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Business Development Financial Institutions: Theory, Practice, and Impact

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Abstract

Over the past decade, many communities have sought to promote their economic development by launching business development financial institutions, or BDFIs for short. A BDFI is a private financial institution that seeks to advance the economic development of a community by providing loans or equity capital to small- and medium-size businesses in a targeted region. BDFIs can be for-profit or not-for-profit entities, but to qualify as *development* financial institutions, they must be willing to accept below-market rates of return on their capital in order to further community economic development goals. Major funders of BDFIs have included local and state governments; the federal government, primarily through its Community Development Financial Institutions Fund; commercial banks, largely motivated by tax credits and the Community Reinvestment Act; and philanthropic foundations.

In this paper, we analyze the economic development theory underlying BDFIs. We examine their business practices and discuss efforts to quantify their development impact.

Business Development Financial Institutions:
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I. INTRODUCTION

For decades, local and state governments have conducted regional business development efforts, usually using tax incentives, low-cost loans, or promises to improve local roads or other public infrastructure, to entice large employers to locate or remain in a targeted community. In recent years, organizations in some communities have tried a new approach to community economic development. They have started business development financial institutions, or BDFIs for short. A BDFI is a private financial institution that seeks to advance the economic development of a community by providing loans or equity capital to small- and medium-size businesses in a targeted region. BDFIs can be for-profit or not-for-profit entities, but to qualify as *development* financial institutions, they must be willing to accept below-market rates of return on their capital in order to further community economic development goals.

BDFIs are a subset of community development financial institutions (CDFIs). Most CDFIs finance the development of housing for low- and moderate-income households. Although BDFIs are community development financial institutions, they deserve their own label, BDFI, to distinguish them from the larger group of CDFIs that do not provide business development financing. BDFIs are also distinct from microenterprise loan funds. BDFIs usually work with already existing businesses that employ three or more people. They rarely make loans or investments under $25,000, and some BDFIs commonly make loans or investments of several hundred thousand dollars. Microloan funds generally finance the creation or growth of small businesses intended to provide income to a single entrepreneur, and they rarely make a loan for more than $25,000. In most cases, the vast majority of their loans are for well under this amount. In making these distinctions, we should note, however, that some BDFIs are

affiliated through holding company structures with microloan funds and with CDFIs that finance housing development.[1]

Existing BDFIs have a variety of structures and funding sources. Most are organized as independent investment funds. Some are affiliates of banks and credit unions, but BDFIs are not themselves deposit-taking institutions since such entities cannot make the higher-risk loans or equity investments that are the niche of BDFIs. Some not-for-profit BDFIs have capital of several million dollars, generally obtained from philanthropic foundations and government grants. Many BDFIs function as intermediaries, borrowing from foundations or government agencies at below-market rates to finance their loans and equity investments. Numerous BDFIs have obtained some of their equity capital and debt financing from banks that are willing to receive a below-market rate of return on these funds in exchange for tax credits or to fulfill their Community Reinvestment Act obligations.

There is no official list of BDFIs as we have defined them, but many exist throughout the country. Prominent ones include Cascadia Revolving Fund in Washington, Coastal Enterprises in Maine, DVCRF Ventures in Pennsylvania, Enterprise Corporation of the Delta in Mississippi, Kentucky Highlands in Kentucky, Northern Enterprises in Michigan, Southern Dallas Development Corporation in Texas, and Southern Ventures in Arkansas.

Despite the variation across the regions in which BDFIs operate and differences in their funding sources and activities, most or all BDFIs share many general traits. This paper describes and analyzes those traits. In doing so, we do not imply that all BDFIs operate exactly in the manner we describe. Nevertheless, it is useful to examine a composite characterization of their activities to understand better what BDFIs do to promote community development and whether their efforts are effective. The next section discusses the economic development strategy of BDFIs, the third section examines economic

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[1]Shorebank Corporation, formed in 1973 under the name Illinois Neighborhood Development Corporation, pioneered the holding company structure for a development finance organization. In Shorebank' case, the holding company is centered around a commercial bank, South Shore Bank, that has several affiliated organizations devoted to real estate development, business lending, consulting, and other activities. For a thoughtful assessment of Shorebank's evolution and operations from its founding through the late-1980s, see Taub (1988).

theories that can justify the funding of BDFIs, the fourth section reviews BDFI operating procedures, and the final section analyzes efforts to measure the cost-effectiveness of BDFIs.

II. ECONOMIC DEVELOPMENT STRATEGIES OF BDFIs

All BDFIs work with at least one tool: an ability to provide financing to businesses in their region. In addition, many BDFIs have a second tool: an ability to diagnose and help remedy weaknesses in the management practices of businesses. A small number of BDFIs use a third tool: close working relationships with agencies that screen and train socioeconomically disadvantaged workers for employment positions with the BDFIs' business clients.

BDFIs differ somewhat in the way they use these tools to promote the economic development of a community. In some cases the differences arise from different beliefs about the most effective way to promote the economic development of a region or different priorities about the allocation of resources. In other cases, differences in BDFIs' financial and management capacities and differences in the socioeconomic characteristics of the regions in which they work lead to differences among BDFIs' development strategies. In any case, the vast majority of BDFIs express one of more of the following five economic development goals:

1. *Increase and retain employment opportunities for low- and moderate-income households*. BDFIs, by providing financing and technical assistance, seek to strengthen and expand businesses operating in lower-income communities. Since the ultimate goal of most such BDFIs is to benefit low- and moderate-income households, many assist primarily businesses likely to employ low- and moderately skilled individuals. The expectation is that the survival and growth of these firms will increase demand for local workers, raising household incomes as unemployed and underemployed workers fill these positions.

   Some BDFIs with this development goal add a qualification. They will only provide financing and technical assistance to firms likely to employ low- and moderately skilled workers and that pay "good" wages and offer "acceptable" benefit packages. The BDFI sets its own definition of "good" wages and "acceptable" benefit packages. Again, the expectation is that the survival and growth of these firms will provide local low- and moderate-income workers with more employment opportunities offering minimally sufficient compensation.

   Some BDFIs also emphasize that, in addition to the direct impact of increasing employment opportunities, their efforts may bring beneficial indirect effects. A BDFI might, for example, foster a spirit of entrepreneurship in the community, leading to additional business formations and jobs.

It could also encourage other financial institutions or businesses, which had previously assumed that there were no good business opportunities in the depressed community, to revise this assumption and to begin to look for investment and business opportunities in the community.[2] By stabilizing, and possibly expanding, employment opportunities in the community, a BDFI might slow or halt an out-migration of the population and, in some cases, "preserve a way of life." A revitalization of the community's economy can also increase residents' property values. It may increase local tax revenues, permitting the government to provide more public services. Finally, if a BDFI can demonstrate that firms can pay good wages to low- and moderately skilled workers and still flourish, this might encourage other firms to increase their compensation levels, or force them to do so in order to retain their workers.

2. *Induce firms to employ disadvantaged workers and to offer on-the-job training*. A BDFI may provide financing and technical assistance to firms that are willing to provide on-the-job training to low- and moderately skilled workers. It may also provide financing and technical assistance to firms that are willing to employ recent graduates from job-preparation programs serving lower-income households. The rationale is that the on-the-job training or entry-level employment experience gained by these individuals will likely raise their future incomes and the quality of lives of their families.

3. *Stabilize or expand businesses owned by women and racial and ethnic minorities*. A BDFI seeks to provide financing and technical assistance to such firms in the community. The increasing wealth of women and minority entrepreneurs helps remedy past, and possibly current, discrimination and increases their political power within the community. It may also increase employment opportunities for women and minorities if these firms disproportionately hire from these groups. If labor markets are segmented, the increased demand for minority or female workers could also raise their incomes relative to other workers.

4. *Increase the availability and/or quality of community facilities*. A BDFI may try to increase the availability of community facilities, such as child care and health-service centers, that it believes improve the quality of life in the region. A BDFI accomplishes this by providing financing and technical assistance to the for-profit or not-for-profit entities operating or contemplating starting such facilities. An increase in the availability of such facilities might also raise household incomes since health problems and a lack of affordable child care can be barriers to employment.

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[2]Thomas Miller, a former president of Kentucky Highland Investment Corporation (KHIC), explained that KHIC sought to promote the development of businesses in its ten-county rural region of Kentucky. It hoped that:

> New enterprises would bring not only new jobs and increased demand for services and supplies from local businesses, but opportunities for residents to gain business experience and knowledge of new industries. Bankers, local government officials, attorneys, accountants, small business people and potential entrepreneurs would become more familiar with large-scale business enterprises and the markets in which they competed. People would see neighbors succeeding and be more inclined to feel confident in their own entrepreneurial abilities and desires. These factors would in turn help stimulate and support development of indigenous entrepreneurship and increase enterprise formation rates in an upward spiral. The area's economy would move toward vibrancy, resiliency, and self-sustaining growth. Its narrow base of political and economic power would broaden. (Miller, 1994, p. 29)

5. *Promote the growth of environmentally benign businesses*. A BDFI may seek to accomplish this by providing financing and technical assistance to "clean" businesses that can grow with such aid, or that might flounder without it. As the local economy shifts toward environmentally benign businesses, this should improve the quality of life in the region.

