Social Lending Today: Challenges Facing Social Finance Intermediaries

By Rupert Ayton and Stephanie L. Sarver

The greatest challenge currently defining the social lending realm is the lack of efficient finance intermediaries to facilitate loans, notes, or bonds. In the mainstream debt (or fixed-income) markets, finance intermediaries are loan companies, finance companies, or banks. In the social finance space, intermediaries include foundations, credit unions, community development financial institutions (CDFIs), and non-government organizations (NGOs) created to meet specific sector finance needs.[1]

Although the intermediaries that serve the mainstream market are abundant, those that serve the social finance market are not. Social finance intermediaries do exist, but they are few and the transactions into which they enter form an incomplete patchwork marked by finance gaps where social enterprises are unfunded.

The challenges facing the social finance space center on four phenomena: fragmentation, inefficient investment and loan processes, limited finance expertise, and the scale of social enterprise/social mission company financial need. Until these challenges are addressed, social enterprises will face limited options for procuring low-cost financing.

Fragmentation. Social finance intermediaries have emerged from organizations with varying missions and agenda. For example, foundations differ in their missions from credit unions, CDFIs, and finance-oriented NGOs. Each institutional type approaches the work of financing social enterprises from a different perspective, which has resulted in fragmentation of the social finance environment. The fragmentation also results from limited access to rating information, low investment liquidity, and limited ease of ownership transfer.

Inefficient investment and loan processes. Social finance intermediaries have created institution-specific transaction processes that are neither standardized nor consistent across all social finance intermediaries. This condition limits the ability of investors and borrowers to interact across intermediaries, which is a condition necessary for the formation of a true capital market wherein lenders and borrowers can come together.

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[1] For example, foundations involved in social finance are the Ford Foundation and Rockefeller Foundation, which have created program-related investment vehicles; Calvert Foundation, and RSF have created loans funds; community development financial institutions (CDFIs) provide community development loans; NGOs that have created financing vehicles include the Independent Press Association and Public Radio Capital, and EcoLogic Finance, which intermediate loans to independent publications, public radio stations, and fair-trade businesses, respectively.

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Limited finance expertise in the social finance space. Social finance intermediaries typically are affiliated with either the philanthropic or community banking sectors. The expertise of philanthropic lenders resides in their ability to evaluate loan applicants for their alignment with a philanthropic mission. Community banks are skilled in evaluating the risk of loan applications, but bring to their work a less thorough understanding of the social benefits of a given enterprise. A limited collective expertise in the machinations of global finance limits the ability of social finance intermediaries to aggregate and create a social finance marketplace.

Scale. The relatively small scale of social enterprise financial need and return excludes their participation in the global financial markets. The debt underwriting process, which assures that the principle and interest will be repaid as contractually agreed, is costly.

In the global financial markets that support mainstream business through debt instruments, the cost of underwriting is recouped through scale. Participation by investors and recipients is governed by transaction size (the dollar amount of the bond issuance), transaction volume (the number of times a bond is reissued), and trading volume (the number of times a bond is resold after it is initially issued).

Typically, global finance intermediaries engage in very large transactions that generate the greatest earnings per transaction. Thus, a typical small mainstream bond issuance may be $250 million. Social enterprises that require financing ranging from tens of thousands to several million dollars are far too small to be funded by the mainstream market.

Traits of Mainstream Finance Intermediaries

To understand the limitations of today's social finance intermediaries, it is helpful to understand how mainstream debt-market finance intermediaries are structured. Mainstream finance intermediaries have become highly specialized in their expertise. Typically, the mainstream debt market has developed and applied expertise in three areas: evaluation of the repayment risk and liquidity profiles of enterprises they finance; understanding the business models on which the borrowing enterprises are based; and understanding the industry sectors served by the enterprises.

Evaluating Repayment Risk and Liquidity Profile

Underwriting is the process by which an intermediary assures itself and investors that the principle and interest from a loan, note, or bond will be repaid as contractually agreed. The underwriting process requires specialized knowledge; the diligence associated with underwriting is comprehensive and costly – costlier still when an enterprise doesn't repay a debt.

