Capital Access in Israel's Underserved Markets

Financial Innovations Lab® Report

February 2015

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Financial Innovations Labs® bring together researchers, policymakers, and business, financial, and professional practitioners to create market-based solutions to business and public policy challenges. Using real and simulated case studies, participants consider and design alternative capital structures, and apply appropriate financial technologies to them.

Acknowledgments

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About the Milken Institute

The Milken Institute is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs, and improve health. We do this through independent, data-driven research, action oriented meetings, and meaningful policy initiatives.

This report is dedicated to the memory of Hadar Goldin and all those who, in their lives, have given time, service, and support for those in need.

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Executive Summary

In 2014 the Milken Institute convened a Financial Innovations Lab® on the topic of how to build mechanisms for financial inclusion. Unlike a number of previous Labs that have focused on easing barriers to capital for entrepreneurs and small and medium businesses, this Lab addressed the needs of Israel's poorest and most vulnerable populations. The Lab was held in Jerusalem with more than 50 policymakers, regulators, and community and industry representatives.

The Citi Foundation (the philanthropic arm of Citigroup Inc.), Citi Community Development (U.K.), and the Yad Hanadiv Foundation sponsored the Lab, which included representatives from the Bank of Israel, Supervisor of Banks; the ministries of Justice, Economy, Finance, Welfare, and National Insurance (Social Security); tax authorities; and community and financial services industry representatives.

The Lab addressed local initiatives in alternative banking, community lending, asset building, and financial technologies. Robert Annibale of Citi Community Development (U.K.) introduced a framework for the Lab and moderated the discussion about best practices; the Lab hosted three additional international experts, including Cathie Mahon, CEO of the National Federation of Community Development Credit Unions (U.S.); Andrea Levere, president of the Corporation for Enterprise Development (U.S.); and Gina Harman, CEO and president of Accion U.S. Network. The discussions tackled the four pillars of inclusive financing strategies: capital growth, community development, credit, and capacity.

The lessons learned from these experts form the basis of the Lab's recommendations and proposed roadmap:

1. **Make small credit available:** personal, household, and small-business credit is essential for building the foundation of a self-sustaining lender and community.
2. **Be transparent and accountable to the customer:** the savings and credit services offered by financial institutions must be open, accessible, and responsive to the residents within their communities.
3. **Reach those in need:** it will be necessary to design and tailor new financial services to provide access to the unbanked and underbanked.
4. **Start small, but scalable and sustainable:** new community-based financial institutions can start small and grow, if they are given the flexibility to be innovative.
5. **Expand sources of capital:** innovative and flexible methods of sourcing new capital and investing in the communities are needed in order to reach these underserved and needy communities.

Two particular areas of focus and follow-up came out of the Lab. The first addressed the possibility of *building a new community banking service*. The Lab pointed to several existing models—including community and mainstream credit unions, and community loan funds—that could serve as guides for the development and implementation of new community banking initiatives. These models demonstrate that it is possible, and desirable, to develop local financial institutions to target population segments that large commercial banks cannot or prefer not to serve.

The programs and tools available to policymakers should facilitate startup, strengthen financial feasibility, and encourage scaling to reach the market (1) to attract the funds that would capitalize these community banking and lending services, and (2) to sustain the services to be made available to these populations—the underbanked and unbanked—in desperate need of financial access. Thus, in addition to building a depository community-based institution, the Lab recommends writing policy and designing the organizational structures through which a new source of capital would allow these new institutions, and other community-based lenders, to reach scale.

The second major initiative is to create tools to build *liquid assets* for the unbanked and underbanked. Nearly twice as many Israelis live in “asset poverty” as live in actual poverty. This is a key measure of household illiquidity and means they lack sufficient savings to cover three months of living expenses if they lose their incomes. Thus, the Lab focused on implementing child development accounts to begin lifelong savings and financial services. It also proposed the introduction of a system of data collection and reporting to quantify and monitor poverty conditions by location and population groups. In addition, the Lab recommends the design and implementation of a consumer protection, development, and asset-building initiative that would allow for the collection of credit data—positive as well as negative. Finally, participants call for the strengthening of financial education and technical assistance, and the integration of both with new community-based financial services initiatives.

Israel’s existing banks will not solve the problems of financial exclusion. Poor and vulnerable populations and communities who live at subsistence levels will not be able to lift themselves up by wishing it so. Rather, new approaches, innovations, experimentation, and collaborations are needed. This Financial Innovations Lab turns a spotlight on the issue and the possibilities for positive change.

The government must lead the way forward with regulations, programs, and tools. The Bank of Israel, and the ministries of Welfare, Economy, and Finance have recognized this opportunity and are taking steps in right direction. More, however, is needed. Stakeholders in the community—including organizations serving these populations and communities, and existing financial service companies—are becoming involved in financial programs, processes and new products. Even so, we are just beginning.