Although this taxonomy is conceptually useful, we stress that many BDFIs fit in several of these categories. There are, for example, BDFIs that claim that they are pursuing all of these economic development goals at the same time. In addition, as this taxonomy should make clear, the definition of "community" in the generic label "Community Development Finance Institution" is rather fluid. In most cases, the community is a specific geographic region or regions. In other cases, however, it is a community of a certain type of business owner, such as members of racial or ethnic minorities, wherever they are physically located.

III. THEORETICAL JUSTIFICATIONS FOR FUNDING BDFIs

In reviewing these explanations of BDFI development strategies, professional economists are trained to ask: "If the present value of the benefits of these development activities exceeds the costs, why won't the private sector provide the resources? Why do governments or foundations need to fund BDFIs?"

Managers and backers of BDFIs provide a number of answers to these questions. In the early stages of the movement to use BDFIs as regional development tools, some argued that profit-maximizing financial institutions were blind to good business opportunities in certain communities or passed up good opportunities out of racial or other prejudices. Those offering this explanation often claimed that BDFIs could make a market rate of return on their portfolios by finding and taking the good business deals refused by profit-maximizing financial institutions. Across the country, there is now sufficient experience with BDFIs to refute this belief. Profit-maximizing financial institutions are undoubtedly blind to some good investment opportunities and some may even avoid good opportunities out of prejudice. But there is almost no evidence that BDFIs can attain market rates of return on their portfolios by investing in deals that would be refused by profit-maximizing financial institutions. BDFIs that provide financing which

would not be provided by profit-maximizing financial institutions make below-market returns on their portfolios.[3] A below-market rate of return does not necessarily mean that a BDFI earns a lower rate of return on its portfolio than average for profit-maximizing institutions, although nearly all BDFIs do. Rather, it means that a BDFI earns a lower rate of return, given the risk it bears, than a profit-maximizing institution would be willing to earn given that same risk.

The standard economic rationale for directing financial capital to projects that are likely to earn a below-market rate of return is that there is some market failure. This means that the projects, judged from the point of view of society, offer above-normal returns even if the private returns are below normal. Implicit in the BDFI development goals listed above are several alleged market failures that could make BDFI development efforts a worthwhile use of funds.

Some advocates of BDFIs see them as a response to *market failure in financial markets*. In economics jargon, the alleged market failure arises because information is a "public good," meaning that it is valued but it is also difficult to keep anyone from benefiting from it, even people who do not pay for it. Because of this characteristic, people are reluctant to pay to produce information, hoping instead to benefit freely from the information produced by others. If everyone behaves this way, useful information is not produced.

Consider a concrete, but hypothetical, example from financial markets. Imagine that a group of banks has little knowledge about a set of industries in a region. Some of these industries are good business prospects but others are not. Since the banks have little knowledge about the industries, they cannot tell the good prospects from the bad. But we also assume that if a bank were to incur significant learning costs that arise from lending to firms in industries with poor prospects, it would eventually

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[3]As we discuss later, there may be some exceptions as BDFIs increasingly shift over to providing equity financing. If enough do so, a small fraction of BDFIs, from pure luck, are bound to finance at least one firm that turns out to be extremely successful. In some cases, this could result in market rates of return or better on the portfolios of these BDFIs.

identify the industries with good prospects. Moreover, we assume that the future earnings of the firms in the industries with good prospects will be sufficient to repay the banks' learning costs with interest.

Suppose that one bank, "Pioneer National," decides to pay these learning costs. After discovering which industries will thrive in its region and which will not, its plan is to terminate its exposure to firms in the bad industries and continue lending to the firms in the industries with good prospects. It expects to charge these firms an above-normal interest rate in order to recoup its learning costs. If the other banks, however, see that Pioneer National is successful in lending to the firms in the good industries, they can begin to do the same. They are "free riding" on the information obtained by Pioneer National. This competition from banks without learning costs means that Pioneer National will be unable to charge higher-than-normal interest rates to the good prospects that it discovered, and it will not recoup its initial learning investment. If Pioneer National anticipates this outcome, it will never begin the learning process in the first place, and the firms in the industries with good prospects may never be able to raise the necessary outside financing.[4]

Equity investments might be a solution to this conundrum. If Pioneer National's affiliated venture capital firm were to make equity investments in firms rather than making loans to them, then it would share in the profits of the firms in good industries. Competition from other free-riding investment firms cannot undermine the return on its good investments since they cannot dislodge Pioneer's ownership claim. The equity investment solution, however, is only likely to work in cases where the good industries are expected to have very strong growth records. Equity investors have a lower priority claim to the earnings and assets of a firm than do its creditors. This means that equity investors in the industries with the bad prospects are likely to suffer larger losses than will their creditors. To make up for these losses, the equity investors will need to make a higher rate of return from the firms in the good industries than would Pioneer Bank. This explains why most venture capital firms confine their investments to firms that have some chance of generating very high returns.

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[4]See Nakamura (1993) for a more extensive discussion of this point.

If BDFIs are a response to failures in financial markets, a BDFI should be seen as a pioneer that takes the risks necessary to sort the good business prospects in a region from the bad. After it has discovered the good prospects, profit-maximizing financial institutions will win these clients away from the BDFI. This will prevent the BDFI from earning a market rate of return on its portfolio. Nevertheless, from a social point of view, the BDFI's role could be cost-effective if the present value of the future earnings created by identifying the good industries exceeds the learning costs borne by the BDFI.

According to this view, as the BDFI corrects a market failure, it promotes the productivity and wealth of a region because financial capital is directed to its most productive uses. This may in turn raise the incomes of lower-income households in the region, but the policy is not targeted to benefit these households in particular.

A second possible market failure that might justify a BDFI is a *failure in labor markets*. The economic theory behind labor demand suggests that, as a rough approximation, firms will hire workers until the wage that the firm has to pay a worker to induce her to work at the firm equals the additional financial gain that the firm obtains from having that worker. If it costs $8/hour to hire a worker and her labor brings $10/hour of additional revenue to the firm, the firm hires her. It continues hiring workers until the wage the firm must pay roughly equals the additional revenue a worker creates. The theory behind labor supply is that people decide whether to work in a formal-sector job or do something else, such as handling household chores. If the wage offered by employers exceeds the value of a potential worker's time doing something else, he will take a job. If not, he remains out of the labor market.

According to this view of labor markets, unemployment is voluntary. Some people will be unemployed for long periods because the value of time spent outside of the formal labor market is worth more than what they could earn given their skills and prevailing wages. Others will be unemployed for relatively short periods as they search to find the best job match for their skills and interests. Rather than take the first available job, it makes sense for them to search for a good long-term match. If labor markets

function in this way, there is no social benefit to a job-creation program, even if long-term unemployment in a region is high.

Consider a hypothetical example. Imagine that the value of some people's time spent doing household chores is $8/hour. If they were to enter the formal labor market, they could produce goods and services worth about $6/hour. It would be socially inefficient to try to create jobs for these people in the formal labor market. Assume, for example, that government funds are used to create $9/hour jobs for this group of people. The net benefit to one of the new workers is $1/hour ($9 wage – $8/hour opportunity cost). The net cost to the government of providing this benefit is $3/hour ($9 wage – $6/hour value of worker's output). Clearly, it would have been more efficient for the government to simply give each of these unemployed people $1/hour and permit them to continue doing household chores.

If there is a market failure in labor markets, this conclusion need not hold. The argument in this case is that there are people in the community whose time out of the labor market is worth less than the value of what they could produce if they worked in a formal-sector job. Human resources are being wasted. Imagine, for example, that firms are paying their workers $10/hour. There are similarly skilled people who are not employed and who value their time out of the formal labor market at $5/ hour. Yet, for some reason, despite serious job searches no employer will offer them a job and they remain involuntarily unemployed. Job creation in this case, even if modestly costly, would bring a net social benefit.

