13 ITEMS TO CONSIDER WHEN STARTING A LOAN FUND

A friendly guide for foundation and nonprofit teams interested in establishing a loan fund to align more assets to achieve mission

#1 INITIAL FUND SIZE

How much are you willing to invest to deliver measurable impact aligned with your goals?

There is a minimum operating size to consider if you are going to have a financially viable fund and several variables that affect that determination. Initially, you may choose a percentage of your total investment pool or of a specific fund or funds that are a part of the pool. Some organizations allocate a portion of a specific asset class, typically fixed income, which a loan is considered. Most foundations make an initial commitment and expand upon it as they develop their familiarity and competency. One thing is certain, your fund will and should grow over time.

#2 SOURCES OF CAPITAL

What will be the capital sources for your fund?

The most common initial source of capital is your foundation's investment fund or assets; however, there are other sources and partners worthy of consideration. If you are a community foundation or if your foundation has donor-advised funds, then your donors are the most obvious source of capital, with the added benefit of deepening your engagement and attracting additional capital. Fellow foundations who are aligned with your impact goals can make exceptional partners. Regional, county and local governments may have resources to grant, loan or align toward your fund's impact goals. The federal government may be a source of funds through various programs. Finally, banks that lend in your area can also be a source of capital due to their Community Reinvestment Act (CRA) requirements.

#3 SOURCES OF OPERATING FUNDS

How will you pay for the ongoing operating expenses of your fund?

Nonprofit loan funds have operating expenses that need to be funded. Keep in mind that the fund is an expense and should be a part of your operating budget. Many foundations fund the start-up and the initial operating expenses out of their budgets but may not want to carry these expenses indefinitely. Your donors, other foundations, and various government agencies might also be willing to support your loan fund.

What is the minimum or maximum amount you might be willing to lend to any one borrower?

#4
LOAN SIZE

The factors that most influence this decision are concentration risk and cost of origination. You will want to avoid concentration risk by not lending too much of your total fund to any one borrower. Initially, 10% of your total fund size might be reasonable but as your fund continues to grow you may want to reduce this ratio. Minimum investment size will be most influenced by your origination costs for doing a loan. Those costs may be thousands of dollars for legal review and underwriting which may be a significant ratio of the loan size and unreasonable assuming you want to manage the cost of your fund.

#5
LOAN DURATION

How long are you willing to loan money to any borrower?

You will find there are opportunities to loan for very short or very long durations, there is a need for both. Your source of capital and origination expenses will influence your consideration of what duration of loans you may offer, the duration of your funds capital sources need to match up with loan fund durations. External or donor sources will likely have repayment requirements that are 5 years or less which limits your ability to make loans for longer time frames. The cost of originating a loan is fixed but longer maturities allow you to amortize the cost over a longer period which improves investment performance. The bottom line is that you should avoid shorter-term loans that are complicated and expensive to originate.

Will you offer interest only term loans, fully amortized term loans, lease purchases or any of a myriad of other options?

#6
LOAN TYPE

Your organizations financial operating capacity and the market requirements will help you determine what types of loans to offer. Most foundations choose to make loans for a specific term and normally they are unamortized or interest only with principal due at the end of the term. Real estate or equipment loans are typically amortized. You may also decide to offer lines of credit, equipment leases, guarantees or other variations of providing credit. A best practice is to keep it simple and ensure you have the organizational capacity to manage whatever structures you choose to offer

#7
SOURCES OF OPERATING FUNDS

What interest rate will you charge on loans?

Because foundations create loan funds to expand their charitable initiatives, they typically don't charge market rates for their loans. You are making loans and expect repayment as well as a return on your capital, so you need to charge some reasonable rate that is acceptable for you to earn. The source of your capital and operating cost considerations will also influence your decision. Whatever rate or rates you charge, make sure it's not too complicated for you to manage on an ongoing basis and that it is in consideration of your fund operating requirements. Keep in mind that PRI's require below market rates to qualify.

#8 ORIGINATION & TRANSACTIONAL EXPENSES

How will you pay for the transactional expenses of your fund?

Each loan will have costs associated with underwriting and closing the loan. Legal counsel will be required to provide loan documents, review them and do the appropriate filings and perform actions related to your loan agreement requirements. Unless you underwrite loans internally you will need to pay for those services. You may incur specific cost related to securing your collateral for a loan. Your organization will need to decide how these costs will be handled and if you want your borrower to pay any of them.

#9 GEOGRAPHICAL CONSIDERATIONS

Do you have a place-based strategy?

Community foundations have geographical boundaries or constraints as may other foundations. You need to be clear about those constraints and apply them to your fund as you deem appropriate. They are an important aspect of your consideration of possible investments.

#10 SECURITY OR COLLATERAL

What security or collateral will you require?

Some of the loans you underwrite may have insufficient on non-existent collateral to offer for securing the loan. Part of the gap nonprofit loan funds fill is to loan to financially viable organizations that are unlikely to have a specific asset they can collateralize. Your organization will need to determine what, if any, security or collateral they require for a specific loan.

#11 RISK MANAGEMENT CONSIDERATIONS

How will you evaluate the risk?

Most of the loans your fund underwrites may be considered higher risk than those that local, regional or national financial institutions would make. This is part of the gap that your fund will fill in your community, to invest in and support aligned organizations that may not qualify for a commercial loan and/or the favorable terms you may offer. Given this presumption, you still have an obligation to run a viable fund and not turn your loans into de facto grants or suffer ongoing defaults of your loans. Make sure you are clear about how your loan will be repaid and any issues that might impact repayment.

#12
IMPACT METRICS

What specific impact outcomes do you want your borrower to agree to as a condition of the loan?

This element and requirement of your loan covenants is the most significant and important aspect. It is the key differentiator and raison d'etre of your fund. Each loan will have specific outcomes or impacts that you may require and that may be unique to that deal. These requirements may not be much different than some of the requirements you expect your grantees to report. Most importantly they should be derived from and in support of your organization's strategic goals. Tracking and reporting of these metrics should be a part of your ongoing fund operations.

#13
FUND GOVERNANCE STRUCTURE

What structure will you have for approving policies and transactional decisions related to the operation of your loan fund?

Your foundation already has a governance structure in place for managing the business of the foundation, but your loan fund will require its own structure for promulgating and deciding policy and managing important decisions. A loan or impact committee could be a subcommittee of the finance committee, but you will likely want to have members of your grants or program committee involved as well as foundation staff.

A NOTE FROM COMMUNITY CAPITAL ADVISORS

At Community Capital Advisors, we work with several foundations to create, build and operate their loan funds. We start by providing clients with a better understanding of impact investing and why loan funds are the most appropriate foundation for their impact investing strategy. We then help clients form a committee in their organization to determine how their fund will operate and to also guide and advise them. The initial work of this loan or impact investing committee is to begin to determine the policies and procedures for their fund or to create a policy framework.

We prepared this guide using elements of our client process to provide foundations with a tool they can use to better understand some of the considerations they will have in creating a loan fund. Using this guide you can begin to have a more detailed conversation in your organization about some of the most important aspects of creating and managing a nonprofit loan fund.

SCHEDULE A 30-MINUTE CONSULTATION

We'd love to learn more about your loan fund needs. Email Marc Rand at marc@communitycapitaladvisors.us.

Visit us at communitycapitaladvisors.us

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