Federation
Credit Unions United to Serve the Underserved

November 24, 2015

Ms. Annie Donovan
CDFI Fund Director
U.S. Department of Treasury
Community Development Financial Institutions Fund
U.S. Department of the Treasury
1500 Pennsylvania Ave. NW
Washington DC 20020

Dear Director Donovan:

The National Federation of Community Development Credit Unions (the Federation) is the national association for credit unions with a primary mission of community development and promoting financial security and well-being among low-income consumers and communities. In recent years, the Federation has worked closely with the Fund and partners in to increase the size, number and impact of credit unions promoting community development. The increased participation of credit unions with the CDFI Fund has the potential to significantly expand access to capital in some of our nation's most underserved communities. And yet, the Federation believes there remains tremendous untapped potential.

Through this letter and corresponding discussions, we seek to provide guidance to the Fund on how to better understand, assess and value high-performing and high-impact credit unions for investments that will significantly increase the level of safe, responsible banking services and financing to communities most in need.

In this letter, we would like to recommend an improved process for scoring applications for Financial Assistance and Technical Assistance (FA/TA) under the CDFI Program. We recognize that the CDFI Fund will not be able to make significant changes to the application structure before the 2017 funding round. However, we do believe it is possible to improve the scoring and allocation process in anticipation of a more ambitious redesign process for FY 2017. While our primary focus is on CDFI credit unions, we believe that some of these recommendations would strengthen the evaluation of performance and impact of the CDFI industry as a whole. For this reason, we have presented our recommendations in three parts:

- Part 1 offers general recommendations to improve the quality, consistency and efficiency of scoring application data for all types of CDFI applicants.
- Part 2 offers specific recommendations for reviewers of credit union applications for the next FA/TA competition. These recommendations assume that the FY 2016 application will be substantially unchanged from the FY 2015 version.

- Part 3 offers recommended criteria to help determine the size and distribution of FA/TA allocations to CDFI credit unions to ensure the greatest leverage and impact.

In a separate letter we will offer our thoughts and recommendations for an expected redesign of the FA/TA application beginning in FY 2017, including a unified impact indicator for all CDFIs that are engaged in consumer finance.

These review-specific recommendations have been designed to meet five overarching objectives:

1) Improve the efficiency and consistency of the review process for FA/TA applications
2) Increase the transparency of review criteria for all applicants
3) Increase the leverage and impact of CDFI Financial Assistance and Technical Assistance (FA/TA) allocated to CDFI credit unions
4) Establish improved performance standards for credit unions that receive FA/TA
5) Create clear incentives for all CDFI credit unions to increase their provision of financial products, financial services and development services in CDFI Target Markets.

Part 1: General Recommendations for the Review of All CDFI Applications

a) Substantive Debriefings for All Applicants

The Federation has long noted the lack of consistency in the scoring of credit union applications, with little or no clear pattern to distinguish successful from unsuccessful applicants. Without discernable criteria for success or a substantive debrief, credit unions are left without any guidance or incentives to improve specific areas of performance. As a result, the CDFI Fund has missed an opportunity to leverage improved performance and increased impact across the industry, beyond the reach of FA/TA recipients.

Other federal agencies provide robust debriefings to applicants in competitive grant competitions. For example, since 2008 the Federation has served as a HUD-approved National Housing Counseling Intermediary for credit unions. Every year the Federation submitted successful grant applications, and every year had the opportunity to receive a detailed debriefing. Even though our applications were successful, these debriefings helped us to target specific areas for improvement and helped us to strengthen performance across our network of housing counseling agencies.

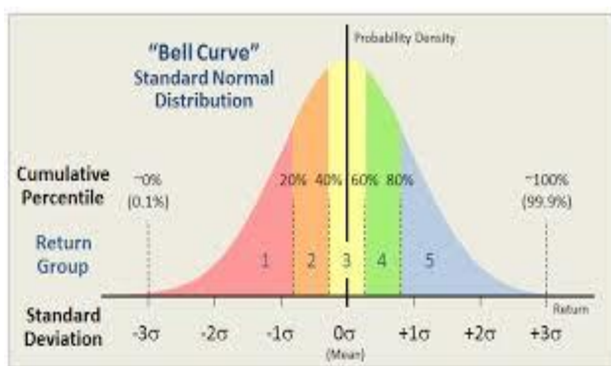
The Federation recommends that the CDFI Fund provide detailed and substantive debriefings to all applicants – successful and unsuccessful alike. At a minimum, applicants should receive their exact scores for each application section with specific reasons given for all point deductions. This change would provide all applicants with important, objective feedback on performance areas that are less competitive with their peer CDFIs and in need of improvement. Each year, spurred on by this feedback from the CDFI Fund, the CDFI industry would experience a “race to the top,” with ever strengthening applicants competing in each successive year.

