New Pathways to Scale for Community Development Finance

The Economic Opportunities Program (EOP) of the Aspen Institute advances strategies (primarily in the areas of workforce development, microenterprise, community-based forestry, and access to capital and credit) that connect the poor and underemployed to the mainstream economy. The EOP facilitates participatory learning among practitioners using applied research to stimulate dialogue and action among funders, policymakers, nonprofit, and community leaders. This paper is one in a series focusing on issues of scale and sustainability in the not-for-profit and community development field. For more information, go to www.aspeninstitute.org/eop.

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By Gregory A. Ratliff and Kirsten S. Moy with Laura Casoni, Steve Davidson, Cathie Mahon, and Fred Mendez

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We are especially grateful to the minds and insights of Clara Miller, Alan Okagaki, and Allen Moy, whose dedication to systems, process, infrastructure, and true sustainability inspired and motivated us to attempt to adapt proven business strategies to the unique culture of community development work.

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Section I. Introduction

A. Background and Context

Between 1998 and 2000, Kirsten Moy and Alan Okagaki conducted research through the Community Development Innovation and Infrastructure Initiative (CDIII) that considered the future of community development and community development finance.[1]

The fundamental conclusion was that:

> "Economic restructuring, the emergence of telecommunications and information technology, and other national and global trends had dramatically changed the environments in which community development takes place. Capital gaps have changed; capital itself is becoming less "localized" and the financial services industry has evolved in entirely new ways to transact business and

service customers. These changes have significant implications for community development financial institutions (CDFIs). The CDFI industry will need to re-engineer, reposition, and retool itself in order to be viable in the 21st century. In particular, the CDFI industry must critically examine its structure and invest significantly in its supportive infrastructure if it is to be an effective conduit for the flow of capital to low-income communities."

The CDIII research inspired considerable thinking and reflection among leaders in the community development finance field, funders, investors, and supporting organizations, about the evolving role for institutions and the implications for viability in this changing environment. Today, many recognize that low-income populations have limited access to affordable financial services and that community development finance, and the related set of institutions, can be an effective approach to providing access. It is also recognized that the current system is inadequate for meeting the needs of the majority of low-income communities across the country. Achieving scale may allow CDFIs to reach more broadly into targeted populations.

Funded through the Heron, Fannie Mae, and MacArthur Foundations, the Aspen Institute, led by Kirsten Moy and Greg Ratliff, began developing a next phase of research that would further the discussion of scale, how it is defined and understood, and models for achieving scale at different operational levels.

Through this research, the Aspen team sought to further the practical development of what can be characterized as a "new architecture" for the development finance field that will facilitate its growth to scale.

B. Statement of Need

Initial successes of the CDFI industry in addressing the capital needs of particular low- and moderate-income communities derive from the typically small, autonomous nature and narrow geographic focus of its institutions. While this customized approach has served the institutions and the customer base well, it has also inhibited growth.

As the conventional financial services industry has changed its structure and adapted to changes in technology, the economy, and public policy, the CDFI industry has not kept pace. Many in the industry now see the very characteristics that made CDFIs successful as barriers to their achieving greater impact. For the CDFI industry to expand its capacity to help low- and moderate-income communities, it must develop new ways of serving its customers and leveraging the resources of both the mainstream and nontraditional financial industry.

For years, the CDFI industry has been focused on increasing the scale of its activities. Foundation program officers, CDFI executive directors, and many familiar with the industry, have urged greater industry scale, as if achieving scale was a panacea for all of the issues the industry faces. Yet, discussions among funders, practitioners, policymakers, and others, have not led to a precise definition of scale. And understandably, there is little consensus as to how to achieve scale.

C. Purpose of this Paper

Our interest is in understanding how to strengthen the overall system for financing community development in the United States. Can improvements in the effectiveness of the development finance system – greater volume, lower costs, efficient delivery of new products and services, and ultimately greater impact – be accomplished, and if so, how?

This paper attempts to provide a useful understanding of scale, how it can be achieved and the possible advantages and disadvantages of achieving it. It also proposes a new strategic framework for CDFIs and funders to consider to facilitate product development and greatly expand delivery.

By looking at 10 case studies of organizations with lessons for CDFIs, the authors concluded that misconceptions of scale are fundamental. Also, pursuit of scale in the industry through replication of best practices is an overly simplistic, and in many cases, a misguided pursuit.

This paper captures the lessons of these cases, and explores ways CDFIs may grow and extend their reach to millions of unserved and underserved households in need of their services. It is potentially the first paper in a series that will:

- Help create a consistent industry vocabulary around the subject of scale
- Assess the critical factors for growth and expansion
- Build new models for scale that will identify the critical steps toward achieving it
- Explore barriers to achieving scale for CDFIs (and possibly other community based organizations and nonprofits)
- Identify related areas for future study

This paper discusses:

- A better definition of scale and where and when it is attainable
- A better understanding of key factors influencing or constraining scale such as sustainability, use of subsidy, and funding and capitalization
- More meaningful models or pathways for CDFIs to achieve scale

Section II. Scale: An Initial Framework

A. Clarifying Language on Scale

One initial challenge to the research was in defining the term "scale" and understanding how it is used for CDFIs. Private sector actors tend to talk about "scale" as in "economies of" – i.e., presuming a cost model in which variable costs decline as production increases. However, for the CDFI industry, reaching scale typically refers to delivering product(s) to a larger audience, delivering more products, or increasing assets or loan volume.

CDFIs may focus less on cost control or increased efficiency, and more on expanding service delivery and program impact. But serving larger numbers is generally equated with increased likelihood of sustainability and reduced costs per product or service delivered. The goals of the industry are to reach more people, achieve economies of scale, and become more sustainable.

The challenge is that scale pursued in this manner may not serve these goals. A distinction must be made between "scale and sustainability" versus "scale or sustainability." The adage about a business that loses money on each widget it produces and seeks to solve the problem by making more widgets illustrates the point. In the case of CDFIs, their high-touch products and services may create a situation where growth of fixed costs occurs at a pace with growth in the customer pool.

Reaching less profitable markets is an important social goal that may require generous amounts of subsidy, but achieving a sustainable level of "scale" will require creativity and efficiency, including use of cross-subsidy[2] and an appropriate mix of profitable versus subsidized products.

Ultimately, the notion of scale for CDFIs must include expanded volume, reach, increased efficiency resulting in sustainability, and deepened social impact. The models and lessons that follow, which have worked successfully in other context, suggest ways to address these sometimes conflicting goals simultaneously.

B. A Model for Conceptualizing Growth to Scale

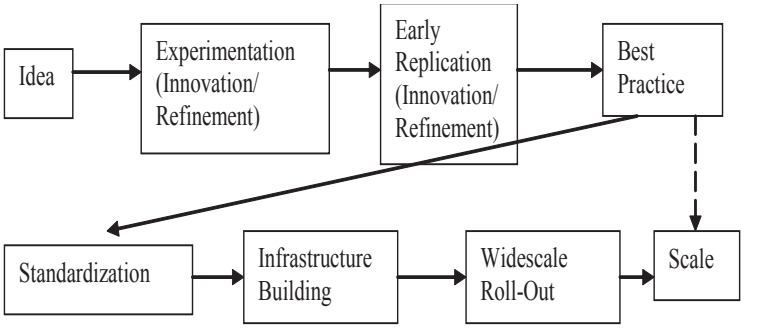
We began with a hypothesis of how organizations grow, expand their reach and become sustainable. Diagram 1 lays out an alternative to common foundation and nonprofit models to promote successful growth and sustainability of their interventions. It briefly describes the stages through which an idea moves to reach scale.

Current foundation and nonprofit thinking focuses on the first four steps. It takes products and services from the best practice stage directly to "scale." The proposed model differs in a number of ways from the conventional model. For example:

- Sharing information on best practices in a field is, in and of itself, insufficient for getting to scale.
- In practice, scale is not possible without some degree of standardization.
- No field can go to scale without appropriate infrastructure, and this infrastructure must be consciously invested in and built.
- Replication is part of the process, but scale occurs not through fortuitous replication but a deliberate and well considered roll-out.

In essence, the proposed approach to reaching scale adds three critical steps to the process: standardization, infrastructure, and roll-out.

Diagram 1: Pathways to Scale



Standardization: Consistently delivering a high quality product or service that is uniform across customers is one way that corporations deliver products and services in volume. The practice of standardizing products runs counter to the traditional thinking that each solution or product offering must be customized to the local conditions and/or the individual beneficiary. Successful, broad-based product implementation will require a nuanced understanding of standardization and its limits in addressing development issues.

Infrastructure: Development of new infrastructure entails the codification of new ideas into widely available systems, products and services. Without development of supporting infrastructure, replication and scale are not possible and promising demonstrations may be little more than isolated efforts. The language of "creating infrastructure" is relatively foreign to the nonprofit world, yet it is a vital component for the widespread implementation of an idea. Today's mainstream financial institutions are supported by highly developed infrastructure. This infrastructure has many aspects including: common definitions; standards; standardized procedures; protocols and methodologies; industry-wide databases; widely accepted rating systems; technology platforms; and institutions (e.g., investment

bankers, investment advisors, brokers, research firms) and institutional relationships. Together, this infrastructure enables financial institutions to match users of capital with suppliers of capital quickly, efficiently, and profitably.

