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INDIAN COUNTRY
DEVELOPMENT

FEDERAL RESERVE BANK of MINNEAPOLIS

CULTIVATING NATIVE ECONOMIES IN THE 21ST CENTURY

Native CDFIs

JULY 11, 2023

Native CDFIs: Lending Insights, Best Practices, and Policy Levers

Valentina Dimitrova-Grajzl
Peter Grajzl
Joseph Guse
Michou Kokodoko
Laurel Wheeler

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The views expressed here are the presenter’s and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.

Outline

1. **Overview**
2. Industry Insights
3. Native CDFI Practices: Assessing Client Risk
4. Native CDFI Practices: Client Counseling
5. Policy Levers

Native CDFIs Help Fill the Credit Supply Gap

- Credit is necessary for pursuing economic opportunity and enhancing financial security

- Native communities have been underserved by mainstream financial institutions (Listokin et al., 2017; Jorgensen, 2016)

- Approximately 16% of AIAN households have no account with a bank/credit union (FDIC, 2020)

- Native Community Development Financial Institutions (CDFIs) help fill the credit gap in Indian Country (Kokodoko, 2015)

Native CDFIs in Indian Country

- Increasingly important source of credit and financial services
- Serve “low- to moderate-income communities and other distressed markets that are not fully served by traditional financial institutions” (Kokodoko, 2015)
- Currently 65 certified Native CDFIs
- Native CDFIs predominantly serve AIANNH borrowers
- Have a social and educational mission
- Design services with culture and relationships in mind

Overview of our Research Agenda

- We are pursuing a research agenda that seeks to better understand the operations of Native CDFIs
- Documenting lending operations
- Studying how borrower and loan characteristics predict loan performance
- Studying the link between financial training and loan performance
- Holding listening sessions, interviews with 45 CDFIs
- Administering a comprehensive quantitative survey (planned)

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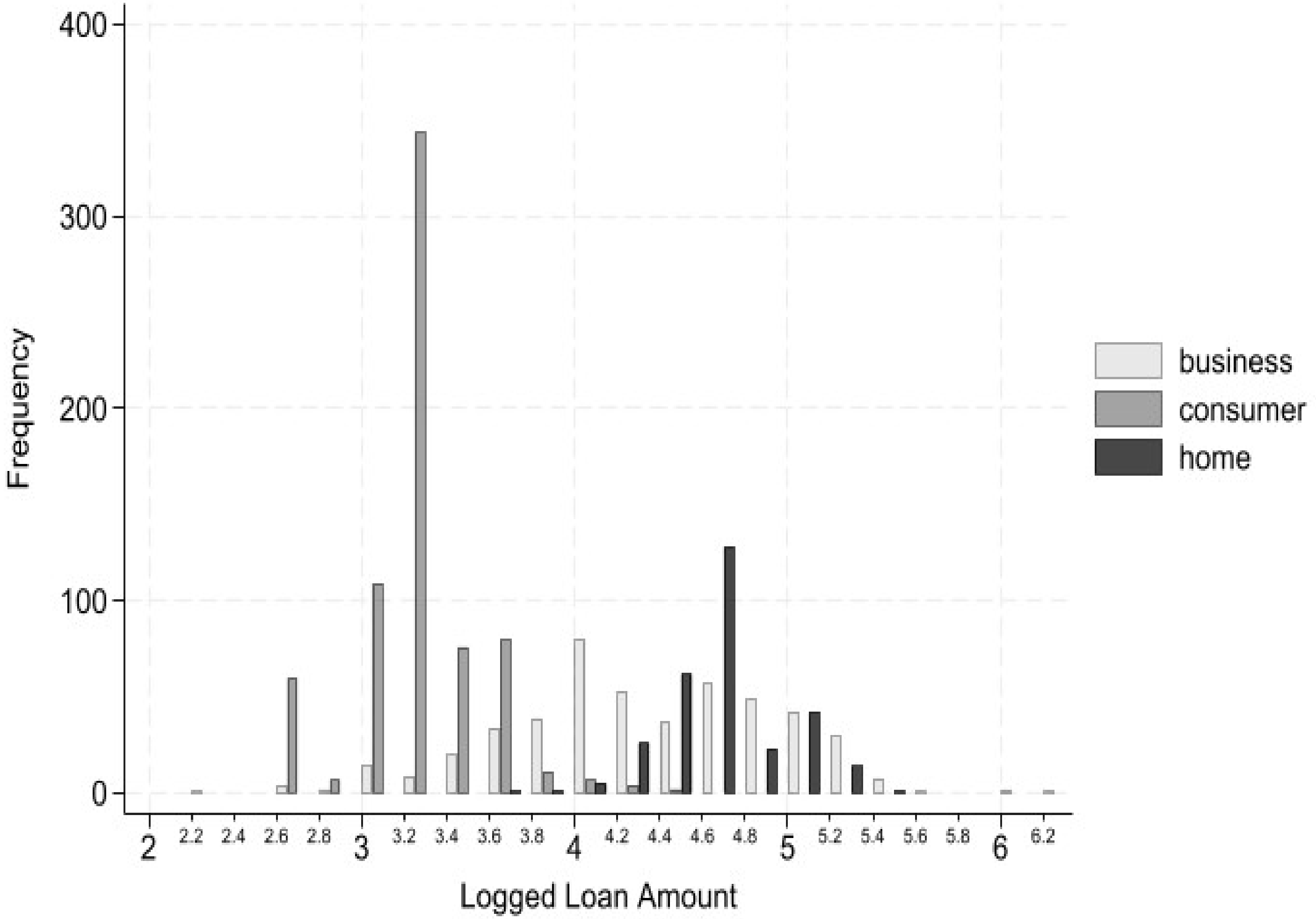
We Rely on Unique Loan-Level Data from Native CDFIs