b) Recommended Approach to Scoring Quantitative Data

No application component is more amenable to objective analysis than quantitative performance data, but here, too, scores are highly inconsistent. Currently, four of the seven application sections rely heavily on data -- financial, target market, activity level or impact – that is contained in the application workbook. This data accounts for more than half of the total application score, but most is not comparable across different types of CDFIs. As a result, the CDFI Fund has customized both the application workbook and the scoring guidance given to reviewers to accommodate different types of CDFIs. For example, the Financial Data Input Chart for credit unions is different than for banks or loan funds, as are the Minimum Prudent Standards (MPS) benchmarks for each type of CDFI. The scoring instructions given to reviewers are likewise customized for different types of CDFIs.

The Federation has welcomed the CDFI Fund’s many efforts to adapt the application and scoring to fit different types of CDFIs, but the current guidance still leaves considerable discretion to reviewers to rate the comparative performance of all CDFIs that exceed the MPS benchmarks. To give a few examples from just one part of the Performance section of the application:

- For loan funds, reviewers are instructed to give a top rating to CDFIs that exceed the 50% MPS benchmark for loan fund deployment, but there is no guidance to differentiate the scores of loan funds with deployment rates between 51% and 100%.
- In that same Performance section, credit unions do not have an MPS benchmark and are not evaluated at all for deployment.[1]



Of course, numbers do not tell the whole story; reviewers must also consider the qualitative information in the application narrative in combination with the quantitative data in the workbook. But this is difficult to do without knowing how a single applicant compares with the others of their type in the pool. For this reason the Federation recommends each quantitative performance indicator be reviewed in the context of the total pool of applicants for each CDFI type on a normal scale, like the one shown at right. This combined with historical performance from recent application rounds will give reviewers greater context for what is occurring overall in the marketplace.

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[1] The sole MPS benchmark for credit union financial performance is a minimum 6% ratio of Net Worth to Total Assets. As with loan fund deployment, reviewers are left with no guidance on how to score credit unions with Net Worth Ratios of 7% compared with those with ratios above 10%, 15% or even higher. In Part 2 of this letter, we recommend a full set of MPS benchmarks for credit union financial performance.

In terms of the examples discussed above, the scoring process for loan deployment could look like this:

- Deployment for unregulated loan funds would be rated on a scale from zero (for those that fail to meet the 50% MPS benchmark) to five points (for those with deployment percentages in the top quintile of all loan fund applicants that exceed the MPS). Reviewers would derive a final score for deployment by evaluating the qualitative narrative for consistency with the quantitative score for this benchmark, and adjust scores for applicants with strong explanations for relatively weak performance data.
- Deployment for credit unions could be evaluated for the first time along similar lines, with deployment measured by the loans-to-shares ratio, a readily comparable measure for all credit unions. Although no MPS currently exists for credit union deployment, the CDFI Fund could adopt a 50% loans-to-shares MPS. Credit unions would then be scored from zero (for those that fall below the 50% MPS benchmark) to five points (for those with loans-to-shares ratios in the top quintile of all credit union applicants that exceed the MPS). As with loan funds, reviewers would derive a final score for deployment by evaluating the narrative for consistency with the quantitative score for this benchmark, and adjust scores for applicants with strong explanations for lower deployment rates (e.g., recent surge in deposits due to rapid growth).

By providing reviewers with the data of distribution in the most recent rounds as additional context, they will be able to identify how the applicants they review align within their industry and how the total applicant pool is distributed in relation to recent prior year awards. This normalized scoring of performance data will ensure that each type of CDFI can be scored against the metrics and benchmarks that are most appropriate for their structure and performance. The objective scoring of quantitative data will increase the consistency and efficiency of the review process itself, while establishing dynamic performance benchmarks as incentives for all CDFIs.

Part 2: Specific Recommendations for the Review of Applications from CDFI Credit Unions

a) Selection and Preparation of Reviewers

In recent years the Federation has documented many cases where credit unions have received low scores in areas that have earned top marks from NCUA examiners. This indicates a significant disconnect between the expectations of reviewers (that may be drawn from a broader community development pool) with the realities of operating a strong, successful and well-balanced regulated depository institution. We strongly recommend that all reviewers of credit union applications have credit union expertise. At a minimum, reviewers must understand the following:

- Federally-insured credit unions are required by their regulator to maintain adequate checks and balances, including comprehensive policies and procedures that meet regulatory standards. These policies must address a broad range of federal laws and regulations and therefore contain language that reviewers must understand and be comfortable with.