Deliberate Roll-Out: Roll-out promotes the widespread adoption of new products and services by actively fostering, through appropriate incentives, the development of the systems and supporting infrastructure necessary to ensure their use. By contrast, "replication" assumes that the merits of new product innovations will be self-evident and that individuals, organizations, or communities will, in isolation, copy the innovation discovered or initiated in another locale.

The CDFI industry has many best practices but far fewer generally accepted standards, protocols, methodologies, or technology applications that allow for large-scale and deliberate roll-out.

Section III. Case Studies

To test this model and better understand the dynamics inherent to reaching scale, ten case studies were developed. Go to the Aspen Institute Web site at www.aspeninstitute.org/eop for summaries of these ten case studies. The organizations were chosen from a mix of for-profit and not-for-profit businesses (though the majority were private sector businesses) that have successfully achieved scale. The following criteria were used to identify cases to be studied:

- Industry leaders generally acknowledged to have successfully scaled up
- Organizations where a personal contact or other means provided access to higher quality information
- Organizations that emphasize financial service delivery in nonprofit, for-profit, or cooperative models, unless the organization developed an innovation with broad applicability
- Organizations whose business approach could provide lessons for CDFIs

In developing the case studies, the goal was to understand how different organizations achieved scale, highlight critical lessons along the growth path, and identify particular issues/lessons for CDFIs and the development finance industry. Cases and models selected were the following:

7-Eleven, Inc. V-Com: This case analyzes the roll-out of a financial service kiosk in a global retail company following intensive research, piloting and testing of prototypes and product modification. 7-Eleven developed the V-Com financial service kiosk, with services that included ATM access, check cashing, money orders, phone cards, Internet e-commerce, and auto insurance. The product connects the demand for financial services with customer needs for convenience and accessibility. 7-Eleven identified financial and technological partners to supply the infrastructure and help provide financing at each stage.

Dell: The case reviews the development of a customized product (incorporating standardized components) that is customer-driven and eliminates intermediaries. The direct model of service to the customer enables the company to have a permanent customer feedback loop. The relatively inexpensive innovation of providing a multiple array of options using standard product components provides the feel of a customized purchasing experience.

Self-Help Community Advantage Program: This case documents the creation of a secondary market for nonstandard, high loan to value (HLTV) single-family mortgages. Self-Help purchases these home loans from financial institutions, and requires the participating institutions to use the liquidity gained to make new loans to low-wealth families. Self-Help piloted and tested the program initially with conventional financial institutions in North Carolina to help them extend mortgages to low-wealth African American families, many of which have mortgages with loan-to-value ratios in excess of 97 percent. These loans were purchased and resold with a credit enhancement to Fannie Mae. After the portfolio of HLTV loans had been modeled and the relevant characteristics (defaults, delinquencies, prepayments) analyzed, the program was ready for a national roll-out. The roll-out established a national program for HLTV mortgages for poor families, and involved a number of financial institutions around the country. To date, this program has funded 9,015 mortgages with a value of more than $615 million.

ACCIÓN International/ACCIÓN USA: This case documents the evolution of one of the world's premier microfinance organizations/networks. After its initial 12 years of focusing on public works and infrastructure in four Latin American countries, the organization retooled its operations and reinvented its core business. ACCIÓN International now consists of a network of close to 30 independent partner microfinance institutions (MFIs) in 18 countries in Latin America, the Caribbean, and Africa, and nine locations in the United States serving 30 U.S. cities and towns. The mission of ACCIÓN is to bring microlending to millions of people; scale is built into the mission. One key to its expansion was the creation of the Latin American Bridge Fund to provide loan guarantees to banks that agreed to lend to the microfinance institutions within the ACCIÓN Latin American network. In the six years following the creation of the Bridge Fund, lending volume throughout the Latin American network increased 20-fold. ACCIÓN then created BancoSol, the first commercial bank devoted solely to microenterprise, and

within 10 years, another 15 ACCIÓN affiliates became regulated financial institutions.

Banknorth Group, Inc.: A community bank that grew tenfold in 10 years to $20 billion in assets through new product development, geographic expansion, and acquisition. The bank recognized that it must grow to compete with regional and national banks entering its market. The road to scale was primarily through acquisition of small financial service firms that were consistent with the community-based focus of the bank. Banknorth incorporated both the assets and management talent of acquired firms and their knowledge of both their business and local market. With every acquisition, the bank was better able to efficiently incorporate the acquired financial service company. Through piloting different acquisition and integration processes, the bank was ultimately able to standardize a process for acquisition and integration of new firms from divergent businesses and locations.

ACE Cash Express: This case documents growth of a non-bank financial institution with a broad retail presence. ACE relies primarily on franchising for growth, but is also active in acquisitions and new company-owned store openings. They offer a wide range of financial services. The organization is divided into districts and regions under a regional vice president. For every 100 retail stores, a district is formed and managed by a district administrator, and regional oversight managed by regional VPs. Human resources, oversight, and administrative functions are managed at this level. Regional management is centralized and encourages training including online training and videotapes. As a check cashing and transaction-based financial service provider, ACE relies on transaction fees to generate a profit, and depends on a high number of transactions. A store must generate a minimum of 1,000 transactions per month; some stores do as much as 15,000. Overall, ACE conducts roughly 2 million transactions per month.

Allied Capital and BLX: A diversified financial services company focused on investing in small and emerging businesses. Starting as a small business investment company (SBIC), Allied grew five public companies and has an overall market capitalization of $2.9 billion. Allied's growth was driven by increased portfolio size and diversification, and a robust and durable capital structure – which combined, allow Allied to deliver added value to shareholders through consistent dividend payouts. Allied is both shareholder and customer-centric, exemplified by a focus on dividends and the search for emerging market opportunities. BLX, a portfolio company controlled by Allied Capital, reaches into underserved markets by partnering with groups that represent the target demographics.

The Reinvestment Fund (TRF): This case tracks the evolution of a CDFI into a regional development and finance organization. The expansion relied on strategic investments in technology to identify market opportunities, establish standards for underwriting and servicing, and integrate systems throughout the organization. TRF also relies on extensive data analysis to better understand the shifting regional markets, and to assess productivity, efficiency, and outcomes. They have developed an integrated regional strategy that extends beyond credit and the provision of financial services to policy (cost-benefit) analysis, public policy research, and labor market development. The investment in technology and reliance upon data analysis has enabled the institution to grow to $100 million in assets and extend its market throughout the region.

Unified Western Grocers: Unified Western Grocers (UWG), Inc. is a retailer-owned, wholesale grocery cooperative that supports independent grocers in the Western United States. UWG serves as a wholesaler, buying foods and other goods in bulk and re-selling to grocery store members. UWG also provides services to enhance performance and support the growth of members of the cooperative, including: insurance, in-store promotions, information technology, inventory management, marketing, and administrative and financial services. UWG is a merger of what were two distinct cooperatives, and continues to expand its network of member grocery stores. It also demonstrates how a cooperative network can increase the scale of an entire industry of small, autonomous retail stores through the purchase and distribution of goods and services at discounted rates and through shared infrastructure. UWG reaches about 3,700 grocers.

VISA Credit Card: VISA is the world's most widely accepted payment system for consumers and businesses. The Visa story is initially that of a single product, a card enabling bank customers to conveniently access small lines of credit. Through partnerships and a very well-rooted infrastructure, Bank of America, the industry driver, took the initial BankAmericard to new levels, as it became a widely accepted tool for flexible credit that united the systems of banks, merchants, and consumers through technology.

Section IV. The Evolving Framework: Three Levels of Scale

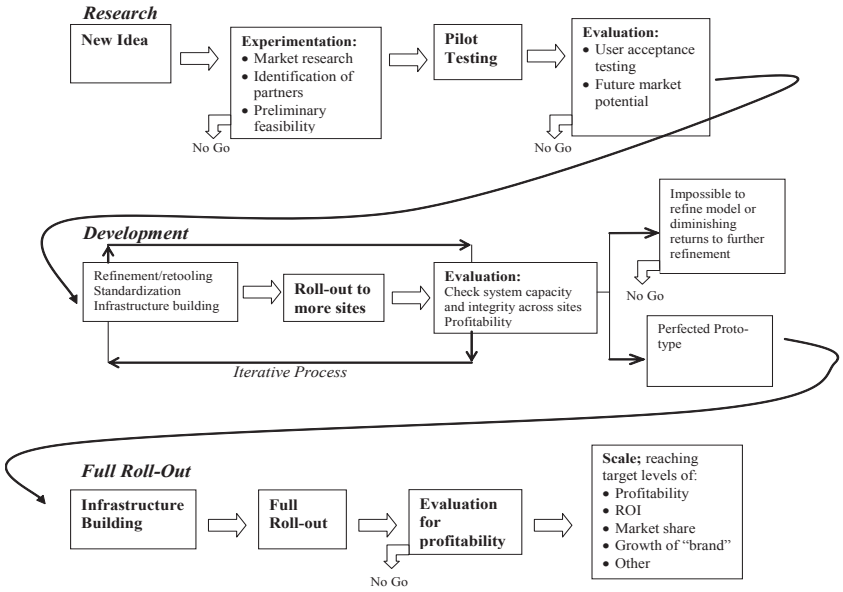
In looking at the case studies, we realized that our initial model for scale was too simple and incomplete. The model for understanding scale did not recognize the different levels at which scale may be reached, nor the relationship between the levels. In analyzing the information and data gathered from the case studies, we developed a more

evolved framework to study scale at three levels:

- Product
- Organization
- Industry

To best understand lessons on reaching scale, research is needed to focus on the specifics at each level. In addition, achieving scale at one level contributes to successful scaling at the next level. The cases reflected learnings in one or more of these areas. The following attempts to capture the insights on these three levels and demonstrate how studying select cases further refined each level. Some cases may provide lessons for scale at multiple levels and therefore may appear in discussions at more than one stage.