The problem is to explain why such market failures would occur. The common explanation is that firms have hired all of the workers they want at $10/hour. If they were to hire more workers, these workers would have to do less productive things. Therefore, to induce the firms to hire more workers, the wage would have to fall, say to $9/hour. But, it is argued, there are a number of social factors that prevent wages from falling. These factors might include a binding minimum wage law or a general ethos holding that firms that cut workers' wages are "unfair" to labor. As a result, any firm that tried to cut wages just because it had a larger number of suitable job applicants than it had positions to fill would embitter its employees. Its employees might become unwilling to do more than the minimum necessary to avoid

being fired. Productivity at the firm might decline so dramatically that, despite the lower wage, the firm's cost per unit of output rises. If firms believe that this is a realistic possibility, they will not reduce wages and the socially inefficient, involuntary unemployment will persist.

A third possible market failure that could justify funding a BDFI is a *failure in labor-force development markets*. The story here is similar to the one about the possible failure in financial markets. If markets worked perfectly, whenever the present value of the returns to a firm from on-the-job training of its workers exceeded the cost, a firm would pay for the training. In competitive labor markets where firms can observe workers' job skills, firms may not be willing to pay for cost-effective job training programs for their employees. Imagine, for example, that firms pay $8/hour for unskilled workers and $15/hour for skilled workers. Assume that with a substantial expenditure any firm can convert an unskilled worker into a skilled worker. A firm might be willing to make this expenditure if it could keep the newly skilled workers' wages artificially depressed, say around $10/hour, for a period of time in order to recoup its training costs. Firms will not be able to do this, however, if the newly trained workers are free to move to other firms. These other firms, which did not incur the training costs, will offer more than $10/hour to obtain a skilled worker. Since firms will know this, they will never initiate the job-training effort in the first place.

One possible solution to this problem would be for workers to pay for the training. In theory, they could borrow money, pay their firm to train them, and repay the loan from their higher earnings. In practice, this solution is unlikely to work. Financial institutions may not be willing to lend, since there is no hard collateral backing the loan, and a newly trained worker might decide to pursue a less remunerative occupation. Workers might also be reluctant to pay for training since they would not have the expertise to evaluate the quality of the training or its value in labor markets.

According to this rationale, BDFIs overcome the market failure by subsidizing firms to train their workers. With this subsidy, firms need not try to hold down wages to recover their training costs because BDFIs are covering these costs. A BDFI provides its subsidy by providing a firm with access to below-

market-rate financing. The financing is below market rate either because the BDFI charges a lower-than-normal interest rate (or demands a lower-than-normal rate of return on its equity financing) or because the BDFI takes on greater risks than would a profit-maximizing financier.[5]

Another market failure story can provide a rationale for a BDFI that requires firms to employ new entrants to the labor force, such as people making a welfare-to-work transition, as a condition for receiving financing or technical assistance. The story is parallel to the story about market failures in financial markets. Suppose that there are both good and bad workers among the targeted group, and that a firm can distinguish them only by employing them for a period of time. A firm must pay $7/hour to induce either set of workers to enter the formal labor market. The good workers produce $9/hour of output for the firm and bad workers produce $3/hour of output. One firm considers employing the group. The firm knows that it will suffer losses from paying the bad workers more than their value to the firm, but its plan is to terminate the bad workers as soon as they are identified. It hopes to continue to pay the good workers $7/hour for a period of time and use the resulting $2/hour gain to recoup its losses from employing the bad workers. The problem with this plan is that other firms will observe which workers are retained at the firm. They will then bid to attract these workers by offering wages up to $9/hour. This will force the firm that did the sorting to offer the good workers the higher wage and it will never recoups its losses from employing the bad workers. Expecting this outcome, no firm will undertake the costs of employing the new labor force entrants in order to identify the good workers. A BDFI can overcome this

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[5]One might wonder why the BDFI provides the subsidy in this form rather than simply making a payment to firms that increase the marketable skills of their workers. One might also wonder why the BDFI offers the subsidy to employers rather than to specialized job-training firms. In both cases, the answer is based on empirical observations. It is frequently reported that employers do not participate in programs offering subsidies to firms willing to hire or train low-skilled workers. Many firms, however, do recognize that they have a pressing need for financing, and some will agree to hire or train low-skilled workers in exchange for loans or equity investments. In addition, several empirical studies have found that training programs intended to provide skills for particular jobs have much higher returns than does training unrelated to a particular job. Katz (1998) has references to studies that document the reluctance of employers to hire low-skilled workers in exchange for wage subsidies. Friedlander et al. (1997) contains references to studies that support the conclusion that job-training programs aimed at particular jobs are more effective than training programs focused on general employment skills.

market failure by subsidizing, through below-market-rate financing or technical assistance, firms willing to play this role.

We note in passing that there could be *failures in markets for technical assistance* that are also caused by imperfect information, with rationales similar to those discussed above. If so, the key contribution of the BDFI springs from the technical assistance that it provides directly or indirectly.

Another justification for BDFIs is a *failure of prices to reflect properly environmental effects*. Imagine, for example, that clean water and clean air are valued, but there is no price attached to actions that pollute them nor any reward for actions that restore polluted areas. In this case, the market can misdirect resources. A firm that pollutes may be more profitable than one that reclaims “brownfields,” but if prices were to accurately reflect the value that people attach to goods, the reverse might hold. According to this view, the role of a BDFI is to subsidize, using below-market-rate financing or technical assistance, firms that create benefits that are not properly valued by market prices. This will encourage firms to take appropriate actions.

The final justification for BDFIs is not based on an alleged market failure. Rather, it sees BDFIs as effective tools to redistribute wealth and associated political power. This view starts from the premise that discriminatory laws and social practices have left some racial and ethnic groups severely disadvantaged in their ownership of wealth compared with groups that have not faced such discrimination. This outcome is self-reinforcing since ownership of wealth provides advantages in accessing high-quality education, in financing privately owned businesses, and in shaping political decisions to benefit oneself and one’s community.

According to this view, BDFIs can help remedy this situation by finding capable individuals, with good business plans, who are members of the specified disadvantaged groups. The BDFI then provides them with access to business financing and technical assistance that they would not otherwise obtain. This assistance is to help them establish and expand their businesses. Over time this could have two broader effects. First, as the owners of these firms build wealth, they may use some of their increasing political

and social influence to advocate policies that benefit other members of their racial or ethnic groups. Second, as their firms expand, they may be more likely to hire new employees from their own racial or ethnic groups.

The implicit rationale for this approach is that the BDFI can accomplish more for a large number of disadvantaged individuals by taking an indirect approach. Rather than spread its limited resources widely among a minority community, it seeks to concentrate them on a small group of capable minority entrepreneurs. It hopes that these entrepreneurs will, over time, take actions that benefit larger numbers of households from their racial or ethnic groups.[6]

The next two sections of the paper discuss BDFIs' actions to implement their development theories and efforts to assess the effectiveness of BDFIs. In doing so, our focus is on BDFIs that make one of their priorities the creation or retention of jobs for low- and moderate-income households in a region. This narrowed focus is appropriate since the majority of the BDFIs proclaim this goal. Moreover, much of the analysis applies to BDFIs with the other development goals.

IV. BDFIs IN PRACTICE

A. What Do BDFIs Look for in Clients?

As the above economic development strategies suggest, BDFIs look to provide financing or technical assistance to businesses that have multiple characteristics.

- BDFIs look for firms that are likely to grow more rapidly, or more likely to survive, if they are given access to needed financing and technical assistance. The firms need not be located within the targeted region at the time the BDFI opens discussions with them, but they must be willing to locate some or all of their operations within the region if they are to use the BDFI's resources.

  Inadequate financing can limit the growth of successful and potentially successful firms. Financial constraints, for example, can prevent a firm from buying new equipment necessary to expand or from

[6]Some critics charge that this may have exactly the opposite effect. If small numbers of a disadvantaged racial or ethnic group become wealthy, those that perpetuated the discrimination may point to these individuals to support their arguments against broad redistributive social policies.

paying for the inputs and inventory necessary to operate on a larger scale. Managers of these firms may be forced to turn down new orders that they could fulfill profitably if they had larger financial resources. Inadequate financial resources can also threaten the survival of an otherwise profitable business. Managers of cash-constrained firms, for example, may have to place orders for inputs in small increments, which have much higher unit costs than bulk orders. Cash-constrained firms are often forced to operate with minimal inventory levels, impeding their ability to fill orders on short notice and causing them to lose customers. Cash-poor firms may not be able to purchase equipment necessary to match the quality improvements of competitors. Managers who do not have the cash necessary to meet expenses while awaiting payment from sales may periodically delay paying some bills. This can be costly if there is a penalty for late payment or if suppliers respond by refusing to provide necessary inputs in the future except on a prepayment basis. Severely cash-constrained firms might drop their insurance coverage, fail to pay taxes, or try to do without needed professional services. These steps can ease short-run cash constraints at the risk of significant, and possibly ruinous, long-run costs.

- BDFIs seek firms whose needs for financing and technical assistance are within the capacity of a BDFI to deliver directly or indirectly.