- Credit unions can only grow in direct proportion to their net worth, which can only be increased through retained earnings and equity grants. Similarly growth in specific financing activities must be balanced with growth in the overall loan portfolio to assuage concentration considerations. The interplay between dynamic growth to meet community needs and opportunities must always be balanced with safety and soundness considerations from the regulator. Thus, credit union growth patterns will naturally differ significantly from their non-regulated counterparts. Reviewers must understand management of complex financial institutions prior to reviewing credit union applications.
- Credit union boards are made up of members who are democratically elected by other members and serve as volunteers. Credit union boards are not expected to raise external funds for the institution. Their collective value to the institution is measured by the balance of skill sets they bring (small business owners, accountants, legal backgrounds, etc.) not in the level of connections or potential leverage they bring from external investors or funders.
- The cooperative ownership structure of credit unions ensures community oversight and accountability, but also prevents credit unions from raising equity from capital markets in times of rapid growth.
- Credit unions do not use institutional partnerships to leverage loan capital, but instead leverage their net worth to mobilize deposits from the community for loans to the community.
- Credit unions instead use partnerships primarily to expand outreach, improve delivery and increase impact in the communities that they serve.
- Credit unions predominantly focus on consumer finance – the products and services that help low-income individuals to establish or build credit, consolidate and reduce debt, avoid predatory payday lenders and buy affordable used cars that are essential for employment. In short, credit unions help consumers to protect and build assets, which slow the debilitating drain of wealth from low-income communities. Reviewers must understand that safe and affordable consumer finance is essential for communities to safeguard the positive impacts generated by commercial loans or affordable housing developments.

b) Specific Recommendations by Application Section

i. Purpose

The Federation has noted a tremendous variation in scores given to credit union applicants that describe essentially the same purpose. For example, many credit unions apply for FA for the purpose of increasing their capital or loan loss reserves to leverage increased lending across a spectrum of consumer financial products. Some credit unions receive top scores for this purpose, but most are marked down. We believe there are two possible explanations for this variation;

i. Reviewers who have a limited knowledge of the financial structure of credit unions may not understand how credit unions use grant capital on their balance sheets to leverage deposits and increase lending in their Target Market; and,

ii. Reviewers may find the Target Market concentration data in this section to be unimpressive when compared with other types of CDFIs that can concentrate up to 100% of their activities in their CDFI Target Market.

The first point would be addressed by our recommendation to have reviewers with sufficient credit union expertise. Rather than reward CDFIs with a single clear purpose, reviewers must be able to evaluate the full range of financing activities that CDFI credit unions can accomplish with CDFI financial assistance plus the deposits leveraged by a CDFI grant.

The second point is a bit trickier. While reviewers in the past have been instructed to give top scores to applicants with more than 90% of their loans concentrated in their CDFI Target Market, very few regulated CDFIs can sustain such concentrations without incurring the wrath of their regulatory authorities, jeopardizing their financial sustainability, and refusing to meet their obligation to a portion of their membership. The current metric is designed for simple CDFIs that have few large transactions as opposed to more complex high volume transactional CDFIs that are unable to "restrict" lending or service to a specific target market. Reviewers with more credit union knowledge would certainly help. But instead of comparing Target Market concentrations against a fixed standard, it would be much more helpful for reviewers to know how each CDFIs Target Market concentration data compared with other CDFIs of their type in the applicant pool. This could be done through the normalized analysis recommended in Part 1 of this letter, above. Since CDFI certification sets the baseline metric of 60% of financing activity in a target market, we recommend that this serve as the MPS benchmark for all CDFIs.

ii. Products

In the most recent FA/TA application, all financial products had to be entered in the "Activities Level" chart on the Input Sheet, with descriptions and metrics provided on the Products tab. While the workbook allowed credit unions to enter a small number of financial services, all of the metrics on the Products tab were designed exclusively for *loans*. We realize that this is unlikely to change in FY 2016, and will offer recommendations on a redesigned application in our next letter. In the meantime, we recommend that all reviewers of credit union applications read our report, "*From Distrust to Inclusion: Insights into the Financial Lives of Very Low-Income Consumers*," (http://www.cdcu.coop/from-distrust-to-inclusion-insights-into-the-financial-lives-of-very-low-income-consumers/) that describes the critical role of financial services in community development finance.