Diagram 2: Scale Model at the Product Level



A. The Product Level

1. The Model

The following model describes the typical process for the creation and development of a product. The process of taking a product to scale has three basic stages—research, development, and roll-out—each of which involves multiple attempts to develop, test, and improve the product in a process that is not linear, as suggested in the original model.

As Diagram 2 illustrates, the **research** phase incorporates not only idea generation, but also preliminary market research, identification of strategic partners, and feasibility of the product. An initial piloting of the prototype in a few sites, concludes with an evaluation of user acceptance and an assessment of future market potential.

Products that make it through this stage go on to **development**, which involves refinement and early elements of standardization. The development stage is a much more expensive phase. The organization begins to think about infrastructure that will be required to deliver the product efficiently and profitably. The refined product is rolled out to more sites, and then further refined. This phase of development is an iterative process that culminates with an evaluation of whether the product and its delivery system has capacity and integrity across sites and potential for profitability. At this juncture, the company can decide whether or not to move ahead with the product.

The products that make it through the research and development phase move on to full **roll-out**. The roll-out stage is the most expensive of the three phases as it requires a new or greatly expanded infrastructure to deliver the product to many more sites – potentially thousands. As the product becomes available to a larger share of the market, the company evaluates its profitability and competitive positioning. As a gauge of success, private sector corporations will have set a key strategic target such as a minimum return on investment (ROI), or market share. The example following the model is drawn from the cases and illustrates the model in action.

2. Illustration of the Model

7-Eleven offers an excellent example of how a company researches, pilots, tests, and redesigns new products prior to large-scale roll-out. The company, known for its focus on convenience, operates each store with limited space, thus each product line must prove its value in competing for space. It was the first retailer to offer automatic teller machines. When 7-Eleven decided to upgrade to the V-Com product, a technology-powered kiosk offering multiple financial products, the organization undertook an extended process of research, pilots, and redesign.

During the research phase, 7-Eleven identified financial and technological partners who could supply the infrastructure while 7-Eleven offered the locations, existing customer base, and brand recognition. Partner companies included: Western Union for money transmission, Certegy for check cashing, Cyphermint for e-commerce, Verizon for telecommunications and phone cards, and American Express for the ATMs. Partners provided support for testing, development, and roll-out, while also selling their competencies to build the V-Com infrastructure.

Product Model Key Findings:

- **Going to scale is not a linear but an iterative process comprised of idea development/ standardization/infrastructure building/testing and evaluation at every stage.**
- **The process of achieving scale is almost always far longer and more costly than initially envisioned.**
- **Many developing products will be rejected along the way, or substantially retooled from the original.**
- **A full roll-out cannot be staged until there is a perfected prototype – something rarely achieved in the CD world.**
- **Implicit in the model is strong product demand (i.e., broad acceptance or desire for a product), if scale is the ultimate goal.**

From 2000 to 2001, they tested the model in select locations (nearly 100 locations primarily in Texas and Florida) to determine if V-Com would generate revenue for 7-Eleven beyond the market testing and development costs. The pilot test indicated to 7-Eleven and the partners that V-Com would be profitable with custom improvements to the prototype. For example, the target demographic required new check approval criteria and ergonomic changes to the kiosk. The pilot also proved that a lower-cost, technology-intensive delivery system worked. The research took approximately two years and laid the groundwork for the development phase. During development, V-Com was further retooled to accommodate increases in volume and additional product offerings, and 7-Eleven conducted a small-scale roll-out to further test the economics of the model. At the time of the case study, 7-Eleven and its partners were planning expansion from 350 sites to 3,500 locations.

Estimated costs during the initial stages of research and development totaled $20 million. Once fully rolled-out, 7-Eleven estimates total development costs at $200 million, with an additional $430 million needed to secure financial services such as check cashing and money orders. In this instance, as with other potential financial service or product innovations, the capital needed is substantial and indispensable.

B. The Organizational Level

1. The Model

Growing a business model to scale is more complex than taking a product to scale, in part because of multiple product lines. Also, organizations face varying environments and challenges in their development and do not all grow in the same way. Refer to the diagrams and case studies at the Aspen Institute Web site (www.aspeninstitute.org/scalecasestudies) for an example of how one particular organization grew to scale. The process for taking a business to scale generally has three major stages: **start-up, expansion,** and **maturity**. As in the product model for scale, these stages also reflect an iterative set of activities to reach scale.

As Diagram 3 illustrates, the model begins with the entrepreneurial start-up of a company. The entrepreneur may not have a formal business plan, but rather a vision or idea about a product or set of products for which there is some quantifiable market demand and that s/he can deliver on a competitive basis.

The initial stages may focus on a single product or a mix of products and services that complement each other and reinforce organizational focus and direction. Over the course of time, the company collects data through customer feedback and market research. The organization may experiment with different aspects of product delivery, packaging, or marketing tactics. At some point, a company reaches a stage where it can more predictably achieve annual increases in the level of sales and profitability. The company then enters the growth and expansion phase.

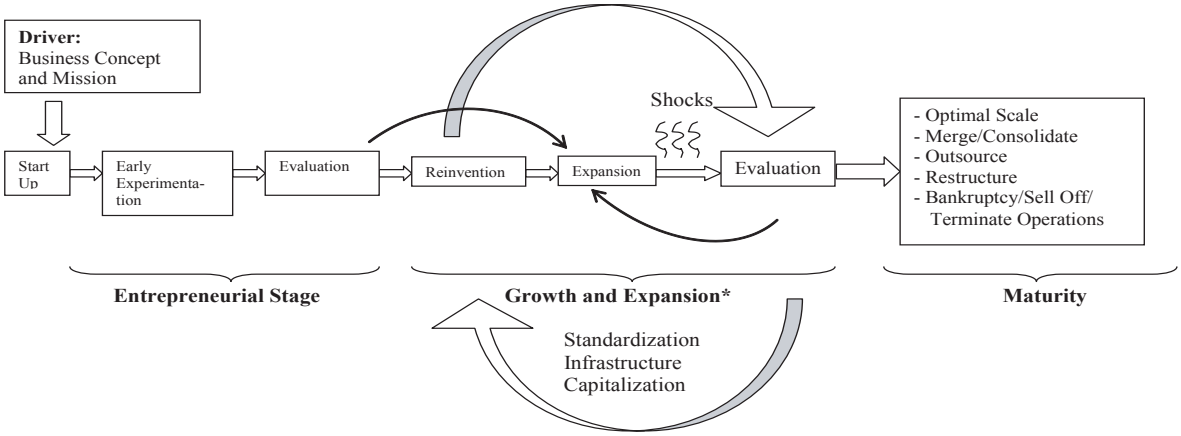
Inevitably changes in the economy or the company's operating environment produce shocks, which may force the company to reinvent or reposition itself. During the process of reinvention, the company may retool existing products, develop new products for its existing customers, exit certain products, tap new customers for its existing products, and/or enter a larger geographic service area.

Each stage of growth is generally accompanied by a new phase of capital raising and investment in infrastructure to support the efficient delivery of quality product at increased volumes. The supply of capital the company can access for continued growth and investment is critical and can be raised through a range of debt and/or equity instruments (e.g., issuance of stock, bank financing).

In some instances, growth was limited by the legal structure of the organization and several organizations changed their formal legal structure or added other legal entities in order to facilitate expansion, future growth, and/or access to capital.

Eventually, a **mature** company will reach one of several points in its growth: a position of optimal size and scale

Diagram 3: Possible Pathways to Scale at the Organizational Level



* Growth and Expansion (reinvention, expansion, and evaluation) may occur along multiple product lines, in growing or expanding markets or with greater penetration of a single product within the existing market.

of operations; a point where it will merge or consolidate its operations with another corporation; or a stage where it outsources a significant portion of its operations or restructures its own operations. In some instances, a company may cease operating independently, due to a bankruptcy, a sale of assets, or simply a decision to go out of business—depending on its ability to adapt or reinvent itself following environmental shocks.