- BDFIs look for firms that are unable to obtain needed financing or technical assistance from other sources on terms that are consistent with the survival or growth of these firms.[7] Otherwise, a BDFI is simply replacing the financing and technical assistance that would be provided by other entities. In this case, the BDFI would have no development impact.

- BDFIs seek firms that meet the other screening criteria imposed by the development strategy of the BDFIs. As noted above, this frequently includes requirements that the firms plan to increase the number of employees as they grow, the firms pay good wages with benefits, the firms are women- or minority-owned, or the firms are environmentally benign.

- If the goal of a BDFI is to expand employment in its region, then the growth or survival of the assisted firms should not come at the cost of the growth or survival of other firms within the targeted region. In practice, this frequently means that a BDFI seeks firms that sell their products primarily to customers outside of the region and that do not compete with other firms in the region. A BDFI will also seek firms whose products might substitute for the locally consumed products of companies located outside of the region.

B. What Type of Clients Do BDFIs Have?

As some reflection would suggest, this list has strong implications for the type of firms that BDFIs end up assisting in practice. One implication is that BDFIs must frequently compromise on some

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[7]Some BDFIs knowingly provide financing to firms that can get financing from their suppliers or from "factors." Factors are firms that purchase the accounts receivables of other firms at a discount. In many cases, the BDFIs argue that the relative high interest rates charged by suppliers and factors, and the relative rigidity of their credit terms, would prevent BDFI clients from using such financing to relieve severe cash constraints or to fund growth plans.

of their screening criteria. This is especially true of BDFIs with multiple goals working in economically depressed regions. Imagine, for example, a BDFI that seeks to create good-paying jobs in export-oriented minority-owned firms that are environmentally benign. It seeks to do so in an economically depressed region with relatively little business activity. Such a BDFI is likely to find very few firms, if any, that meet all of its screening criteria. It faces a choice. It can prepare to search several years before finding a firm that meets all of its criteria. This ensures that the BDFI will have little development impact. It can greatly expand the number of low-income communities in which it searches for deals. This may increase its staffing costs and reduces the chances that the BDFI will have a detectable impact in any one community. Or, the BDFI can relax some of its screening criteria, perhaps financing growing white-owned firms that pay low wages with few benefits or black-owned firms that pollute modestly and compete with other businesses located within the region. All BDFIs with multiple screening criteria working in economically depressed regions face such trade-offs.

A second implication is that the clients of BDFIs are generally small- and medium-size firms. The vast majority of BDFIs are relatively small investment funds, with total assets under $10 million. Nationally, probably fewer than ten BDFIs have total assets between $10 million and $50 million. At the time of this writing, none are larger than this.[8] This means that to remain prudently diversified, most BDFIs generally limit their exposure to any one firm to under $200,000, with only a few going as high as $1 million. Even with such limits, BDFIs do occasionally help finance the activities of large firms, generally by providing part of a financial package put together by several financial institutions. Even when BDFIs provide financing for medium-size firms, they will frequently attempt to arrange for other financial institutions, usually banks, to provide part of the financial package. The banks provide the lower-risk financing and the BDFI provides the higher-risk part. By bringing other financial institutions into its deals, a BDFI can stretch its funds across more deals.

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[8]If the assets of the organizations affiliated with BDFIs are included, then several BDFIs are larger than $50 million. This is frequently true for BDFIs that are part of a holding company structure that includes a commercial bank or credit union.

A third implication arises from the requirement that BDFI clients are unable to fulfill fully their financing needs using other financial institutions. Profit-maximizing lending institutions, such as banks, must be very sensitive to the downside risks their clients face. A loan contract calls for repayments that are unrelated to the performance of the firm, so the lender does not directly benefit if a borrower is unusually profitable rather than just normally profitable. A borrower can, however, fail to meet its contractual loan repayments. So lenders can suffer direct harm if borrowers experience unusual losses. This asymmetry in possible returns to lenders means that banks focus on the possible downside losses of their clients, not the possible upside gains. Consequently, banks look for firms that run little risk of earnings disruptions, that are in lines of business familiar to the lender, that are well capitalized, and that have marketable hard assets that can serve as collateral for loans. Of course they may not find clients that meet all of these criteria, but they will turn down those that do not meet a sufficient minimum set.[9] If BDFIs take clients that banks would turn down, the implication is that almost all BDFI clients have one or more of the following characteristics:

- The firms run substantial risk of earnings disruptions.
- The firms are in lines of business that are not traditional to the region.
- The firms are poorly capitalized.
- The firms do not have marketable hard assets that can serve as collateral for loans.

Profit-maximizing equity investors are willing to put their money into higher-risk enterprises than are creditors. Equity investors share in a firm's profits, so if the firm does unusually well, so too do the outside shareholders. This makes equity investors, such as venture capital firms, much more willing to

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[9]To some extent creditors can increase interest rates and loan fees to cover the increased risk of a loss from a client that falls short of some of these criteria. Finance companies, for example, traditionally charge somewhat higher interest rates than do banks and will take clients with somewhat higher debt-to-equity ratios or with lower-quality collateral. But there is a limit to such risk-based pricing. A higher interest rate could cause a firm's owners to take even greater business risks in an effort to earn an adequate rate of return on their equity. It could also cause entrepreneurs with lower-risk, lower-return projects to cancel their undertakings and withdraw their loan applications since the projected returns from their projects would not leave sufficient profits after paying the higher interest rates. This would leave only entrepreneurs with the highest-risk projects in the financier's loan pool, possibly reducing the lender's expected rate of return. This is why lenders often simply refuse to finance risky projects rather than try to raise the interest rate to reflect the risk.

overlook downside risk if the firm has strong upside potential. A traditional rule of thumb, for example, is that venture capital firms look for businesses that have the potential to return ten times their initial investment within about a 5-year period.[10] Their hope is that such gains will offset the losses they are likely to incur from other firms in their portfolios. In addition, most outside equity investors are not looking to make a 20- or 30-year commitment of their funds. In fact, investors in venture capital funds generally expect to see their original investment and realized profits returned in relatively liquid form within about 7 to 8 years. The managers of venture capital firms must, therefore, plan an "exit strategy" when committing to provide financing to a firm. Generally the strategy is to invest in firms that have a good chance of "going public" or of being bought at a premium by a large firm in a complementary line of business. In practice this means that venture capital firms look to invest in businesses that are perceived as being in new, growth-oriented industries.

If BDFIs require that their clients cannot meet their needs for financing by turning to profit-maximizing outside equity investors, such as venture capital firms, this also has implications for the type of firms that BDFIs will finance. BDFI clients, even if very successful, are unlikely to achieve high, sustained growth rates and to "go public" or to be targets for acquisition by large outside firms within the near future. In fact, the bulk of BDFI clients are small- and medium-size firms with good or modest prospects in traditional industries, making them unattractive prospects to venture capital investors.

C. What Type of Financing Do BDFIs Provide?

Some BDFIs only provide debt financing, some only provide equity financing, and some provide both. In this section, we first analyze the structure of their debt financing and then turn to equity financing.

As noted above, when BDFIs make loans that do not simply substitute for loans that would be made by banks or finance companies, they generally take on substantial risk. Prudent BDFIs take a

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[10]See Zider (1998).

number of steps to ensure that they do not take on more risk than they can tolerate. Most important, in the preloan "due diligence" process, BDFIs try to gain a comprehensive understanding of the businesses that they are contemplating financing, carefully assessing their strengths and weaknesses.

Once a BDFI decides that a potential client should be financed, its staff begins to think more like investment bankers than commercial bankers in the sense that they will work hard to make a deal "doable." Frequently they will work to line up a package of financing sources, including banks, suppliers' credits, government programs, and the BDFI, to meet a client's needs while keeping within the limitations that each of these funding sources imposes on the type of deals that it will do. In such an arrangement, the BDFI typically provides the "gap" financing, that part of the firm's needs that cannot be met by the other sources. Such partnership arrangements enable the BDFI to finance larger deals than it could prudently do on its own. Even when the BDFI has the capacity to finance a deal on its own, getting other lenders to contribute to the package frees up BDFI funds to go into other deals, leveraging the impact of its funds in a region. Moreover, multiple-participant financing packages can create good relationships with other lenders that might refer future deals to the BDFI.[11]

Although BDFIs have a standard set of financial contracts that they use to meet the needs of most of their clients, they will often alter these arrangements to address special needs. It would not be unusual, for example, for a BDFI to agree to an irregular repayment plan if this better fit the projected cash flows of a client. Banks, partly due to regulatory constraints, do not generally show such flexibility.