In this section of the application, reviewers are also asked to evaluate the quantitative data contained in the Customer Snapshot Table. As with the Target Market concentration data in the Purpose section, it would be helpful for reviewers to know how a single credit union's data compared with their peer credit union applicants.

iii. Policies

Credit Unions are regulated entities that have rigorous oversight, rules, and checks and balances. Assurance that these systems are in place are provided by the regulator, NCUA, which would take action if the credit union wasn't performing or operating in an effective manner

The questions in the application workbook – focused on underwriting processes, loan approval authority, loan closing and disbursement, portfolio monitoring, write-off methodology, and loan loss reserve determination – are all standard procedures at credit unions. In light of the rigorous oversight provided by NCUA, one might expect credit unions to excel in this section, yet our member credit unions have consistently scored low on their policies. We suspect the issue may rest in the review process; that perhaps the average reviewer does not know the exacting standards applied to regulated depositories and the degree to which NCUA regulates and oversees credit union policies and procedures.

iv. People

Credit unions elect their board of directors from the general membership. This provides critical skill sets for oversight as well as close relationships and information from the community and membership to guide product and service development. Most credit union boards are not populated by bankers or investors, but rather the common voice that allows credit unions to remain closely integrated into the community and the people it serves, drawing from real and diverse skill sets directly from the people benefiting from the service. As in other areas, we have seen cases where reviewers have rated a credit union "average" or "poor" in this section while NCUA has given the same credit union its top score for "Management".[2] This community engagement is valued in the CDFI certification test as a strong indicator of accountability; however it is significantly undervalued in the current review process. Reviewers should be trained to recognize that this governance structure keeps credit unions tightly accountable to the people they serve. This is valued in the certification process and should be equally valued in the financial assistance review process.

v. Partnerships

The first half of the Partnerships section of the current application is devoted to the use of institutional partnerships to leverage financial resources for lending. As regulated, insured depositories, credit unions **do not leverage loan capital in this way,** but rather leverage their net worth to mobilize shares and deposits for lending. Even though the median credit union has nearly ten times the leverage of the median loan fund, credit unions often receive less than half the available points for this section. Reviewers should be instructed to provide

[2] NCUA examinations of credit unions produce a CAMEL rating based on five factors: Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity/Asset-Liability Management. Each factor is rated on a five-point scale, with a top score of 1 being the most difficult to achieve. As noted above, when a credit union that has been rated "1" for Management by NCUA nevertheless receives a "poor" rating for People from a team of three CDFI reviewers, it raises concerns about the credit union expertise of the reviewers.

all credit unions with full marks on the leverage portion of the Partnership Section. For credit unions, the Partnership Table should simply be reviewed to determine relationships that may help to make the CDFI more effective in its community development mission.

The second half of the partnership section is devoted to Community Partnerships. The questions and reviewer instructions for this part of the application seem appropriate at this time. Our only caveat is the extent to which CDFIs are partnering together. The Fund can play an instrumental role in forging greater alliances among CDFIs by ensuring that reviewers can identify when two or more CDFIs are partnering to leverage resources and provide more comprehensive and cohesive services to target markets. There is currently the perception that CDFIs are disadvantaged when more than one CDFI is applying from a similar location or target market. Yet coordinating diverse activities to provide greater impact should be encouraged and rewarded within the review process.

vi. Performance

The Performance section counts for 40% of the total application score, yet the current application does not capture some of the most important dimensions of credit union financial and target market performance. We have several concerns with the current evaluation process in this area:

- While the CDFI Fund has developed a customized financial data input sheet for credit unions, the financial data is not as robust as the data that is publicly available in NCUA 5300 call reports and Financial Performance Ratios.
- The financial data that credit unions enter in their applications is expected to agree with the accompanying audit reports, but audit reports often contain immaterial differences with NCUA call reports. In addition, some credit union audit reports are based on non-calendar fiscal years, which differ from the majority of credit unions.
- The need to manually enter data is duplicative and increases the possibility of small typographical errors in these detailed financial input sheets, which can result in significant point deductions

The Federation recommends that the CDFI Fund base its quantitative analysis of credit union financial performance on NCUA 5300 call reports and Financial Performance Ratios. This data has the advantage of being comparable in quality, format and time period for all credit unions, which would facilitate the comparative quantitative analysis. For FY 2016, the CDFI Fund could still require that credit unions complete the Financial Data on the Input Sheet, but should use publicly available data from NCUA to evaluate quantitative data on financial performance. By using NCUA reports, the CDFI Fund would be able to produce more substantial analysis.