2. Illustration of the Model

ACCIÓN International was originally founded in 1961 as a volunteer organization focusing on physical infrastructure development, training, and nutrition programs, and the construction of community centers.

Organizational Model Key Findings:

- **Organizational scale cannot be achieved without one or more products/services that go to scale.**
- **Scale cannot occur without sufficient geographic or program scope for an organization to expand.**
- **Scale cannot be achieved without sustainability.**
- **Key investments in infrastructure can catapult an organization to a new level of activity and impact.**
- **Organizations may need new structures and partners as they grow.**
- **Reaching scale can take a long time, a period possibly better measured in decades than in years.**

Despite considerable growth and expansion from Venezuela to Brazil, Peru, and Columbia, within ten years the organization experienced a series of shocks, which forced it to reassess first its mission and core business activity, and then its delivery systems.

In 1973, the organization dramatically reinvented itself to offer financial products to small enterprises. They tested these products and services over a four-year period before expansion through new affiliates and the addition of new partners. By 1977, ACCIÓN had made 885 loans and created more than 1,400 jobs. The products, services, and infrastructure expanded along with the network of new loan products, technology and technical assistance, and financial assistance to network members.

One key to this impressive expansion was the creation of the Latin American Bridge Fund in 1987, which provided loan guarantees to banks that agreed to lend to the microcredit institutions within the ACCIÓN Latin America network. In the six years following the creation of the Bridge Fund, lending volume throughout the network went up 20 times. In 1992 BancoSol, the first commercial bank devoted solely to microenterprise, was founded and was followed within 10 years by the addition of 15 ACCIÓN affiliates that are regulated financial institutions.

As of 2003, ACCIÓN's partner programs operated in 13 countries in Latin America and the Caribbean, in five countries in sub-Saharan Africa, and in more than 30 U.S. cities and towns. ACCIÓN, in its early years, exemplified the entrepreneurial phase of the model from start-up to experimentation and evaluation. Since 1973, their growth pattern has been a series of reinventions and expansions. Key components have been strategies to increase capital, implement a degree of standardization throughout the network with regard to policies, procedures, and

underwriting, and build an organizational infrastructure that supports expansion.

Banknorth presented an interesting case of an organization in the growth and expansion phase. Broader geographic reach was the initial driver of the bank's determination to grow, but its expansion was also in reaction to national banks entering the market.

Banknorth followed a dual strategy for growth and expansion acquiring small financial firms and developing new products. With every acquisition, the bank developed a more standardized process for integrating not only acquired assets, but also management and new product lines. Banknorth acquired the largest insurance agency in Maine, as an example, but relies upon local knowledge and expertise to run the business.

Eventually, the bank integrated all of its acquired entities under a single charter. As the model suggests, capital is essential to growth to scale. Banknorth's capital came from internal earnings and issuance of stock. The bank used its stock to acquire other financial services companies. The capital base grew from $50 million to $1.7 billion. With standardization, capital, and ongoing infrastructure development to support the expansion, Banknorth has grown to over $20 billion in assets.

C. The Industry Level

1. The Model

While organizational capacity to plan for and pursue growth affects scale, at some point in its growth an organization must acquire outside capacity. Industry models for scale involve actions and outcomes that cannot be achieved other than through collaborative efforts.

Different industries have different structures and it is not possible to articulate a generic industry model. (The diagram and case studies at www.aspeninstitute.org/scalecasestudies describe the process in one case: the Bank of America Visa example.) Nevertheless, there is value in identifying general outlines of the model for discussion purposes. We began by looking at the relationships among different actors in an industry, their respective roles, and their relative power or influence. The value of the model lies in its illustration of the varying characteristics of an industry based on the relationship and influence of the players.

It is often the case that the most important players in an industry determine the dynamics of the industry. We did not include the critically important, but secondary role of suppliers and vendors in our discussion. Overall, we identified five regularly occurring actors in industries: **customers; industry members; investors and funders; policymakers/regulators**; and **trade associations** or other **industry intermediaries**. The typical activities or services of each actor are listed next to or underneath the actor's box along the lines of relationship to another player in Diagram 4. For example, the relationship between customers and industry members includes the exchange of products and services, as well as data on purchasing patterns, whereas customers look to policymakers and regulators for consumer protections.

Using these five actors, we developed three potential industry structures that reflect the dynamics found in the cases:

- A model dominated by large corporate players
- A model populated with a significant number of small players and a limited number of large players
- One for the CDFI field, which consists of mostly small players

Industry Structure 1: In the dotted-lined box is an industry model where the dominant interaction is between the customers who drive demand for products produced and sold by corporations. There is also a temporal aspect to the model; the corporate-customer dynamic dominates the early phase of the industry's development, but as the industry grows, the investor's group may influence the structure of the industry more by the types and amounts of capital they provide. Together, these three players affect the range of products to be offered, the growth and expansion of organizational capacity to deliver product, the pricing, standards and product protocols, and the development of additional products that meet new customer needs. Within this model, trade associations play a relatively minor role, and such an industry may or may not be subject to strict regulations.

Industry Structure 2: In the thick-bordered box is an industry where the dominant interaction is between the smaller **industry members** attempting to deliver products and services to **customers** while competing with larger, better capitalized, and better known members of the industry. In this setting, the smaller firms look to the trade association or **industry intermediaries** for assistance in delivering products and services on a competitive basis relative to the large players in the industry. The formation of cooperative networks and other industry intermediaries can play a critical role assisting small players in meeting customer needs profitably. The investor/funder relationship varies and is direct to the corporation with large players, but is indirect and agglomerated through the industry intermediary for smaller players. Policymakers and regulators may or may not play important roles.

Industry Structure 3: In the dash-lined box is an industry with many small players where the dominant interactions are among the **investor/funders, regulators, industry members**, and **industry intermediaries/trade associations**. This model characterizes the CDFI industry

where the relationship between the CDFI and its funders and regulators can drive the industry dynamics more than the relationship between the CDFI and customer, the ultimate beneficiary of its productive activities.

The most remarkable hypothesis to come out of this industry model is that there is a disconnect between members of the CDFI industry and customers when subsidy becomes an important component of successful product delivery. Rather than having a direct relationship as in the other two structures, it appears that the role of subsidy disrupts the customer interface focusing attention on investors/funders and the regulatory process. Because the target market consists of a mostly low-income population that cannot fully afford the goods and services provided, the CDFI is forced to look elsewhere to cover its operating expenses and support continued delivery of its products.

Another important dynamic emerges among growing organizations and their relationship with trade associations and other industry intermediaries, which changes over time. In the early stages of development (the entrepreneurial stage of the previous organizational scale model), small organizations are often fairly self-sufficient as they seek to meet and satisfy customer needs. It is only when they begin to pursue growth that internal systems are challenged and organizations begin to look outside for support to assist in their growth and development. For example, at very small sizes of operations, community development credit unions are fairly self-sufficient, yet their impact is limited because they don't offer a full range of products or serve a lot of people. Also, their interaction with the trade association and other intermediaries may be limited, possibly only to attendance at annual conferences.

Once they decide to grow, however, the relationship with the industry intermediary expands and often includes discussion of issues such as capitalization, organizational structure, strategy, and other fundamental aspects. At some point, organizations reach a size where they have the relationships necessary to support continued growth, with, one hopes, a higher level of impact. And the relationship with the end customer can become closer and more direct.

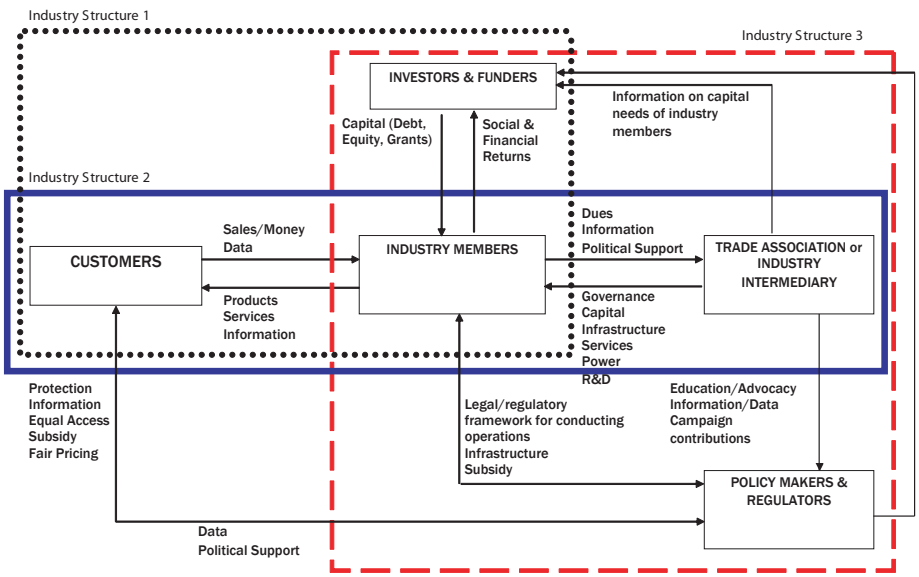
A critical issue raised by this industry model is the ability of the trade associations/industry intermediaries to provide the full range of services needed by industry members as they grow.