When evaluating repayment risk and liquidity, underwriters assess the ability of a

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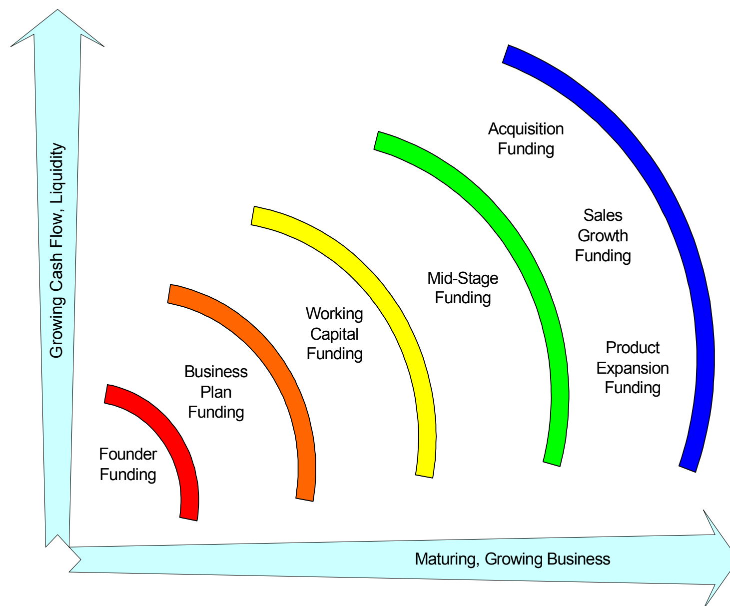
borrower to repay the debt with regard to its specific life-cycle business stage (i.e., start-up or mature). This assessment requires specialized knowledge because the risk and liquidity of businesses will vary depending on business stage. As companies mature, their cash flow typically also grows through net income and credit access (Figure 1). Sufficient cash flow is crucial to timely repayment of debt, a hallmark of successful financing. This cash flow is a factor in the overall liquidity of a company.

Figure 1: Enterprise Maturity and Cash Flow Funding Curve



Finance intermediaries specialize in managing risk at a single rather than multiple stages of company growth; therefore they expect successful borrowers to grow and advance to subsequent stages as they mature. As a company matures and its borrowing needs evolve, it also migrates to different intermediaries to meet funding needs. This migration among finance intermediaries is an accepted and important attribute of economic development. As successful companies grow and migrate, they can borrow more money (or refinance) usually at a lower cost, which further accelerates their ability to operate successfully.

The refinancing process allows intermediaries to constantly circulate funds. As a company grows, it obtains new financing from the next-stage intermediary. This enables the repayment of the debt to the previous intermediary, which can then loan the money to a new enterprise. When companies cannot migrate from one intermediary to another, the issuance of new loans to new enterprises is constrained. The finance intermediary cannot issue new loans unless previous loans are repaid or it can raise fresh capital. This situation currently prevails among current social finance intermediaries and is a factor that limits the robust expansion of the social finance arena.

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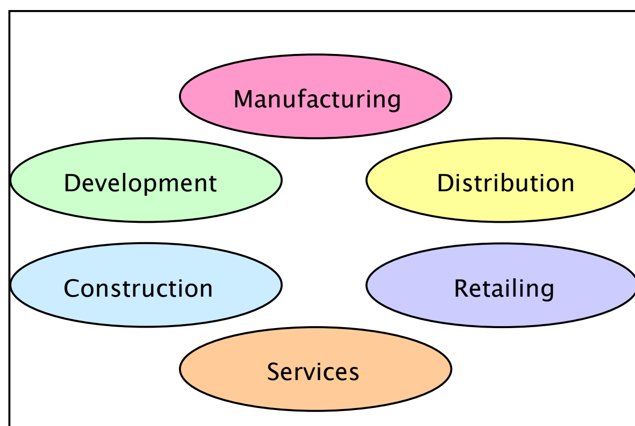
Understanding Types of Enterprises

Mainstream finance intermediaries also have developed expertise in evaluating companies by the business type, or primary mode of operation. This expertise is critical to financial intermediaries, especially when underwriting enterprises in their early stages.

