Social Enterprise ASSOCIATES

INITIAL SUMMARY FINDINGS:
Municipal Revolving Loan Funds

Document purpose:

This brief document outlines Social Enterprise Associate's findings from informal field research on behavior and qualities of Municipal Revolving Loan Funds (RLFs). Research was conducted via publicly available documents and interviews (phone and in-person). This is not put forth as comprehensive research, but rather a summary of common and emerging practices. While certain approaches stood out as desirable behaviors, it is important to emphasize reasonable practices also include those that work within a community to accomplish the fund's mission.

Topic areas:
1. Fund management
2. Performance incentives
3. Lending approaches
4. Training & technical assistance
5. Customer service
6. Financial self-sustainability

Sample Size	11 RLF funds
Fund Size	Range: $300 K to $14 M Median: $800 K
Fund Mgmt	2 Internal 9 External
Lending Approach	2 Direct lending focus 5 Gap lending focus 4 Both direct & gap

1. Fund management

Of the funds reviewed, overseeing and running the fund was handled in one of two ways: two of the 11 managed it within the municipal government, the other nine outsourced, usually to community development financial institutions (CDFIs), NGOs handling other non-bank lending.

External management: Most municipalities lack financial expertise in-house to adequately manage lending activities and have concerns about political influence. Challenges include adequately skilled fund managers may be lacking in smaller markets. And, fund management by firms outside the municipality raised issues including lack of local presence, reduced availability, less knowledge of local market conditions, and customer service.

> "We put out an RFP to have our loan fund managed; only one firm applied. We haven't been thrilled with their performance, but we don't have the skills to manage things in-house either."
> \- Municipality

Internal management: Those municipalities that manage their RLFs in-house might do so because the fund size is large enough to create economies of scale for hiring in-house staff. RLF's stated best practice for this approach includes:

- Hiring finance professionals and/or providing sufficient training to RLF staff
- Investing in management information systems (MIS) loan tracking software
- Organizing a loan committee consisting of local financial and small business professionals

Universal qualities: Regardless of internal or external control, there were common management best practices. Mission purpose is important: there should be documented written loan fund mission and market information. Transparency is critical, assisted by clear underwriting guidelines and loan fund advisory group of independent stakeholders with relevant expertise: bankers, small business owners, and technical assistance providers. A loan committee ideally has external membership to help with decisions. Sufficient oversight and on-going review should ensure political influence is avoided.

2. Performance incentives

Few municipal RLFs tie fund manager compensation (internal or external) to performance metrics. However, most recognize the need to do so. Performance examples include providing payment on a per-loan basis, incentive rewards for low portfolio at risk, reimbursement rather than upfront grants for technical assistance hours provided, or bonuses for "graduating" borrowers to mainstream banks.

Performance incentives should align with the fund's mission. It is important to identify helpful metrics and avoid unintended consequences. For example, remuneration based on number of loans made might incentivize lending to "bankable" businesses or to un-creditworthy individuals – increasing defaults. Bonuses for low default rates may lead to not taking enough risk – contrary to the intended purpose of most municipal RLFs.

3. Lending approach

Gap approach: Many of the managers interviewed identified their RLP using "participation" and gap lending as core practices. Five of the 11 cited only doing this and four more did them as well as direct lending. These RLF managers cited numerous benefits:

- Resources and impact are increased when the RLF develops working relationships with the range of financial providers in the community: Banks, CDFI's, SBA, foundations, etc.
- Working with financial institutions increases a small RLF's ability to provide solutions
- RLFs can be valuable to local banks by helping to bring a loan within "bankable limits"
- Depending on the nature of the bank partnership, RLFs may benefit from banks' due diligence, origination and/or servicing, reducing RLF staff time invested per loan.

> "It is an especially good idea for small funds to get outside capital involved because it reduces operating costs and increases fund impact at the same time."
>
> \- External management company

Community-focused approach: Some RLF managers stressed the importance of understanding the local community and designing financial solutions that fit their needs. This covers lending services less likely to be offered by existing financial institutions. Examples include Shari'a (Muslim)-compliant funding and lending to a specific industry requiring specialized knowledge. These activities should be focused according to a well documented mission and integrated within a wider strategy (i.e. a city's strategic plan or departmental initiative).

4. Training & technical assistance

Value of training & technical assistance (TA): Auxiliary services to lending, including training and technical assistance, were considered overwhelmingly to be necessary complements to a loan fund. Although cost centers, they were seen as increasing the chances of business success and reducing default rates. Classes in particular as well as one-on-one assistance were seen as 'priming the pump', activating demand for the RLF and contributing to business success. Hard data on this fact compared with the cost would be interesting. Services, like increase financial literacy, were cited as important precursors in supporting local small businesses. TA helps with visiting clients both before and after lending.

Service provider quality is key: Interviewees stressed only skilled service providers added value. They must be tapped into local business needs and have bank relationships. Some TA providers used by the RLFs or offering free services in the communities were seen as “out of touch” with business realities and not viewed favorably by bankers.

5. Customer service

Local knowledge is essential: RLF managers and bankers noted the importance of having a local presence tapped into business need and banking relationships. This includes preference for regular office hours rather over “by appointment only” schedule, and approaches actively engaging across public and private sectors.

Hassle-free processes for business-owners: Some RLFs, particularly those engaged in participatory lending, work hard to reduce the number of steps a small business must take to get RLF financing. The ideal for at least one manager interviewed is all RLF application materials are congruent for standard bank loan. And, superfluous bureaucratic ‘hoops’ are minimized.

6. Financial self-sufficiency

Fund self sufficiency was a recurrent theme cited as important for interviewees. Details included:

Sufficient size a challenge:

- Difficult for small funds to be operationally self-sustaining (especially <$1 M) they don’t generate enough revenue to cover costs
- Smaller funds rely on grants, renewing community block grant money to cover operations

Winding down an RLF: when an option?
Interviews touched on reasonable conditions for winding down RLFs that are not financially self-sufficient when funding is in doubt. While every situation is different, common themes emerged:

- Presence of other small business lenders serving the market
- If there are other uses for that capital that will generate higher mission oriented impact
- RLF too small to cover its costs are also likely to have too small an impact with its loans
- Starting and then ending an under-capitalized program may do more dis-service
- Low expertise to manage the fund, may turn a good idea into bad practice

In a wind-down scenario, municipalities can re-orient efforts to complement local lending, such as connecting lenders to businesses; and ensuring technical assistance reflects local business and banking needs. A loan guarantee pool is also an alternate use of RLF cash.

About the firm

Social Enterprise Associates (www.socialenterprise.NET) is a US consulting firm specializing in applying business principles to community efforts. Its management team has decades of experience in for-profit and non-profit organizations, developing strategy, raising capital, implementing new programs, and marketing core concepts.