2. Illustration of the Model

a. The **Visa** case study demonstrates how Bank of America ultimately became the driver of a new industry within consumer finance, the credit card industry. In 1958, the bank piloted this product in Fresno, California, a town of 250,000, 45 percent of whom were bank customers. Obtaining merchant buy-in was essential to success, but on a small scale was relatively easy. As it expanded to additional markets, the bank needed to maintain the support of two key constituents: customers to use the cards and merchants to accept them. As the product was rolled out to more geographic areas, the bank developed partnerships through licensing arrangements with other banks, thus allowing for broader use of the card beyond the market reach of individual banks.

As the industry grew, the bank was compelled to expand the key constituencies from customers and merchants to include licensees. After less than a decade, the card had wide distribution, but was increasingly encountering obstacles. In addition to the challenges of operating without formal operating guidelines or means of sharing information between partner banks, there were technical problems such as, inter-bank clearance procedures – the

Diagram 4: Industry Model



means by which a bank in Ohio could handle the card purchase of someone visiting from California.

To expand the market for the product and reach scale, a member-owned company was formed that licensed access to the system and the Visa name to participating banks across the country. Bank of America was responsible for much of the industry's initial infrastructure and the widespread roll-out of credit cards. With the creation of Visa, the constituency base included not only the customers and merchants, but the member banks and investors in the company.

b. Unified Western Grocers (UWG) resulted from the merger of two West Coast cooperatives and now serves independent grocers throughout the western United States. UWG is an example of how thousands of small-scale institutions can pool resources and compete with larger companies.

In this industry structure, a trade association or intermediary helps smaller members compete with industry leaders. The solid box in Diagram 4 reflects this relationship between customer, small-scale industry member and trade association/intermediary. UWG provides governance, capital, services (including R&D), and infrastructure to industry members. Since many small industry members have problems accessing capital markets, an industry intermediary such as UWG can act as a bridge. UWG also assisted industry members in dealing with a radically changing customer base.

D. Conclusions about the Three Models for Achieving Scale

Despite the complexity inherent in each model for achieving scale, it is important to focus on the bigger picture—the relationship between each scale model. The research suggests that successfully achieving scale at the product level is a necessary precondition to the possibility of achieving it at the organizational level. Also, there must be a robust set of organizations actively delivering similar products and services prior to successful scale up at the industry level.

Across the case studies, several themes emerged that represented clues to successful scale up. A number of regularly repeated "key success factors" helped organizations get to scale:

1. Projected profitability of new products was a primary driver of product development; the ability to produce a diversified yet complementary set of products was critical to achieving scale.
2. Demand for services or a clear market gap also represented primary drivers in determining which products and services to scale up.
3. Geographic expansion was central to generating sufficient volume of transactions to reach scale.
4. Significant investments in infrastructure were crucial to successful growth. Investments often increased integration of operations and facilitated product development.
5. Investments in technology often led to increased efficiency and cost savings.
6. Companies partnered with organizations that had specific knowledge or expertise in an area that the growing organization did not, or where the partner produced a needed component of the product or service the company wished to provide.
7. At strategic points in the growth and scale process, growing companies raised significant capital, often in the tens of millions or more, to further the growth process.
8. Several organizations in the study changed their legal structure to accommodate future growth.
9. The regulatory or policy environment can play a central role in driving and/or facilitating expansion and growth to scale.
10. Successful organizations recognized that different management skills are needed at different points in the growth process, and accessed the requisite skills through a variety of means.
11. The ability to adapt to changing market conditions in a timely manner was critical for organizations to survive and grow.

The table on pages 14 and 15 links the lessons to key points found in the six case studies that provided the illustration to the models appearing above. In the diagrams and case studies at www.aspeninstitute.org/scalecasestudies, a table with a complete set of lessons, including the remaining four cases studied can be found. In each, the left hand column offers the lessons while the names of the organizations are aligned along the top row and the information drawn from the cases displayed in the resulting grid.

Section V. Tactical Approaches to Achieving Scale: Lessons for CDFIs

The challenge before the CDFI industry lies both in deepening our understanding of the three models for scale and in identifying the specific steps that need to be taken to move the industry forward. The industry must develop strategies to support growth and development at each level of the scale effort.

A valid question is: Where are the practical points of intervention that will move the industry forward? This section presents a more detailed description of the

lessons drawn from the cases that suggest tangible steps toward greater scale in the industry.

Lessons 1 and 2: Projected profitability of new products was a primary driver of product development; the ability to produce a diversified yet complementary set of products was critical to achieving scale. Demand for services or a clear market gap also represented primary drivers in determining which products and services to scale up.

In most of the for-profit cases, product profitability, not size or scale, is the driver for implementation of new products and services. Product profitability as a driver for developing products and services generally relies more on product "pull." In successful cases of reaching scale, the company identifies and quantifies market demand for the product or service, either through extensive data collection and analysis, or familiarity with specific market segments gained through past experience in serving these segments. The anticipated demand and use of the product prompts experimentation, innovation, and pilots during which market demand can be fully tested through customer feedback loops prior to roll-out. In this instance, market research is an inseparable component to experimentation, testing, and innovation.

Product development in community development finance is often driven less by demand and more by need in the community. The approach often involves a product "push" model where CDFIs see a need for certain services in their communities (e.g., charter schools or child care centers) and proceed to create financial products to meet those needs. Products are delivered to low-income communities through a process designed to educate the consumer about the value of the product or service, but not designed to collect additional data for determining the characteristics of customers, or extent of the market opportunity.

Market research beyond simple needs assessment and based on a thorough understanding of customer needs is essential for developing scalable, profitable products.

Rarely do CDFIs evaluate products to the extent described by firms in the product scale model. The product development process engaged in by most CDFIs only occasionally reaches the level of complexity described in the model. CDFIs, therefore, rely upon the market knowledge of staff and board members. This approach serves some organizations well, though the narrow focus on a local target audience may limit the organization's ability to see broader market opportunities and reduce the potential of the organization to reach significant scale.

In addition, when creating the product and defining the critical product attributes, CDFIs most heavily weigh factors that make the transaction affordable to the borrower and moderately weigh factors that lead to cost recovery. Product pricing, however, must move beyond cost recovery to include a healthy profit margin that ensures financial stability and the opportunity to offer the same product the following year.

Not all products must be profitable, but the overall product mix must be profitable if a CDFI is to be sustainable. Product mix and profitability is under-studied in the development finance field.

Product profitability directly impacts the level of subsidy required to operate the organization on an ongoing basis. While not every product has to contribute to an organization's bottom line profitability, at least some of them must if the organization is to be sustainable. Product mix and profitability is under-studied in the development finance field, and more research is needed to help organizations develop a more sustainable product mix.

While an unprofitable product mix may be sustained through subsidy at a small scale, as the organization and product lines grow, so does the subsidy required.

A principal barrier to scale may be the inefficient use of subsidy.

For example, a $2 million loan fund that requires an annual operating subsidy of $300,000 may dependably raise this amount from its current set of funders. If the loan fund grows to ten times that size or $20 million, the required operating subsidy will also increase. The fund may not have to raise $3 million (ten times the original amount of subsidy) due to increased efficiencies, but having to raise even half that amount may prevent the organization from achieving its growth objectives.

Clara Miller explores the role that growth has on the capital structure of nonprofit organizations and introduces the concept of core versus subsidy businesses. Growth in the core business, even when driven by grant support, without growth in the subsidy business, can place the overall institution at risk.[3] Thus CDFIs, despite successful fundraising, may be at their most vulnerable during and immediately after high growth periods.

CDFIs, despite successful fundraising, may be at their most vulnerable during and immediately after high growth periods.