The Federation has provided some benchmarks that may be useful to the CDFI Fund when reviewing CDFI credit union applicants:

CDFI Minimum Prudent Standards	Metric	CDFI Definition	MPS (FA Applicants)	MPS (TA Applicants)
Capital/ Leverage	Net Asset Ratio	20% for CDFI Loan Funds 6% for Credit Unions	6% No proposed changes.	6% No proposed changes.
	Financing Entity Test	Formula: Financing + Development Assets/Total Assets MPS > 50%	No proposed changes.	No proposed changes.
Liquidity	Current Ratio	Formula: Current Assets divided by Current Liabilities MPS >1.25	No proposed changes.	No proposed changes.
	OP Liquidity Ratio	Formula: Operating Cash/ (Annual OP expenses x 25%) MPS >1	No proposed changes.	No proposed changes.
Performance	Deployment	MPS > 50% minimum Goal	50% Total Loans to Total Shares & Deposits (with exception for rapid deposit growth in recent years)	50% Total Loans to Total Shares & Deposits (with exception for rapid deposit growth in recent years or unless TA is targeted to increase lending)
	Net Income	Greater than or equal to 1	Greater than equal to 0 for 2 of the past 3 years	Greater than equal to 0 for at least one of the past 3 years
	Self-Sufficiency	Formula: Financing + Development Assets/Total Assets MPS > 40%	No proposed changes.	No proposed changes.
Portfolio Quality	Write-Offs	Formula: Loans charged off % of Net Loans Receivable MPS Housing Loans 1st Lien < 1% MPS Housing Loans Subordinated < 3% MPS Business Non-Micro Loans < 5%	Net Charge-Offs/ Avg Loans for the full loan portfolio versus the current methodology of looking at segregated portfolio ratios.	Net Charge-Offs/ Avg Loans for the full loan portfolio versus the current methodology of looking at segregated portfolio ratios. Net Charge-Offs/ Avg Loans: Less than or equal to 2.00% (unless TA request is targeted

		MPS Micro and Consumer Loans < 9%	Net Charge-Offs/ Avg Loans: Less than or equal to 1.50%	to improved servicing and collections)
	Loan Loss Reserves	Formula: 50% and 150% of PAR ($ value of loans delinquent 90 or more days) compared to sum of cash plus accrual loan loss reserves. MPS : .5 PAR < LLR < 1.5 PAR	No proposed changes.	No proposed changes.

vii. Projections

One of the most critical ways that CDFI Financial Assistance can build a credit union is through its balance sheet leverage. However, the current application only allows credit unions to project two financial line items (Unrestricted Cash and Total Assets), which restricts any discussion of this greater impact to the narrative. Since it is unlikely that the financial chart will be substantially revised for FY 2016, reviewers should be instructed to take careful note of narratives that show how credit unions can leverage their CDFI grant to mobilize deposits and increase lending and other activities in their Target Market.

Part 3:Recommended Criteria for Allocations to Credit Union Recipients

The recommendations in Part 1 and Part 2 are designed to ensure that the strongest CDFI applicants will consistently receive the highest scores. But for CDFI credit unions, does this mean that a small group of institutions will continuously dominate the FA/TA competition? The Federation is concerned that this is already the case. Since inception, 21 credit unions have received half of all the dollars disbursed to CDFI credit unions. While a small number of credit unions may be expected to earn grants in successive years, the concentration of FA grants can diminish the impact of capital by flooding institutions with capital faster than it can be deployed and leveraged. The Federation recommends that the CDFI Fund implement measures to increase the geographic and institutional diversity of FA recipients by considering the following factors:

- CDFIs that have received three consecutive FA grants should be advised not to reapply unless their total Target Market loans have increased by more than three times the value of their current award, they have expanded their CDFI Target Market or the availability of capital in the geographic is highly limited (e.g, rural communities outside large bank market areas).
- Allocations are targeted to CDFI credit unions that have merged smaller credit unions and serve particular underserved target markets. The ongoing consolidation of the credit union industry has increased the number of mergers of small credit unions into larger ones. Many of these small credit unions are minority institutions serving particular

communities through niche loans and services. It is critical that when this occurs the service to that community is maintained.

We recognize that we are providing considerable specific input into the review process. As the association for the CDFI credit union field we would like to offer the opportunity to provide training and\or background materials to Fund staff and consultants prior to the 2016 CDFI FA\TA round.

I deeply appreciate your thoughtful review and consideration of this letter and I look forward to robust discussions on each of these areas.

Sincerely,

Cathleen A. Mahon
President and CEO