The path ahead is filled with regulatory burdens, vested interests in the status quo, and competing priorities.
But even as poverty rates climb and pockets of community distress deepen, Lab participants maintain that solutions are possible and that outcomes will strengthen not just those communities, but the country at large.

Introduction

With no access to traditional credit and banking services, significant segments of the Israeli population are marginalized financially and cannot participate fully in the country's economy. They can neither build credit through savings accounts nor obtain it through standard loans. They navigate a world of financial exclusion, often paying dearly for the "informal" credit options that remain open to them. Theirs is a precarious subsistence that they pass on to their children.

Israel's poor—the unbanked and underbanked who remain on the fringes of traditional credit and savings sources—now total 20.9 percent of the population, according to a recent study by the Organization for Economic Co-operation and Development.[1] Of these, 36 percent are children. Large families, the Orthodox communities, Arab households, and single-parent households constitute a disproportionately high percentage of the poorest citizens. At 20.9 percent, that poverty rate, defined as NIS 4,000 a month for a two-person household, is almost twice as high as the OCED average (11.3 percent).

Moreover, 40 percent to 50 percent of the all Israelis live in what is called asset poverty, according to the study. Asset poverty is the inability of a household to provide for its basic needs for three months using liquid assets alone.

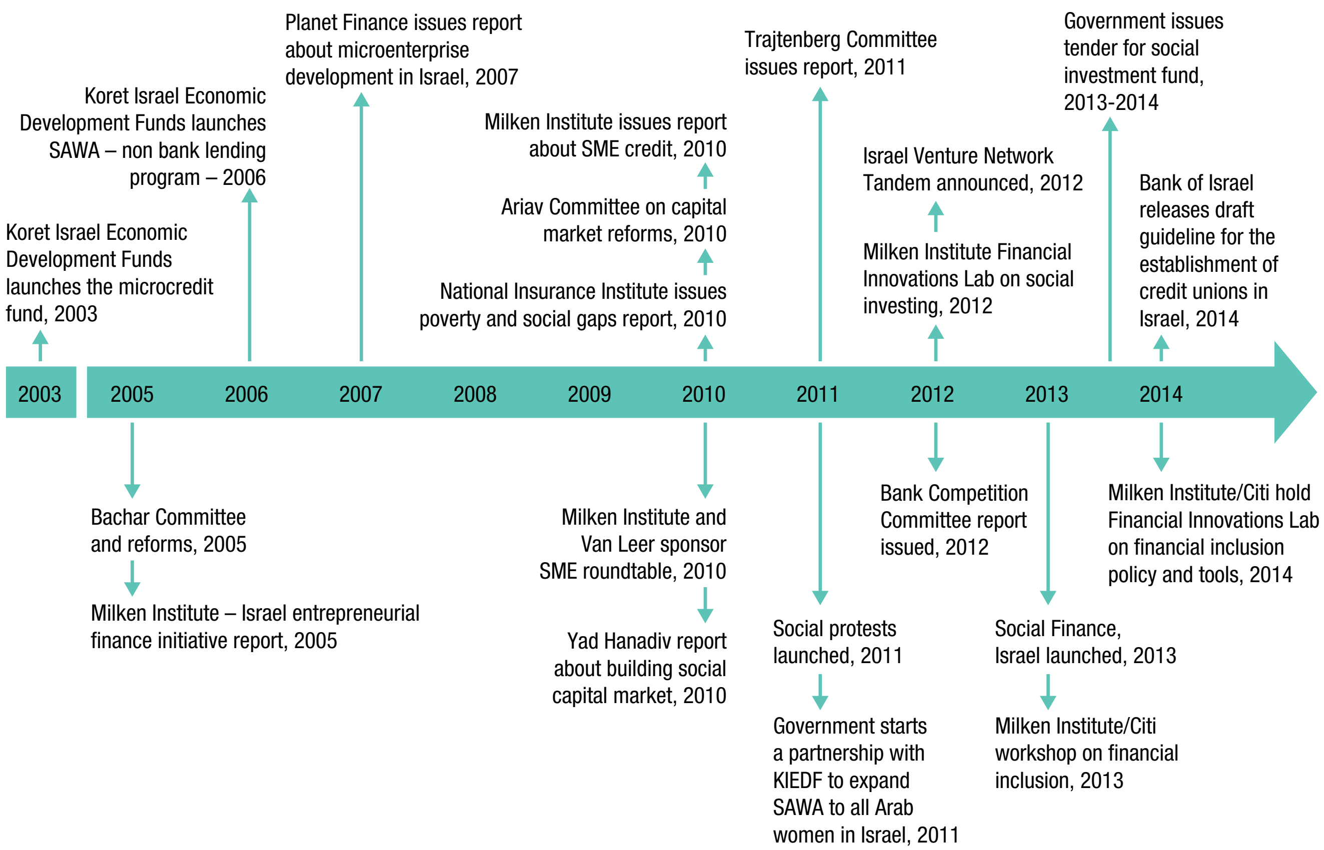
Liquid assets—which include cash, securities, funds in checking and savings accounts, and other fluid investments that can be converted to cash—could be one means by which the unbanked and underbanked engage financial services. (Liquid assets don't include business assets or property, such as a home, that would be more difficult and even undesirable to convert to cash.) But the poor can't build up capital through securities or savings accounts; they can't even open these kinds of accounts, in part because they have no credit history—indeed, no credit identity at all.