Table 1: Lessons from the Case Studies Part 1*

Lesson or Theme	7-Eleven, Inc.	Banknorth Group, Inc.	Allied Capital and BLX	ACCIÓN	VISA	The Reinvestment Fund
1. Product Development and/or Acquisitions	New product introduction based on profitability potential within market niche.	Product diversification and enhancement was primary factor contributing to growth. Profitability was driving force in new product introductions. Gained management talent through acquisitions.	Enter new lines of business only where significant profit potential exists and exit where margins are shrinking. Growth secondary goal, product profitability and risk management primary goals.	Detailed product development process ensures that new financial products meet a real market demand and are profitable.	This product consolidated several bank loan and credit products into a simplified cost-effective system.	Product development grows out of experience base: asset-based lending (housing, commercial real estate) to business lending and then higher risk venture investing. New products added based on reasonableness of risk profile.
2. Demand/Market Opportunity	Significant demand for check cashing for banked and unbanked. Location is key.	Better serve customers; compete head-on with larger regional banks.	Value added business in financing what other financial institutions would not. Offer broad range of financial products, but emphasis (push) based on market conditions and opportunities.	Three billion people in the world live on $2 a day with few options for employment. Many start small enterprises to make a living, but lack capital to grow these nascent businesses.	Creation of a universal credit device: widely accepted, provide full identification and bank authorization for purchases.	Wealth creation and poverty alleviation for low-income individuals and communities in 12 counties of the Delaware Valley region.
3. Geography	Staged introduction of new product into stores with high volumes of money order business.	Broader geographic reach was primary factor contributing to growth.	Bulk of Allied's lending initially on the East Coast, then expanded nationally in the mid 1970s.	Created new affiliates and partnerships in different geographies to meet demand for services.	Broad geographic acceptance of Visa card was critical to profitability and success of venture. Geographic coverage achieved through partnering with banks across country.	Expanded targeted geography from primary 9-county to 12-county region spanning Pennsylvania, Delaware, and New Jersey.
4. Infrastructure	Critical to success. Purchased from technology partners, not developed internally.	Had to integrate acquired businesses and reconcile cultures. Integrate management, transaction processing, personnel, and lending systems across formerly independent organizations. Improved with each acquisition.	Investments in infrastructure and system upgrades at particular points of rapid growth critical to long term success. Consistent underwriting maintained through corporate credit committee, with credit policies carried out at operating division level.	Designed to support affiliate MFI operations & raise capital (both loan guarantees & equity investment). Created "resident advisor" positions in 20 countries to deliver more in-depth TA.	Infrastructure necessary to clear transactions, operate the system, share information, and resolve problems could not be created by any one institution.	Centralized loan administration and processing. Written policies for underwriting and lending by financial product. Tiered loan loss reserves based on risk profile of loan product and proportion in portfolio.
5. Technology	Investment in technology leads to efficiency, cost savings, and convenience for customer.	See above.	See above.	Adapting credit scoring tools & data mining to microfinance. Created ACCIÓN PortaCredit™ software for use of handhelds by loan officers in the field.	Technology was central to success of card. Once initial system is up and running, continued investment in upgrades is required.	Information and technology plan developed to upgrade information systems to provide all staff access to information on borrowers and investors.

*For lessons from remaining case studies go to www.aspeninstitute.org.

6. Partnership	Strategically selected to enhance business success; e.g., financial technology partners. Avoid vertical integration.	Any partner of strategic importance was acquired.	BLX, a portfolio company controlled by Allied Capital, reaches into underserved markets by partnering with groups representing the target constituency.	Partner with individuals and organizations to provide TA at an affordable price to entrepreneurs. Partner with local banks through Bridge Fund, which provides a guaranty to leverage bank resources.	All banks in system.	Bank partnership through "Collaborative" that organizes market for lending for affordable housing; leverages resources and positions TRF as industry leader.
7. Capital Sources and Requirements	Increased significantly at each stage of product development.	Earnings, issuance of new stock, use of existing stock for acquisition.	Capital raised through frequent offerings to mainstream capital markets (100 million shares outstanding on NYSE). Utilize different, often innovative, structures (e.g., REITs) to raise money.	Financial sustainability and profitability must be pursued alongside growth otherwise, the larger the organization grows, the greater the funding gap. Self-sufficiency is difficult. No more than 1% of the estimated 7,000 micro-lenders are self-sustaining.	Earnings, initially BofA and then by member banks at later stages of development.	Created task force to develop approaches to increasing access to capital for the organization. Looked at outside sources (especially individuals) as well as improved operating revenues.
8. Organizational Structure	Not raised in case study.	Shifted organizational structure from limited savings bank to commercial bank charter to accommodate growth. Integrated all acquired entities under a single bank charter.	Restructured company from five affiliated to a single corporation to facilitate growth and satisfy investor base. Non-bank structure of BLX has helped attract minority customers who were uncomfortable with banks.	ACCIÓN changed the structure of affiliate PRODEM from a nonprofit to a commercial bank, Banco Sol, to access larger pool of capital.	Created a new institutional structure: non-stock, member-owned company operating on a not-for-profit basis.	Restructured Collaborative into syndicated credit facility to lower its cost of capital. Created organizational subsidiary depending on its role and financing needs; e.g., limited liability corporation to raise venture capital funds for business investing.
9. Regulation/Public Policy	Not raised in case study.	Able to make acquisitions and enter new lines of services (e.g., insurance) because of bank deregulation.	Its business development company structure provided a tax incentive.	Not raised in case study.	Banking laws limited lending activity to one state. This forced BofA to partner with banks in other states in order to expand their market.	Existence of the CDFI Fund helped TRF grow through capitalization.
10. Management	Gaps in management expertise addressed through partnerships above.	Management expertise added through acquisitions.	Selectively brought in new people to add management and other skills as needed.	Success of MFI partners heavily relies on local management.	Specialized payment system required hiring of managers knowledgeable about all aspects of the system.	Key issue was freeing CEO of day-to-day management tasks so he could focus on corporate growth strategy. Recruited needed expertise at board and staff level.
11. Adaptive Ability	Expanded convenience store concept to include financial services in response to customer demand.	Flexibility, vision, adaptive management.	Regularly changes product mix in response to market conditions.	Maintains mission-driven focus, but embraces ongoing change in organizational structure and product mix, using business-like approach for social objectives.	Moved decisively to retool the credit card product, quickly dropping unprofitable merchants and delinquent accounts.	Early identification of market opportunities critical to success.

Lesson 3: Geographic expansion was central to generating sufficient volume of transactions to reach scale. It was also the case that the scaling up of a product involved expanding its availability to new markets or geographies as well as developing complementary products or services. Geographic expansion was fundamental to the business model for both Banknorth and ACE Cash Express. In the case of Banknorth, expansion was achieved principally through acquisition, while ACE employed both acquisition and new outlet opening.

> Scale cannot occur without sufficient geographic or programmatic scope.

In those instances where an organization has a profitable set of products, expanding the market for the sale of those products is a critical factor in getting the organization to scale. Yet, the geographic expansion of a community development organization's service area is often at odds with its original mandate and with funder desires. The organization must resolve the conundrum of having to expand geographically to reach scale while still meeting local needs to retain funding. There has been expansion of some organizations' service areas, but few industry-wide examples exist.

Lessons 4 & 5: Significant investments in infrastructure were crucial to successful growth. Investments often increased integration of operations and facilitated product development. Investments in technology often led to increased efficiency and cost savings.

The business model for organizations studied required a relatively complex coordination of productive activity across several lines of business, each with a range of product offerings, often delivered through multiple departments. In every case study, there was a significant and well-planned series of investments in infrastructure and technology.

> In getting to scale, products and services must become more standardized to facilitate their delivery through infrastructure.

Infrastructure consists of the base systems and resources available to an organization that enables it to conduct business. The language of "creating" infrastructure is relatively foreign to the nonprofit world, yet the existence of infrastructure is a benchmark for the widespread implementation of an idea.

In getting to scale, products and services become less idiosyncratic and more standardized. They can no longer depend on one or two experts, but must be able to be delivered by anyone anywhere (see the ACE Cash Express case explaining their software interface). Infrastructure and technology facilitate the delivery of multiple products to a customer, assist in cross-selling of products, maintain quality production, inform customers and employees that interact with customers or who need information to complete their part of the production process. These functions may be handled within the company, between the company and a vendor, or with multiple vendors handling discrete functions.

CDFIs are generally vertically integrated institutions with all financing functions performed in-house. It has been difficult for CDFIs to develop specialized expertise across the many functions required in an increasingly sophisticated industry. This has limited the range of services available to low-income communities and the growth of the CDFI field. One way to address this issue is through investment in infrastructure. Appropriate infrastructure would: 1) provide support for CDFIs across a range of financing activities and instruments (secondary market transactions, institutional rating systems, new product development, etc.); 2) develop useful technology (for portfolio management, accounting, internal systems and procedures, communications, marketing, etc.); and 3) generally broaden the range and increase the sophistication of the financial product and service mix offered by individual CDFIs.

> An industry of small, vertically integrated institutions with limited resources cannot be expected to scale up solely through the growth of individual organizations.

Unfortunately, more commonly CDFIs focus on development and testing of new products and programs. Some attribute this to funder fatigue or a funder's constant desire for innovation, but the consequences can be serious. Very little investment and energy goes into the thoughtful development of infrastructure for CDFI organizations. By contrast, the private sector regularly invests in infrastructure because the rate of return from increased efficiency and sales volume translates into increased profits.

> The principal focus in the CDFI field is toward the development of new products. Scale cannot occur without significant investment in infrastructure and technology.

As Miller notes, "In the business sector, profits are used to fund working capital and other growth needs. During growth or start-up, businesses budget for unprofitable years, sometimes several of them, and have tools to plan for and fund these deficits. With these planned deficits, the business is investing to build the market and infrastructure it needs to

> CDFIs cannot finance infrastructure from future profits and rarely are able to obtain outside capital that supports infrastructure development.

succeed. Among nonprofits, profit margins are frequently thin, discouraged, or simply prohibited. Both government contracting and nonprofit culture discourage the development of operating surpluses or induce nonprofits to hide them."[4]

CDFIs cannot finance infrastructure from future profits and rarely are able to obtain the outside capital that truly supports infrastructure development throughout the entire operation. Although a series of grant funds can be raised for the design, development, and construction of infrastructure, the relatively limited amounts build only a certain amount of infrastructure. Even the most significant source of capital for the field in recent years, the CDFI Fund, is increasingly product-driven and concerned less with overall business strategy and more with a few measurables. The efficiency benefits produced by investments in infrastructure, however, can reduce the amount of subsidy needed per transaction extending the life of this limited resource, expanding the range of services that can be provided, and potentially increasing impact.