To ensure that their clients cannot fully meet their need for financing by tapping other sources, BDFIs frequently ask potential clients, if they have not already done so, to apply to a bank or other financial institution for assistance. In addition, some BDFIs price their loans less favorably than banks in their regions. BDFIs offer several justifications for this practice. The higher interest rates help the BDFI

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[11]Some BDFIs report the dollars that they leverage from other financial sources as an indicator of their effectiveness. As we discuss later, all measures of the social impact of BDFIs are problematic, but the leverage measure strikes us as particularly troublesome. A BDFI could report very high leverage numbers by taking small participations in deals largely financed by others. But the BDFI's role in these deals may not be essential. A BDFI that finances projects that other financiers would turn down may find it difficult to achieve high levels of leverage.

target its assistance, since firms that are "bankable" will not seek BDFI financing. The higher loan fees also reduce the extent to which BDFIs compete with banks. This makes banks more willing to refer appropriate firms to BDFIs and to participate with BDFIs in financing projects. The higher rates enable BDFIs to cover part of the costs associated with making high-risk loans, providing basic management assistance to clients, and patching together funds from a variety of sources to meet a client's needs.

To reduce the risk faced in providing development financing, BDFI loan contracts generally contain numerous default clauses that permit the BDFI to call the loan if a client's business prospects deteriorate or if the management takes actions contrary to the interests of the BDFI. In addition, BDFI loans tend to be relatively short-term and the loans are secured by all available collateral, even collateral of questionable value such as accounts receivable and inventories. Once a loan is made, most BDFIs will closely monitor the firm's progress and compliance with the terms of the contract. Most banks also use such risk-control measures. The difference comes when a BDFI client encounters business setbacks that impair its ability to service its debt. BDFIs will frequently waive default clauses and restructure the debt to ease the firms' immediate cash flow constraints. Banks are generally much less flexible. Two factors account for this difference. First, banks generally have better collateral for their loans than do BDFIs and suffer a smaller loss if they force firms into bankruptcy. BDFIs with poorly secured loans often have little to lose by being flexible. In fact, flexibility may increase the chances that a BDFI will be repaid fully. Second, bank regulators generally require banks to set aside specific loan-loss reserves for loans that are renegotiated due to the financial distress of a client. This reduces a bank's reported earnings. In contrast, BDFIs are unregulated and are not subject to short-term market performance pressures.

Equity Financing. Increasingly, BDFIs are providing equity financing or equity-type debt financing. Three considerations have led to this development. First, BDFIs found that many of their loan applicants did not, in the near term, have reliable free cash flows to cover additional debt service payments. The applicants, of course, predict that their earnings will grow, but the BDFI is always uncertain about the realization and timing of such projections. Since the returns to equity are tied to the profitability of a firm,

equity provides needed financial flexibility to the firms. A firm pays the outside equity holders only when it is sufficiently profitable to do so. In this sense, equity is “patient” capital. Second, BDFIs were reluctant to provide debt financing to severely undercapitalized loan applicants. Loans have fixed repayment schedules with the amounts to be repaid unlinked to the performance of the firm. Since creditors do not participate in the upside potential of the firm, they also want to ensure that they are not unduly exposed to its downside potential. As noted earlier, a firm’s equity capital protects its creditors from this downside potential, but most BDFI clients do not have sufficient capital to offer much protection.[12] BDFIs concluded that if they are to bear the downside potential they should also share in the upside possibility. In other words, they needed an equity claim in the firm. Third, equity holders can vote their shares to control the policies and management of a firm. A BDFI with a sufficient ownership share could use this power to intervene and take control of a client firm needing significant changes in its management personnel or policies.

Offsetting these advantages are several disadvantages to equity investments versus loans. For one, there is the danger that a firm in which a BDFI has an equity investment will never live up to its projections. It might never attain sufficient profitability and financial strength to pay out dividends to its shareholders. A related concern is the term of the investment. Unless the BDFI can eventually find a buyer for its stake in the firm, it is likely to find that its funds are permanently invested in the firm. This can impede the ability of the BDFI to finance other firms in the future. In addition, outside equity investors may incur much higher monitoring costs than do lenders to the firm. A lender needs to monitor the firm only to ensure that the firm does not take actions that increase the likelihood that the lender will not be paid what it is due. An equity holder, however, who shares in a firm’s profits will want to ensure that the managers maximize those profits. This can require much more detailed knowledge of the operations of the firm than

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[12]As noted earlier, equity capital protects creditors from losses because creditors have a higher priority claim on the earnings and assets of the firm than do the firm’s shareholders. Shareholders have a residual claim. They are paid dividends only after all debt obligations have been paid. In a liquidation, the shareholders receive money from the sale of the firm’s assets only after the creditors have been fully paid.

what a lender would require. Outside equity investors with a minority interest in a firm , however, may not like the business decisions made by the majority owners, and yet may not have sufficient voting power within the firm to change these decisions. Alternatively, if a BDFI has the power to take control of a firm and uses it more than a few times, it may find over time that all it is doing is managing a few businesses and no longer has time to look at new business prospects. Finally, equity holders have a lower priority claim to the revenues and assets of the firm than do lenders, so they bear a larger amount of risk.

Despite these drawbacks, the advantages offered by equity have led several BDFIs to finance the growth of some clients with equity investments rather than loans. Most, however, do so for a small number of clients for whom they believe the advantages outweigh the disadvantages. These clients tend to be those that have a chance of achieving very significant earnings growth.

When BDFIs do make equity investments, they generally structure the deals similarly to the way venture capital firms do. In return for their investment, they often obtain preferred stock that is convertible to common stock under a variety of specified conditions. By holding preferred stock they have a higher priority claim on the assets and dividend payouts than do the owners of common stock. If the firm misses specified performance measures, the BDFI generally has the right to convert its preferred shares to a sufficient percentage of the voting common stock that it can control or strongly influence the management of the firm. Some BDFIs achieve roughly the same end by using convertible subordinated debt rather than preferred stock. In addition, when making its initial investment, the BDFI will frequently request a seat on the firm's board of directors or the right to send an observer to its meetings.

Venture capital firms hope to liquidate their investment in a firm within a few years by selling their shares when the firm issues publicly traded equity or when the firm is purchased by another firm. As noted earlier, this is their "exit strategy." Most of the firms financed by BDFIs are highly unlikely candidates to issue publicly traded equity and are unlikely to be purchased by another firm. These firms generally have a small number of owner-managers and are likely to continue to do so. This means that BDFIs must plan different exit strategies. One approach is to plan no exit, expecting to retain an equity

investment in the firms for a decade or more. The hope is that the BDFI can recoup its investment over time through any dividends that the firm pays or, perhaps, as other owners of the firm buy out the interest of the BDFI. The drawback to this approach, noted above, is that the BDFI may become a long-term investor, thereby impeding its ability to help new firms. A second approach is for the BDFI to structure its investment as a subordinated debenture with "equity kickers." This means that the BDFI makes a medium-term loan that is subordinated to existing debts and, perhaps, to specified new debts. The loan typically has a relatively low interest rate but the firm commits to pay the BDFI a share of its revenues for a specified period of time. This is an equity-type feature since it ties the returns to the BDFI to the success of the firm. Such a contract has a built-in exit strategy since it terminates on a specified date. A third approach is for the BDFI to search for an individual or group of investors who are willing to purchase its stock in the firm.

D. Role of Technical Assistance

Some BDFIs, in addition to financing firms, provide technical assistance to their clients, usually in the form of management assistance.[13] This assistance frequently begins in the early stages of contact with the client. BDFI staff will often help clients seeking financing with their business plans and growth strategies. In early or later stages, the BDFI might help the firms to set up computerized accounting systems, to establish payroll systems, to modify their plant layouts, or to devise marketing strategies. In some cases BDFIs draw on their staff members to provide these services. In other cases, they refer the clients to third-party providers and may even make grants or loans to the clients to cover any associated costs. In a few cases, BDFI staff members have filled key management positions, e.g., CEO or CFO, in client firms for a period of time.

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[13]Taub (1994) has an interesting brief discussion of the experience of one BDFI in Arkansas with technical assistance. The paper also notes a number of other issues from this BDFI's experiences that are relevant to other points in this paper.

BDFIs provide several rationales for offering such technical assistance. Frequently, they argue that improved management practices are as important to their clients' survival and growth as is access to external finance, if not more so. Thus, the management assistance serves the BDFIs' community-development mission. BDFIs also note that improving their clients' management practices increases the odds that clients will be able to repay their loans or offer attractive returns to equity investors, reducing the risk in the BDFIs' portfolios.