- Loan-level data obtained by Oweesta Corp. and Sweet Grass Consulting
- Data from 11 Native CDFIs:
  - Representative loan products, portfolio size, and loan disbursement
  - Range of geographic regions
  - Lending volume is 15% of industry total
- 2,067 business, home, and other consumer loans
- Closing dates from 2003-2021, most after 2015
- Active, paid in full, and declared bad debt

Native CDFIs are Fulfilling their Mission

- Provide a variety of products across different loan categories:
  - Business: Microloan, vehicle, equipment, etc.
  - Consumer: Automobile, employee, credit-builder, etc.
  - Housing: First and second mortgage, construction

Native CDFIs Provide Loans of Different Sizes



Notes: This figure shows the distribution of loan amounts by category.
Mean: $33,672; Median: $5,500

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Native CDFIs are Fulfilling their Mission

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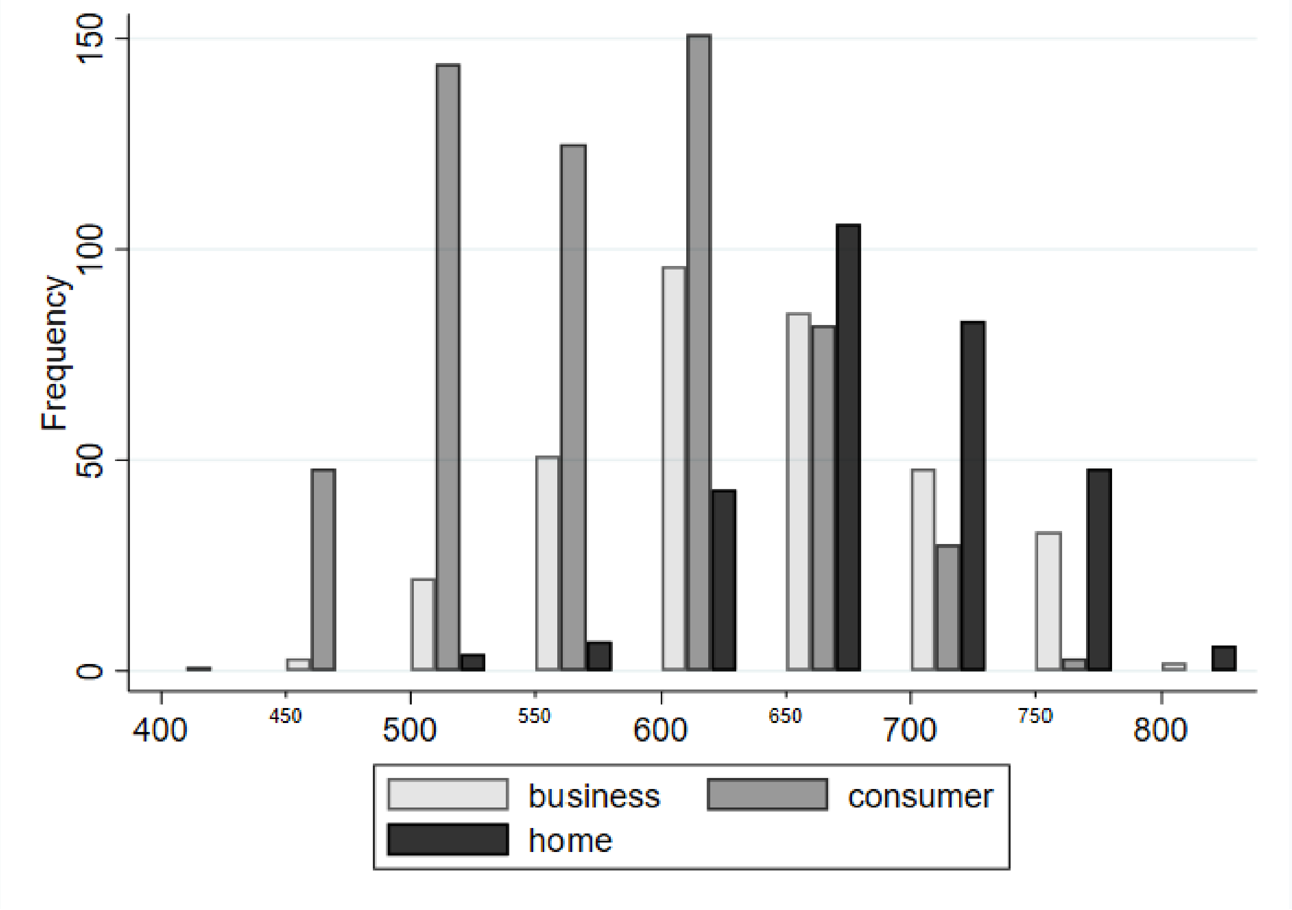
- Support borrowers in varied circumstances
  - Credit extended to old and new businesses
  - Borrowers range in age from 18-96
  - 50% female and 83% AIANNH
  - Wide distribution of credit scores, including thin files

Credit Score by Loan Category



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CDFIs Assess Client Risk to Reduce Delinquency

- Loan delinquency affects CDFI financial viability and hampers future lending
- Mainstream institutions use information about credit score, household income to mitigate delinquency risk

For Native CDFIs: What are the Determinants of Loan Delinquency?

- What is the relationship between loan and client characteristics and delinquency?

- Factors we consider:
  - Credit score
  - Household income
  - Demographic variables (e.g., age, gender, education)
  - Innovative measures utilizing community-specific knowledge and relationships:
    - Character score (Four Bands)
    - Commitment to business (Four Bands)
    - Client engagement

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Finding: Conventional Measures are Sometimes Effective

- **Credit score** is negatively associated with delinquency
  - All loan categories: A 100-pt increase in credit score reduces probability of delinquency 7%

- Consumer loans: **Household income** is negatively associated with delinquency
  - Relationship does not hold for other loan categories