Technology upgrading is a typical infrastructure investment to improve operational efficiency, and reduce costs. To make meaningful strides toward shared technology platforms, the industry will have to address several questions. What is the pallet of business technologies that are available? What is needed by the development finance industry, or by different CDFIs? How willing are funders to invest the significant dollars needed to bring the industry into the 21st century?

Lesson 6: Companies partnered with organizations that had specific knowledge or expertise in an area that the growing organization did not, or where the partner produced a needed component of the product or service the company wished to provide.

Organizational competency, capacity, and compatibility, should be the key to identifying strategic partners.

Partnerships occurred most frequently where an organization did not have the technology or could not construct the infrastructure to succeed in a particular line of business. Thus, the partners provided a key component enabling the organization to deliver a product or service at scale.

The challenge to identifying an appropriate partner lies in clearly understanding one's organizational strengths, weaknesses and needs. CDFIs often focus on identifying partners with similar values and commitment to social mission. While important, the central criteria should be the capacity and capability of the partner. These partners must have the required technical capacity, sufficient infrastructure, an audit process that ensures quality, a proven track record, the ability to analyze and correct problems as they arise, and adequate capitalization and staying power.

The relatively small size of CDFIs can be a major challenge in partnering with larger, more powerful private sector organizations who may perceive the limitations of small organizations as a lack of sophistication, professionalism, and timeliness.

One challenge to structuring partnerships in the field can be the relatively small size of CDFIs in contrast to a larger and more powerful partner. The impression is that small institutions may operate without the level of standardization, infrastructure, and even professionalism to which a large partner is accustomed. For private sector companies, the ideal CDFI partner is one with sufficient scale of operations, organizational stability and sophistication, credibility, and the capacity to implement product sales and growth at the rate needed by the partner, anticipating and/or addressing problems in stride.

Lesson 7: At strategic points in the growth and scale process, growing companies raised significant capital, often in the tens of millions or more, to further the growth process.

Capital requirements for getting to scale are significant, occur at each level, and increase from the product to organization to industry levels of analysis. As the product model indicated, each critical step from research to pilot and ultimate roll-out requires progressively more investment. The ability to take a product to scale can mean a commitment to invest millions of dollars. Organizations also require additional resources for critical investments in infrastructure, which will result in greater efficiency.

In the 7-Eleven case, the capital needed to develop the V-Com increased by multiples of ten at each stage of product development. Banknorth used a combination of internal earnings, existing stock, and issuance of new stock to purchase new lines of business and expand operations.

The models point to several under-funded areas essential to the future of the CDFI industry and its potential to reach scale. Among these are:

- Market research – to understand demand for new and existing products and market trends
- Patient capital from funders that understand the R&D process – CDFIs often fear the repercussions from funders for not proceeding with proposed products, even when the R&D process legitimately –

Not only are the current amounts of capital inadequate for scale-up, but the types of capital available can be counter-productive to growth.

and successfully – leads to a decision not to pursue a product

- Infrastructure development, both at the organizational and industry level

Lesson 8: Several organizations in the study changed their legal structure to accommodate future growth.

At certain points, organizations can outgrow their initial organizational or legal structure. Several of the successful organizational scale cases reached certain points at which they changed their legal structure, established related or affiliated businesses with more flexible structures, or consolidated multiple affiliates under one structure. All of these shifts facilitated future growth and development.

Banknorth shifted its structure from a limited savings bank to a commercial bank charter to accommodate growth, and thereby integrated all acquired entities under a single bank charter.

The constraints to growth inherent in the current legal structures under which the CDFI industry operates need to be systematically researched and explored.

VISA created a new institutional structure: a non-stock, member-owned company operating on a not-for-profit basis that extended its reach in the market by attracting a greater number of bank members.

ACCIÓN transitioned several of its affiliates from non-governmental organizations to regulated bank holding companies. The structure allows each bank to collect deposits and fuel its microlending activity.

Allied Capital restructured from five affiliated businesses to a single corporation to consolidate its capital, satisfy its investor base, and facilitate growth.

CDFIs utilize a range of legal structures from nonprofit to for-profit. There are "best practices" around more complex structures to support growth, but the actual lessons from these experiences are limited and seemingly driven by circumstances unique to an institution. A great deal more information about how and why CDFIs might shift structures is needed.

Lesson 9: The regulatory or policy environment can play a central role in driving and/or facilitating expansion or growth to scale.

Regulation and the policy environment can affect CDFIs dramatically.

Certain policy initiatives have resulted in major growth and capacity for CDFIs:

- The low-income housing tax credit fueled the growth of millions of units of affordable housing by providing a consistent source of funds for development.
- The Community Reinvestment Act (CRA) ensures that mainstream financial institutions remain engaged in low-income and underserved neighborhoods. Often banks convinced that they cannot serve an area or community profitably invest in CDFIs that provide capital for the financial services they cannot directly undertake.

Policy and regulation is a major driver in the CDFI field. Policy initiatives must focus on supporting organizations, not merely product development or delivery, to promote scale-up.

- The founding of the CDFI Fund at the U.S. Treasury Department has provided investment of millions of dollars in CDFIs working to improve low- and moderate-income communities.
- Regulated CDFIs such as community development banks and credit unions raise billions of dollars of capital in the form of deposits, some locally, some from investors outside the community, to be reinvested in the communities they serve.

Changes in policy can be the most effective mechanism for adjusting the landscape within which firms operate and provide the necessary stimulus for economic activity that might not otherwise be undertaken by financial institutions and other private players.

Lesson 10: Successful organizations recognized that different management skills are needed at different points in the growth process, and accessed the requisite skills through a variety of means.

The research showed that successful organizations either grew management capacity internally, retained the skills in businesses acquired, or brought in new skills and expertise at each stage of development. While they accessed management skills in different ways, they all shared a common focus on acquiring the management skills necessary to successfully navigate each stage of development.

Banknorth acquired management skills and expertise through acquisitions, retaining existing personnel to manage these new lines of business. This practice not only expanded their lines of business, but also the breadth of management skills and expertise within the company. The Reinvestment Fund strategy focused on consistently removing the CEO from managing day-to-day operations by bringing on individuals with operational expertise. This enabled the CEO to focus on strategic decisions for the organization.

The CDFI industry requires a diverse range of skills and expertise in management and staff. Many CDFIs, however, are constrained by limited management capacity and

must develop or hire the management talent they need to achieve scale.

> Operational expertise is critical for scale-up. CDFIs must have a strategy for acquiring, attracting or training individuals to have appropriate skills at each stage of development. This may require significant up-front investment.

Training programs across the industry are often too general and do not address the expertise needed at each stage of product development and organizational growth. Some trade associations have begun developing more specialized training for their members, but it is challenging to deliver at diverse organizational size and skill levels.

Lesson 11: The ability to adapt to changing market conditions in a timely manner was critical for organizations to survive and grow.

"In reality, change is the norm and stability is an aberration."[5] In the past few decades, the speed at which market conditions shift has increased with each advance in technology. More than 60 years ago, economist Joseph Schumpeter described the capitalist process as "creative destruction," where the very nature of market evolution is to weaken some companies while creating opportunities for others.

In the financial services industry today, the ease and convenience of service is a major component of success. Low-income communities also demand convenience. A community lender that pursues an outdated model for assessing risk and delivering capital may no longer be competitive when market conditions shift.

> A new breed of financial service providers are delivering services to low-income individuals using a business model that emphasizes convenience and generates profitability.

One of the many major shifts in the market is the increased availability of capital going into low-income communities. Some of the capital providers are considered predatory. The threatening dynamic is that this new breed of financial service provider has developed a business model that allows it to deliver credit and other financial services in a manner responsive to the needs of low-income individuals, offers a product mix and pricing structure that generates profitability, and has invested in an infrastructure that allows convenient access to services.

CDFIs tend to respond more quickly to shifts in policy than to changes in the market, yet every organization studied took advantage of or successfully responded to changing market conditions. More research is needed into the changing nature of market gaps and the potential for CDFIs to effectively address emerging financial needs.

Section VI. Conclusion: What the Research Reveals

1) If achieving scale in the sense of reaching larger and larger numbers of people is truly our goal, our thinking must shift from the current focus on product innovation to product delivery and from developing products to developing organizations and the industry. The funding environment must parallel these shifts.

Scale is often pursued as a means of increasing the impact that development finance investments have on low-income communities. Scale, in this context, is defined by the volume of product delivered, and many funders spend time counting the number of loans made or housing units constructed. By only considering the scale effect and its associated demands at the product level, the field severely limits its ultimate impact. Expanding our focus to include the organization and industry level dynamics can contribute useful insights for our long-term success.