The different business types have unique attributes that affect their cash flow. For example, a manufacturing firm requires primary resources such as materials and equipment, while a service firm requires people with skills particular to the service provided.

If an underwriter is unfamiliar with the attributes of a particular business type, wrong assumptions may be made about the ability of an enterprise to repay its debt. Intermediaries that specialize in high-risk lending usually focus on specific business types in specific industries. Intermediaries that deal with lower-risk loans typically focus on mature enterprises and require less specialized knowledge about business type and industry.

Figure 2: Business Mode Examples



Understanding Industry Sectors

The third critical element of specialization required by underwriters is knowledge of industry sectors. To determine how effective an enterprise may be in repaying a loan, an underwriter must understand, not only the way in which a particular type of business operates, but also the larger environment, or industry sector, to which it belongs (Figure 3).

Industries vary widely, and the factors that influence the success of a given enterprise will vary depending on the sector in which it operates. For example, the communications industry is as different from the food services industry as food

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processing is from catering. The efficacy of a business cannot be isolated from the industry sector of which it is a part.

As with understanding a particular business type, if an underwriter is unfamiliar with the attributes of an industry sector, wrong assumptions may be made about the ability of an enterprise to repay its debt. Similarly, intermediaries specializing in high-risk lending usually focus on industry sectors, while low-risk loan intermediaries focus on mature enterprises and require less specialized knowledge about industry sectors.

Figure 3. Industry Sector Examples

Clean energy	Transportation	Garment	Food
Arts & education	Recycling	Health & medicine	Communications
Information technology	Household goods	Leisure	Agriculture

Building an Effective Social Finance Capital Market

Social finance intermediaries are working to fill a finance need, but are limited in their efforts through practices aligned neither with the larger global finance community nor with other intermediaries working in the social enterprise space.

The social enterprise need for a wider range of financing vehicles is evident, but to-date, efforts at delivering financing have been limited. Microfinance initiatives are gaining momentum in funding projects in developing regions but they don't offer loans on domestic projects. Venture capital is starting to flow into some social enterprise projects; however venture capital will usually bypass low-return projects. Moreover it offers few solutions to low-margin businesses needing funding beyond the start-up stage. These laudable efforts are a piecemeal approach to delivering much-needed money to the social space, but they do not represent a true capital market.

A comprehensive and collective effort is needed to create a true social finance capital market where finance intermediaries can thrive and fund new and expanding social enterprises. This collective effort should be directed at 1) standardizing lending and investment practices among social finance intermediaries; and 2) establishing rating systems for rating social enterprise debt instruments, transfer agents for facilitating the sale of investments, and market makers for ensuring the liquidity of social finance debt. In addition, effort is needed to diversify the nature of intermediation to account for enterprise maturity, business modes, and industry sectors. More intermediaries specializing in each of these areas will reduce the cost of intermediation and strengthen the fabric of the entire space.

Financial market services such as ratings, ownership transfers, and market-making must be delivered at a cost affordable to small, low-margin social enterprises. A few

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mainstream finance institutions have taken an interest in transactions in the social finance space, but their emphasis on high-profit transactions will mean that small social enterprises will likely pay more for their money than that paid by large global enterprises. This disparity in opportunity points to the need for the formation of a parallel non-profit capital market that can serve smaller entities at a lower cost.

Social enterprise financing is gaining greater visibility in the area of microfinance and venture funding of social entrepreneurs. The stage is set for the expansion of social finance intermediaries to deliver financing in the form of loans, notes, and bonds to a broader range of social enterprises. The investors are ready. All that's needed is a force for change created through the will of existing finance intermediaries, social enterprises, and change-makers.

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The Center for the Development of Social Finance (CDSF) is a 501(c)(3) non-profit organization that promotes a wide understanding of social finance, global finance, and the economic factors that shape our communities. CDSF's educational programs promote advanced financial literacy.

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