Some managers of BDFIs argue that the financial constraints of a firm are often a symptom of the need for improvements in management practices. These BDFI managers report that applicants for business financing recognize that they have binding financial constraints, but they generally do not recognize the underlying cause of the constraints: poor management practices. The BDFI managers view the financing that they offer as an "entry vehicle." By offering the financing, they get the attention of firm owners who think that this is the solution to their problems. Once the staff of the BDFI begins to work with the firm to analyze its need for financing, they can also diagnose any underlying management weaknesses that may threaten the survival or constrain the growth of the firm. Were the BDFI to offer the technical assistance without the financing, it is unlikely that the owners and operators of the firms would be receptive to meeting with the BDFI staff.

Some BDFIs largely limit their activities to financing firms and provide very little technical assistance. They leave it up to the clients to address their own needs. The major rationale for this policy is that it reduces the BDFI's staffing and expenditure needs. A second rationale is that it reduces the chances that the BDFI might be held liable for any alleged adverse effects caused to a firm as a consequence of following the advice, the so-called "lender-liability" concern.

As noted above, some BDFIs rely extensively on third parties to deliver management assistance to their clients.[14] This achieves three objectives. First, in some cases the outside providers of management

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[14]The Enterprise Corporation of the Delta may have been the first BDFI to rely extensively on private-sector and government third-party sources to provide technical assistance to its clients. ECD's staff attempts to broker this assistance, linking clients to appropriate providers and monitoring the quality of the assistance.

assistance, such as government-sponsored small business development agencies, may themselves cover the cost of the assistance, relieving the BDFIs of that burden. Second, outside agencies that specialize in providing technical assistance to businesses can presumably offer much more specialized categories of management assistance than could even a well-staffed BDFI. Moreover, by relying on outside providers of management assistance, BDFIs can reduce their own staffing levels and focus on providing financial assistance to clients. Third, BDFIs that refer clients to third-party sources of management assistance and that do not make their financing contingent upon their clients' implementation of any particular business practices may reduce their exposure to lender-liability lawsuits.

There are drawbacks to referring clients to outside sources of management assistance. Unless the BDFI devotes knowledgeable staff to monitoring the quality of the assistance provided by third parties, it may consistently refer clients to low-quality sources of assistance. Government-sponsored agencies are the lowest-cost source of management advice, but since they do not need to meet a market-test of the value of their services, they may be especially prone to providing advice that is poorly tailored to the needs of clients. Alternatively, specialized private-sector sources of management assistance may be too expensive to be practical for struggling small- and medium-size firms with modest growth prospects.

E. Labor-Force Development Efforts

Just as BDFIs differ in their technical assistance policies, so do they differ in the degree to which they combine labor-force development efforts with business finance activities. Most BDFIs focus almost exclusively on helping firms to grow or stabilize. They hope that this will create desirable new employment opportunities for the unemployed and low-wage workers in their targeted regions.

A small number of BDFIs have augmented this strategy with policies intended to ensure that a significant number of any new jobs created by their financing of clients go to "hard-to-place" and low-

skilled workers living in the targeted region.[15] Hard-to-place workers might include workers with mental or physical disabilities, workers with criminal records, older workers without previous employment experience, etc. BDFIs using a labor-force development strategy typically form a partnership with job-training or job-preparation programs working with such individuals.[16] The BDFIs insist that the firms they finance give preference to the graduates of these programs in their hiring decisions. In some cases, the BDFIs also ask the employers to provide additional on-the-job training. Some BDFIs help arrange governmental funds to cover additional costs that employers might incur from such hiring and training policies. In addition, some BDFIs try to remain in contact with the new employees, or they rely on a partner agency to do so, to ensure that other problems, such as transportation issues or a lack of child care, do not prevent the new employees from fulfilling work obligations.

In adopting such policies, a BDFI hopes to accomplish one or more of three principal goals. First, it hopes to encourage firms to offer entry-level positions to hard-to-place workers, enabling these individuals to find jobs and to acquire employment histories that can signal potential future employers that they are capable, reliable workers. Second, the BDFI seeks to encourage firms to provide low-skilled workers with on-the-job training, providing them with skills that can lead to higher future wages. Third, the BDFI hopes to help solidify and expand firms that use these employment practices in order to reward them for their socially beneficial actions and to ensure that they are able to continue to employ and train disadvantaged workers.

As in the case of technical assistance, some BDFI managers believe that their most important economic development impact may come from their labor-force development efforts rather than their

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[15]There are frequently multiple barriers, including skill levels, transportation, and child care, that might keep lower-income individuals unemployed or in the lowest-paying segments of the labor market. Without such labor-force development policies, new jobs, particularly jobs offering good wages and benefits, may well be filled by migration into the region or, in the case of smaller regions, by commuters. In fact research on urban economic development initiatives (Bartik, 1991) finds that if a program creates 1,000 new jobs, about 770 of these are usually filled by newcomers to the city. Another 160 are usually filled by local residents who were previously out of the labor market, and only about 70 are filled by local unemployed residents.

[16]The BDFI that pioneered this general approach is Coastal Enterprises Incorporated of Maine.

business financing. Nevertheless, they believe that it is essential to offer business financing to capture the attention of the owners and managers of client firms and get them to agree to interventions in their employment policies.

BDFIs that do not have such labor placement and development policies frequently cite several reasons to justify a continuing focus on business finance. They argue that many of the firms they work with are so fragile that it makes little sense to ask them to take on new commitments, such as hiring people with uneven employment histories. They believe that larger, more established firms with professional human resources departments are better placed to enact such policies. In addition, BDFIs working in relatively isolated poor regions often argue that new jobs in their regions are bound to benefit low-income households even without such labor development policies. This is because people are not moving into these regions in search of employment opportunities. Local firms have to hire local people, especially for moderate-wage positions. Finally, the BDFIs point out that it is costly to add staff to implement a labor-force development strategy. Devoting resources to this effort takes resources away from development finance.

V. THE SOCIAL IMPACT OF BDFIs

As we discussed in Section II, the rationale for creating institutions, such as BDFIs, with low private rates of return is that they have broad social benefits. This section discusses reasons that BDFIs might fail to have the positive social impact they are intended to have. It also discusses efforts to assess the extent of their social benefits and to measure the cost-effectiveness of BDFIs. In doing so, our focus is on BDFIs whose main mission is to create job opportunities for lower-income households.

A. Reasons for Doubt

Philanthropic foundations and governments fund BDFIs in the belief that they can be cost-effective means to assist low-income households in a region and to promote the stability and growth of minority- and women-owned businesses. A skeptic, however, would argue that the case must be proven.

There could be many gaps between the theory and its realization. Consider the case of a BDFI whose main goal is to create jobs in a depressed economic region. The BDFI might not be able to find firms whose growth is constrained by a lack of capital. Those it does find might have other growth-inhibiting problems, such as a bad product or management weakness, that the BDFI cannot solve. If the BDFI is able to solve a firm's management weaknesses, it might be at the cost of devoting the BDFI staff to the management of the firm. In this case, after a few years the BDFI might find its small staff running two or three moderately successful firms in a region, with no time to spare for new deals. If so, the development impact of the BDFI is likely to be small.

Even if the BDFI can find capital-constrained firms that it can usefully assist, it may find that these firms do not add employees as they grow. In fact, they might even use new technologies to replace employees. Assisted firms that do add employees might do so at the cost of employment in competing firms within the region. Alternatively, the BDFI may help to create net new jobs within a region. These new jobs, however, may go to second workers from middle-income households or to people living outside of the community, especially if the major barriers preventing lower-income households from advancing are discrimination, skills, transportation, child care issues, etc.[17] In addition, the BDFI might assist firms that would have been able to attain the needed funds or management assistance elsewhere. In this case, although the firms might grow and add employees, this would have happened even without the BDFI. Similar doubts could be raised about a BDFI whose primary goal is to assist minority-owned firms.

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[17]In analyzing the experiences of Kentucky Highlands Investment Corporation (KHIC), Miller argued:

> It is doubtful that the KHIC experience is of much benefit to the challenges of urban poverty. . . . [T]he overall economy in most urban areas is generally healthy and expanding. Chronic poverty is certainly found in most cities, and residents of Chicago's Cabrini-Green housing project no doubt feel as isolated in many ways as the mountaineer living at the tail end of Blair Branch, Kentucky. But the problem in cities is not so much a lack of proximate economic activity, as a tangle of social difficulties that frustrate access to economic opportunities by the chronically poor: transport systems designed for the suburbs, the pervasive temptation of drugs, inadequate and dangerous schools, racial discrimination, a shortage of affordable housing, and the preponderance of female headed households without affordable day care facilities for their children. . . . Public resources are likelier to be better used in addressing the factors impeding the poor's access to the wider urban economy. (Miller, 1994, p. 161)

Even a BDFI that achieves its goals, as the theory suggests, might find that the magnitude of the achievement does not justify the cost. A BDFI, for example, might spend $1 million in staff time to increase the discounted stream of future earnings of a group of lower-income households by $500,000.

