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

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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


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 AIAN/NH 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
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

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