Impact_Investor_Survey_webfile.pdf