The need to assess the cost-effectiveness of BDFIs is not just to reassure their funders and skeptics that this is a good use of limited community development resources. As noted earlier, BDFIs have diverse operating procedures. Some have large staffs, offering a wide range of management assistance and labor-force development services. Others are comparatively low-cost operations providing little beyond development finance. It would be useful to compare the cost-effectiveness of these different operating procedures so that the field could evolve toward the most effective over time.

B. Difficulties in Measuring the Impact and Cost-Effectiveness of a BDFI

Assessing the social impact of a BDFI is difficult. Consider a BDFI that is attempting to create jobs in a region in order to increase employment opportunities and benefit unemployed and lower-income workers in the region. For brevity, we confine ourselves to just the first issue: Could available data support the claim that this BDFI was able to increase employment in a community? We do not discuss the associated second issue: Did the creation or retention of jobs benefit lower-income households in the region?

In our view, it is nearly impossible to reach definitive conclusions about the employment impact of a BDFI. The first thought of most evaluators' is to conduct a before-and-after study. This means that the evaluator measures employment levels at a BDFI client just before the client receives assistance and again a few years after. There are numerous practical difficulties with implementing this approach, some of which we discuss below. Before doing so, however, we ought to note its major shortcoming. To know the likely sustained impact of the BDFI intervention on employment levels at a firm, the evaluator needs to allow a reasonable amount of time, at least 2 to 3 years, to elapse between the initial assistance from the BDFI and subsequent review of the firm's employment levels. The problem is that numerous factors change over time and affect a firm's employment levels. The overall economy expands or enters a

recession. The industry to which the firm belongs changes due to technological innovations, competitive pressures, or other factors. The firm is subject to unique shocks—the manager gets sick, the county government opens a new road nearby, a partner decides to retire, etc. Sorting out how much of a change in employment is due to the intervention of the BDFI and how much is due to other factors is nearly impossible. Moreover, in many cases, employment might not change at all at a firm and yet, had it not been for the intervention of the BDFI, employment levels would have declined markedly. But determining this will be difficult. In other words, the evaluator cannot establish with confidence the counterfactual: What would have happened to employment levels at the firm had the BDFI not intervened?

In other settings, such as evaluating the efficacy of a new medicine or a job-training program, the solution is to conduct a random-assignment experiment. In the context of a BDFI, this would mean that among a set of firms eligible for BDFI assistance, a research team would randomly select some to receive the assistance and deny it to others. The team could then follow over time the employment patterns at a large number of the assisted firms and at a large number of the firms denied assistance. The difference in employment levels between these two groups is the measured impact of the BDFI. Unfortunately, such an experimental design is infeasible for BDFIs. In light of the considerable time and expense associated with finding and doing background work (due diligence) on potential clients, it would be impractical to bring a sufficiently large number to this stage in order to conduct a meaningful random-assignment experiment.

A second strategy that one might consider is to compare the performance of a BDFI's clients to a comparable group of firms that did not receive assistance from the BDFI. The problem with this strategy is that it is nearly impossible to find a comparable group of firms. The comparison group should be located in the same region as the BDFI's clients to ensure that differences across regions do not cause any observed difference in firm performance. The comparison group of firms should be in the same line of business as those of the BDFI's clients. In other words, they should be in almost all ways identical to the BDFI's clients to ensure that any difference between the performance of these firms and the performance

of the BDFI's clients is due to the intervention of the BDFI. Even if one could locate seemingly similar firms, there are many differences across firms that are difficult to observe, such as managerial talent. If a BDFI's clients grow more rapidly than the comparison group, it could simply be because the BDFI's risk-screening process eliminated the worst-managed firms from its pool of clients.[18]

The difficulties with establishing a counterfactual argue for an impact assessment based on before-and-after studies of employment levels at BDFI clients with rough guesses about the share of any observed change that should be attributed to the BDFI. Though superficially simple, this strategy faces a number of difficulties in implementation. For example, simply counting the employment level at a firm is frequently problematic. Many firms have highly variable employment levels. In some cases, the fluctuations in employment are seasonal. In other cases, firms add or lay off employees in response to fluctuations in orders. In yet other cases, firms use variable numbers of part-time workers whose hours of employment fluctuate based on the demand for the firm's output. If one has extensive payroll histories for a firm, one could try to calculate some steady-state average full-time-equivalent (FTE) employment level for the firm, but such data may not be available. A practical alternative approach is to ask the owners and managers of the firms about their steady-state FTE employment levels at the time of the firm's first BDFI loan closing and at later intervals. In doing so, the evaluator must recognize that owners of firms with similar employment levels may give somewhat different answers because they make different judgmental adjustments.

Another difficulty is to know how long the evaluator should wait before assessing the employment impact of BDFI financial assistance. Imagine, for example, that a BDFI finances a struggling firm with three employees that would have failed without the BDFI loan. In the subsequent 2 years the

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[18]A third potential solution is to use a multivariate regression to estimate the contribution of a BDFI to an observed increase in a firm's employment level. To implement this approach, one would need extensive data on a large number of firms that received varying amounts of BDFI assistance. The data should include information on all of the other factors that could cause changes in employment at the firms. In theory, a multivariate regression could then isolate the impact of the BDFI assistance on employment levels. In practice, it would be nearly impossible to build such a data set, and, moreover, critics could always still question whether some unobserved variable, such as entrepreneurial initiative, accounted for the results rather than BDFI assistance.

firm does not add any employees, preferring to devote all available resources to new product development and strengthening its balance sheet. The evaluator concludes at the end of these 2 years that this BDFI loan only succeeded in retaining a small number of jobs in the region. However, a few years later one of the new products of the firm becomes tremendously successful and the firm adds hundreds of employees. Had the evaluator waited for these years to pass before making her assessment, she would have reached an entirely different conclusion. An additional challenge is to estimate how long the jobs created or retained by a BDFI will last. In some cases, a BDFI loan might enable a firm to grow or stabilize for a year or two before failing as a result of continuing poor management practices or a shift in product demand. Clearly, it would be a mistake to conclude that any jobs created or retained a year or two after a BDFI's initial assistance are permanent jobs. These considerations seem to argue that the impact of a BDFI can only be assessed several years after it makes its investments in firms. Offsetting this, however, is another consideration—the longer one waits the harder it may be to isolate the impact of the BDFI from other intervening factors.

Another factor to consider is that job creation and retention in one firm can destroy jobs in local competing firms. Consequently, an evaluation of a BDFI's impact should not necessarily assume that a job created by firm X is a net new job in the region. It is also true that job creation in one firm can lead to job creation in other firms. This can happen if the expanding firm increases its purchases of inputs from other firms in the region or if the new employees of the expanding firm buy goods and services produced by other firms in the region. Estimates of the net regional job multiplier are bound to be subject to large margins of error.

This list of uncertainties that arise in attempting to answer the question, "How many jobs did a BDFI create or retain in a region?" is compounded if one attempts to answer, "Who benefited from the jobs that were retained or created?" It is further complicated if one seeks to measure the costs and benefits of the development effort.

In trying to assess the cost-effectiveness of a BDFI, the *comparatively* simple part is measuring the cost. Conceptually, the gross operating cost of a BDFI that expects to maintain the inflation-adjusted value of its capital over time is:

Gross operating cost = staff costs + office costs + investment losses + other operating costs + earnings it would have to retain to maintain the purchasing power of its capital.

All of these costs should be measured at market prices to make evident the role of implicit subsidies. Implicit subsidies are loans, equity investments, services, or goods provided to the BDFI at below-market prices.[19] A foundation, for example, might make a 5-year loan to a BDFI with a 1 percent annual interest rate or a law firm might provide pro bono legal services. Without valuing such inputs at market prices, an outside assessment team might conclude that a BDFI is self-sustaining when in fact the BDFI will be self-sustaining only as long as it continues to receive implicit subsidies.

Once the gross cost is measured, the net operating cost is:

Net operating costs = gross operating costs – operating revenue of the BDFI.

Operating revenue includes the interest, dividends, and capital gains from the BDFI's development portfolio. In theory, a BDFI that makes equity investments should include unrealized capital gains in its portfolio when calculating net operating costs, but of course such estimates may be subject to wide margins of error.

If a BDFI's return on equity were to exceed the inflation rate, the net cost would be negative. In fact, all BDFIs of which we are aware require operating subsidies to maintain the purchasing power of their capital, meaning that the net cost is positive.[20] In most cases the operating subsidy is partly explicit

[19]In some cases the subsidy comes from within the BDFI. A very small number of BDFIs have sufficient capitalization that they can invest a significant amount of funds in market-rate financial instruments and still have adequate resources available to fund an active economic development program. The returns on the market-rate investments are used to cover some of the costs associated with the BDFI's economic development activities.