Finding: Unconventional Measures are Sometimes Effective

- Business loans: **Character score** is strongly predictive of delinquency (Four Bands)
- Clients that are **“somewhat engaged”** are less likely to have delinquent loans than unengaged clients
- Don’t find evidence of a relationship between **commitment to business** and delinquency (Four Bands)

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Unconventional Measures May be More Effective

- Recall that credit score is predictive of delinquency

- We find that character score is *more* predictive than credit score

- In analysis with both measures, credit score does not provide additional information about risk

Summary

- Lending models that incorporate borrower-level information beyond credit score and income may be well-suited for Native CDFIs

- We find evidence that character-based and relationship-based lending might improve loan outcomes

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What is Financial Counseling?

- Part of Native CDFIs' innovative lending strategy
    - Client-centered approach at the heart of the mission
- Counseling is free and provided by CDFI staff
- Starts shortly before closed deal and continues shortly after
- Participation recommended by CDFI and sometimes requested by borrower
- Despite prevalence of practice, largely overlooked in the literature on credit default

We Study whether Financial Counseling Aids Loan Performance

- We rely on data from one Native CDFI in South Dakota

- 441 consumer loans issued 2008-March 11, 2020

- The data contain:
  - Loan outcomes: paid in full (321), bad debt (60), pending (60)
  - Borrower exposure to CDFI-provided financial counseling
    - Coaching (individual)
    - Training (group)
  - Loan and borrower characteristics, incl. credit score

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Who Receives Counseling and How Much?

- 28% of borrowers received some counseling

- Borrowers *with* a credit score are more likely to receive counseling
  - 32% of borrowers with a credit score
  - 17% of borrowers without a credit score

- Among those who received some counseling, median exposure to counseling is 0.5 hours

Does Counseling Affect the Prospects of Bad Debt?

- Yes, counseling is associated with a reduction in the prospect of bad debt
  - But only when borrower has a thin credit file
  - In this case, counseling is associated with 82.1% reduction in prospect of bad debt

- Intensity of borrower exposure to counseling matters
  - Exposure to less than 0.5 hours of counseling is not effective
  - For borrowers without a credit score: 0.5 hours or more is associated with 87.8% reduction in prospect of bad debt

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Other Results

- Effect of counseling is approximately equal to the effect of possessing a credit score

- Coaching is more effective than training

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We Conducted a Series of Interviews

- 2021: Listening sessions
- 2022: One-on-one interviews with 45 Native CDFIs
- Interviews conducted by Oweesta
- Questions were open-ended
- Goal was to learn about what matters to Native CDFIs

Policy Levers Focus on Three Sets of Insights

- How Native CDFIs tailor their products and services
- Government requirements that make it difficult for Native CDFIs to access capital
- Changes that would allow Native CDFIs to better meet community needs

Tailoring Financial Products

- Close loans that conventional lenders consider high risk
- Place value on relationship-building and trust
- Help with closing costs
- Keep interest rates low and terms long (patient capital)
- Consider artwork as collateral
- Offer credit builder loans
- Objective is to make sure the loan is not hurting the borrower

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Tailoring Development Services

- Provide ample financial education/literacy classes
- Use storytelling
- Offer youth programming
- Work with elderly centers to teach about scams
- Develop educational programs for people who live on fixed income
- Use curricula that are tailored to Native communities
- Use the Indianpreneurship program

Native CDFIs Described Restrictive Grant Requirements

- Federal grants are typically only one year
- High administrative burden
    - Compliance is time consuming
    - Multiple portals for reporting
- Require high amounts of loans receivables
- Much of the funding is project focused
- Some grants require matches

Policy Levers Could Alleviate some of the Constraints

- Longer-term funding (e.g., 5-year grants)

- Funds for operating capital, not just lending capital
  - Salaries, overhead
  - Cost of compliance, audits, reporting
  - Lending technology

- Tiered levels of access to funds

- Clarity in guidelines for lending on vs. off reservation

- Consultation with Native practitioners before launching programs

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Questions or comments are welcome: Laurel.Wheeler@mpls.frb.org