In its pursuit of impact, however, the field cannot expand indefinitely the amount of product an organization delivers without scaling up the organization. Organizations need a well-developed set of standards, procedures, and infrastructure for producing products. Current public sector and foundation funding streams may actually constrain the scale-up of organizations by limiting the use of funds to enhancing product affordability and promoting innovation and new product development—none of which speaks to the development and strengthening of the organization's long-term viability.

Similarly, paying attention to scale effects at the industry level would support greater and more efficient delivery of product. Better delivery will come about by focusing the field on improving standards and infrastructure, resulting in greater volume and ultimately, one hopes, producing a more powerful impact.

Equally important, most for-profit organizations use internally generated revenues/profits to support R&D and investment in the growth and scaling up process. As currently structured, subsidy in the industry targets the product level (for example, LIHTC go to specific transactions to create a specific number of affordable housing units) and ignores the subsidy, or more accurately the cash reserves, required at the organizational level to support growth. This emphasis does not allow individual organizations to build the capital structure they need to grow.

Achieving scale and impact may mean something different or take a different route than originally anticipated. Aside from delivering a product or service at steadily increasing volume, one might think in terms of achieving a significant market share in a target area that is big enough to

influence a market and change the behavior of other actors. This market development or demonstration effect requires further study in order to understand its value and contribution to achieving better development outcomes.

2) If we seek to achieve greater scale, we must optimize our use of subsidy.

Subsidy is the scarcest type of capital, and many forms of subsidy appear to be decreasing in availability. The granting and use of subsidy needs to become more strategic.

- Developing market research tools that more effectively differentiate between the needs of different segments of low- and moderate-income customers and the level of subsidy each requires will facilitate more appropriate pricing of products and utilization of subsidy. In the long term, the amount of subsidy per customer can be reduced and overall reach extended.
- Broadening the focus of CDFI services to include more traditional customers would allow for the cross-subsidization of products, an important aspect of any business model that seeks to provide a range of services, not all of which are profitable to its operation.
- Finding an adequate product profitability mix and tightening operations to obtain greater efficiencies will enable organizations to support existing lending and investing activities better. Capital raising efforts targeting future growth must support both these core business activities and needed support services that would otherwise not be possible (counseling, technical assistance, etc.).
- The language of investment conveys more power and a positive sense of value than the language of subsidy. Can we shift the terms of debate from the provision of subsidy to investing for an economic and social return? This should increase both the pool of capital and the investors and link subsidy to the social goods and value added identified.

3) Any strategies for achieving scale in the CDFI industry must address fundamental issues of industry structure.

As indicated in the model above, an industry of small, place-based institutions with limited resources cannot be expected to scale-up solely through the growth of individual organizations. The CDFI industry is composed primarily of small-scale organizations with only a handful that have grown to a large enough size to exert influence in their local or regional markets. And none are of sufficient size to influence the market on a national level or to serve as the industry driver. If the CDFI industry is going to pursue scale, industry structure becomes more important to that process.

As the industry is currently structured, the pace of organizational growth will limit the industry's reach into the low-income markets targeted by its members. In order to reach more people with value-added services, the industry will have to pursue other means than individual organizational growth.

Two emerging directions for the industry need to be further investigated:

- The development of or access to stronger infrastructure for networks of organizations working collectively to deliver product or influence a market
- Greater integration of the field's activities into those of mainstream financial institutions, focusing on the value added by CDFIs

While the next phase of our research will delve more into these directions, following are some initial observations.

Stronger infrastructure: The case of Unified Western Grocers offers some guidance as to how cooperation among small players can lead to improved economies of scale, better industry-wide infrastructure, and ultimately better competitive positioning and greater influence over the marketplace. For the CDFI industry, which operates on very thin margins, collaboration around collective infrastructure can support a broader range of financial service delivery and improved efficiency. Well designed infrastructure will enable organizations to offer a broader range of services, and increase the sophistication of the product mix and professionalism of the industry. New strategies and ideas that focus on forming stronger networks of interdependence for cooperation among industry members should be researched and tested.

It may not be necessary or desirable to *create* infrastructure in every case. The private sector has made substantial investments in infrastructure and there are instances where CDFIs have outsourced certain functions, effectively leasing the infrastructure they need from third parties.

Greater integration into mainstream financial institutions: CDFIs owe their existence to a market failure by "conventional" financial service providers in meeting the financial service needs of low- and moderate-income communities. History shows us that community development products and services that show promise of potential profits and scale are often tested in community development organizations and adopted by mainstream financial institutions. This raises two interesting questions about industry structure. First, what are the appropriate roles of CDFIs? The research and development arm of more conventional financiers? A broker of relationships between low-income communities and mainstream

financial institutions? Others? Second, how does one best structure relationships between CDFIs and the mainstream? Regardless of whether the mainstream industry adopts successful community development products and services, those products will undergo tremendous change in their transition to conventional product profitability standards. The heart and soul of community development is ensuring that low-income communities have access to needed services. As the financial services industry continues to evolve, much more research is needed on appropriate industry structure, and critical roles for CDFIs.

4) Growth is perilous.

The current emphasis on growth in the industry seeks to reach more people, tap into economies of scale, increase sustainability, and ultimately have greater impact in the low-income communities we serve. In our zeal, we cannot overlook the fact that smaller organizations are often self-sustaining because of the limited scope of their operations. Despite the fact that product offerings may be limited, the path of growth is not to be undertaken lightly. Organizations that commit to growth must plan carefully and seek sufficient investment to withstand the added pressures that growth brings. Following are a few areas of particular concern for any CDFI pursuing growth:

- Unbalanced capital structure – Rapid growth can drive down an organization's capital base. As assets increase, net worth in relation to total organizational assets declines, creating a less stable capital structure. For CDFIs that have a large percentage of their assets at risk (in the form of loans and investments), a declining capital ratio increases overall organizational risk. In the case of regulated CDFIs, this condition may precipitate a period of friction with regulators. For non-regulated institutions, it may actually limit their ability to attract funders because the organization is perceived as too risky, or cannot meet desired net asset or capital to asset ratios.
- Stretching management – Growth requires leadership to develop a new set of management skills. During a period of growth, the CEO will often need to move toward a more strategic or big picture role (see TRF case study); however, this means that the actual operations, now more complex, must be undertaken by experienced operations managers.
- Running ahead of infrastructure – For many small CDFIs with limited profit margins, the ability to invest in infrastructure is limited. Thus, many institutions will begin to grow their activities assuming that the business will enable them to purchase the needed infrastructure as they grow. This assumption can have disastrous results if new lines of business are not delivered in a high-quality manner (reinforcing an unprofessional image), and can raise the potential for neglecting existing lines of business. A CDFI must identify the appropriate infrastructure needed at each level of scale and design a strategy to obtain it. This may mean greater investment in internal systems, or outsourcing of key functions to ensure competent handling at greater volume.

These and other challenges to growth were common across cases, but are not discussed broadly in the current dialogue about growth in the CDFI industry. A more informed and candid conversation about the feasibility, desirability, and potential impact of achieving scale needs to occur.

5) It's ultimately about impact. Achieving scale is only one way to achieve impact, and single mindedly pursuing scale by expanding the volume of product delivered reduces the broader impact of community development interventions.

The relationship between scale and impact is still not clearly understood. On the one hand, scale may be only one way to reach impact. On the other hand, by concentrating primarily on scale and how to achieve it, we run the risk of losing the focus on increasing impact on underserved people and communities.

- Achieving scale is not possible for many organizations in our field, and it may not even be appropriate. Many organizations can and should look at other measures; e.g., the depth of the transformative effects of their work on a group of individuals or a community, or the value-added that they bring as a community player.
- Policy and regulation can affect far larger numbers of individuals or communities than the delivery of a financial product. While the role of policy and regulation has not been a focus of this paper, it is one of the most critical drivers in the CDFI industry, and potential policy solutions to some of the issues raised in this paper should be considered.
- Becoming sufficiently expert, connected, credible, and resourced as an organization to affect an issue or a market is yet another strategy for impact. While an organization has to reach some significant size to have financial clout, it may not be necessary to become an industry of $500 million or billion dollar institutions to have an impact on poverty and ensure the delivery of financial goods and services to a low-income community.

If impact is the goal, we need to more clearly articulate our theory of change and develop better metrics to measure and track impact that extends beyond scale.

Notes

1 Moy, Kirsten and Alan Okagaki: "Changing Capital Markets and Their Implications for Community Development Finance," *Capital Xchange*, July 2001; available from www.brookings.edu/es/urban/capitalxchange/article5.htm; Internet.

2 Where profit from one product supports a shortfall in another product in the same portfolio.

3 Miller, Clara, "Hidden in Plain Sight: Understanding Nonprofit Capital Structure," *The Nonprofit Quarterly*, Spring 2003. Subsidy business is defined as the agglomeration of resources, activities, systems, procedures, and protocols enabling a nonprofit organization to raise the funding needed to support its core business(es).

4 Miller.

5 Morris, Langdon. *Business Model Warfare: The Strategy of Business Breakthroughs* (University of Pennsylvania and A-CASA, 2003).

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