[20]In our view, this is a good sign. If a BDFI were to obtain consistent market rates of return, this would suggest that it is probably using its financial resources in deals that the private sector would have done anyway. It is possible, however, for a development-oriented BDFI to make an above-market rate of return through pure luck. It might, for example, make an equity investment in a firm that cannot raise equity capital in the private sector because the firm is judged to have limited growth prospects. If the firm, in fact, grows explosively and even conducts a successful initial public offering of its stock, the BDFI could end up with above-market rates of return on its portfolio.

and partly implicit. Explicit operating subsidies are monetary grants or recognized in-kind grants from the backers of the BDFI.

Although net operating costs are much easier to estimate than the benefits, they are far from trivial. In addition to the uncertainty associated with estimating unrealized capital gains on equity investments, one of a BDFI's major costs, losses on its investments, is subject to substantial judgmental adjustment. A BDFI might, for example, carry a doubtful loan on its books at full value and not recognize the loss until it becomes obvious several years later. In this case, the BDFI's costs would appear low in its early years. Banks offset their reported earnings with expected loan losses, a number that is based on a bank's experience with a category of loans or on other banks' experiences. Most BDFIs do not have enough experience with any category of investments to make such forecasts with much confidence. In addition, as unregulated institutions, BDFIs are free to adopt their own accounting standards.

Attaching a dollar value to the benefits of a BDFI's activities is particularly challenging. The major issue is once again the counterfactual. Imagine that a BDFI creates a job and that an unemployed individual in the region fills that job. What is the dollar benefit to the individual? Conceptually it should be the difference between the discounted stream of future earnings of the individual minus the discounted stream of what his future earnings would have been had he not gotten this job. Moreover, in valuing earnings, we should attach prices to valuable activities that are not priced. The individual, for example, might value time spent at home doing household chores at $5/hour and yet not actually earn anything for such work. If he were to take a job paying $6/hour, the net benefit to him is $1/hour. Under either case, it is difficult to project with confidence the likely future earnings for individuals who would have worked in the formal labor market or who would have stayed out of the market.

Such considerations explain why any assessment of the cost-effectiveness of a BDFI is bound to be a crude estimate. Moreover, formal cost-effectiveness studies are unlikely to serve as a basis for

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By the law of averages, such lucky outcomes will occur for only a small minority of BDFIs and should not persist for any one BDFI.

choosing among different BDFI operating strategies. This is because the results will not be sufficiently precise to determine whether one set of operating procedures, such as using third parties to deliver management assistance, is more effective than another. In practice, BDFIs are likely to adapt their operating policies based on crude "gut" impressions from very small samples of experiences about what seems to be most effective.[21]

Even recognizing that efforts to measure the impact of BDFIs and to measure their cost-effectiveness are bound to produce ballpark estimates, we believe that such initiatives can be worthwhile and must be undertaken. The next subsection presents our reasoning and discusses, very briefly, three recent studies that attempted to assess the impact of BDFIs.

C. Existing Social Impact Assessments

Most BDFIs do not make any formal attempt to quantify their social impact. Rather, they report selected anecdotes about the success of a few clients. Readers of these accounts have no idea how representative these clients are of the BDFI's overall portfolio. They must also recognize that statements by profiled clients about the remarkable assistance provided by a BDFI may be self-serving. A client may have in mind that it will need the good graces of its BDFI if the terms of its financing need to be renegotiated or if it approaches the BDFI for new financing.

A small number of BDFIs that focus on job creation periodically report data on the number and types of jobs they create or maintain. Unfortunately, they very rarely present the details behind how they obtain their estimates. It is said, for example, that some BDFIs report the number of jobs that they believe the firms they are currently assisting might create over the subsequent several years as "jobs created" even though no such jobs exist yet. Other BDFIs apparently only count actual increases in employment at firms they have financed in the past. In addition, some BDFIs work hard to ensure that the firms they

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[21]Thomas Miller, recounting his years as CEO of Kentucky Highlands Investment Corporation, provides an engaging account of how this BDFI changed its tactics over time in response to such small-sample impressionistic inferences (Miller, 1994).

finance or advise would not have obtained such services from other sources. Others are not demanding in this regard. BDFIs in this second category may actually deserve little credit for employment increases at their client firms since the firms might have obtained financing from other sources and grown even without the BDFI.

Without detailed explanations by BDFIs of how they count jobs created and how they know that they played an essential role in assisting firms, the numbers reported by BDFIs are largely useless. Moreover, outsiders recognize that BDFIs, which are competing with each other for funds from government agencies and foundations, have strong incentives to present optimistic assessments of their impact. This further diminishes the value of the self-reported numbers.

The BDFI industry is aware of these issues and there are efforts by BDFIs and their funders to settle on common standards for impact indicators and to encourage all BDFIs to adhere to these standards. But some within the industry oppose these efforts. Their principal concern is that any common standards will be imperfect indicators of a BDFI's development impact. Nevertheless, once some specified numbers begin to be reported as indicators of impact, BDFIs are likely to shape their operations to ensure that they report high numbers. A BDFI, competing for funding with other BDFIs, for example, might feel pressure to finance firms that could easily find other sources of financing if the BDFI thought that this would result in a large "jobs created" number.[22] In other words, BDFIs' efforts to maximize the imperfect standardized measures of impact may be at the cost of efforts to achieve a true development impact.

Although we are well aware of these dangers, we support the move toward standardized measures. Standardizing the measures will at least clarify the meaning of the numbers that a BDFI does report. To reduce the chances that funders or other outsiders would use the numbers as simple indicators of a BDFI's social impact, we suggest that BDFIs report the numbers under rather neutral labels, such as

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[22]The parallel to school testing is obvious. Some people argue that standardized tests are poor measures of a student's education. Their fear is that if schools are evaluated on the basis of students' scores on standardized tests, teachers will begin to teach students how to do well on the tests. This could be to the detriment of the students' actual education.

"portfolio tracking measures" and "changes in employment at client firms." In developing the standards, the BDFI industry should consider issuing a statement warning that the reported numbers should not be used as measures of a BDFI's impact, and it should discourage its members from claiming otherwise.

Despite our claim that evaluations can yield only ballpark estimates of the social impact of a BDFI, we strongly believe that such evaluations must be conducted periodically. The governments and foundations that fund BDFIs must know whether or not there is some basis to believe that they accomplish what they intend to accomplish. In the case of BDFIs that seek to create and retain jobs in an economically depressed region, impact assessments should be based on before-and-after studies of employment in the BDFI's clients, with proper recognition that many other factors affect such changes. In our view, key features of a useful impact assessment are:

- an explanation of the BDFI's development strategy;
- a review of its operational procedures over the period of the evaluation;
- a detailed account of the methodology that was followed in measuring changes in employment at the BDFI's clients;
- a careful statement of any assumptions underlying the impact assessment;
- an explanation for why the evaluator believes that the clients of the BDFI would or would not have been able to obtain similar services elsewhere;
- an analysis of the type of jobs retained and added at the BDFI's clients; and
- a review of the socioeconomic context in which the BDFI conducted its development efforts.

Three such impact assessments have been conducted to date. The first (Miller, 1994) assessed the impact of Kentucky Highlands Investment Corporation, a BDFI operating in several rural Appalachian counties in Kentucky. It was conducted by Thomas Miller, the former CEO of Kentucky Highlands. The second (LaPlante, 1996) assessed the impact of Coastal Enterprises Incorporated, a BDFI based in Wiscasset, Maine. Josephine LaPlante, a sociologist at the University of Maine, conducted the study with the assistance of Carla Dickstein and other staff members of Coastal Enterprises. The third (Caskey and Hollister, 1999) reviewed indicators of the impact of the Enterprise Corporation of the Delta, a BDFI that

operates in numerous counties in Arkansas, Louisiana, and Mississippi; all are located near the Mississippi River.[23]

These studies have various limitations, but their principal strength is that they largely meet the criteria that we set out above. All three conclude that, while BDFIs alone are unlikely to bring dramatic changes to an economically depressed region, available data suggest that they can be effective tools for stabilizing businesses and for promoting modest employment growth in depressed regions. Because these studies present the details behind this conclusion, readers with more pessimistic or more optimistic notions about the impact of BDFIs can draw on the information in the reports to make their cases.

VI. CONCLUSIONS

This paper serves as an introduction to business development financial institutions. It sets out the theory behind their community development strategies, reviews their operating practices, and discusses efforts to assess their social impact. Given the amount of money flowing to support BDFIs, there has been surprisingly little research on the extent to which BDFIs accomplish their goals. There is clearly a pressing need for more such studies, especially of BDFIs operating in diverse socioeconomic regions and employing a variety of operating procedures and development strategies.

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[23]We discuss these studies in detail in Caskey and Hollister (2001).

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