Other factors are at play as well: the lack of financial literacy among these populations, the lack of financial education available to them, a dearth of appropriate financial "tools" to service their special needs, and the extreme concentration of the banking sector. While micro and small businesses constitute 96 percent of all business in Israel and employ 60 percent of the workforce, for example, these same business receive only 20 percent of bank credit.[2] This gap in financial services has received few government interventions; more focus in recent years has been directed toward the issue of credit access for small and medium-sized businesses.

But Israel can't ignore its climbing poverty rates. They threaten household, community, and national stability; widen the gulf between rich and poor; and undermine advances in the national economy, which is powered by micro and small business.

A number of programs and initiatives that could increase financial inclusion are being developed. However, they will all require regulatory, financial, and operational innovation.

FIGURE 1 Financial inclusion policy landscape



Source: Milken Institute.

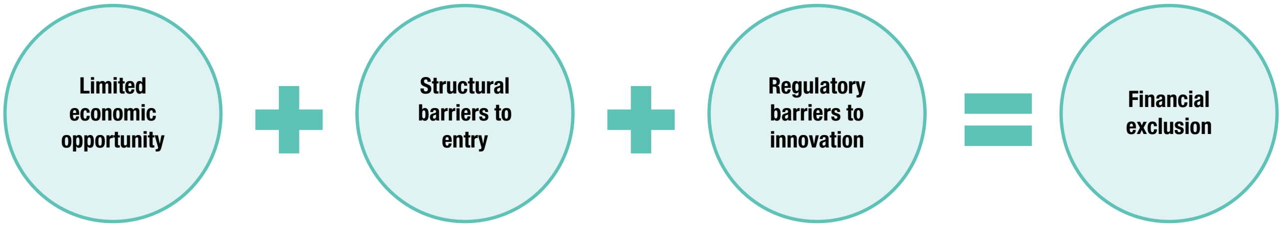
Toward this end, in March 2014, the Milken Institute convened a Financial Innovations Lab in Jerusalem, bringing together representatives from the ministries of Finance, Social Welfare, Economy, Justice; the Bank of Israel, Citi Israel, regulatory experts, and community development experts from Accion U.S. Network, the U.S. Corporation for Enterprise Development, and the National Federation of Community Development Credit Unions (U.S.).

With direction from Robert Annibale of Citi Community Development (U.K.), the Lab approach targeted four areas:

1. **Capital and asset building:** Developing tools, such as savings programs, individual savings accounts, child savings accounts, and low-cost savings programs.
2. **Credit:** Developing credit programs that target personal and micro/small-business needs, including ways to build credit history; and developing ways to help in the continuing evolution of credit bureaus and relevant regulations.
3. **Community:** Introducing community-based financial services.
4. **Capacity:** Developing scalable economic infrastructure to allow community-based solutions, including technology, services, and capital.

Using this framework, the Lab report brings together best practices to (1) address the barriers to full financial inclusion in Israel, and (2) offer specific solutions that form the basis of a roadmap for policymakers, financial services providers, and communities.

FIGURE 2 Components of financial exclusion



Source: Milken Institute.

Issues and Perspectives

Fixing the lack of competition and the ongoing credit discrimination in Israel's banking industry is only part of the overall solution—and won't increase access to underbanked and unbanked populations. Rather, the Lab presented a set of solutions specifically to address financial exclusion. One of its key components is the creation of a new class of financial services company that could provide credit and financial services specifically to these underserved markets and populations—a bank model that operates for the benefit of its customers rather than shareholders. Lab participants heard descriptions of these types of bank models and programs in the United States, the United Kingdom, and elsewhere.

This new class of company is represented by various types of community development financial institutions (CDFIs). CDFIs serve low-income communities in impoverished areas, and may be banks, credit unions, thrifts (savings and loans, and savings banks), and non-depository institutions. They do not currently exist in Israel. Among these CDFIs, the Lab focused on credit unions as a priority model for implementation in Israel. The discussions focused on two types of credit unions: community-based credit unions, which in the U.S. can be designated as a CDFIs, and mainstream credit unions, which are market-based and thus are not traditional CDFIs.[3] The Lab featured both models because both are needed in the Israeli market to provide a competitive alternative to banks and to expand financial services to underserved populations. Plans to launch Israel's first credit union (also known as a cooperative bank) got under way in late 2013.

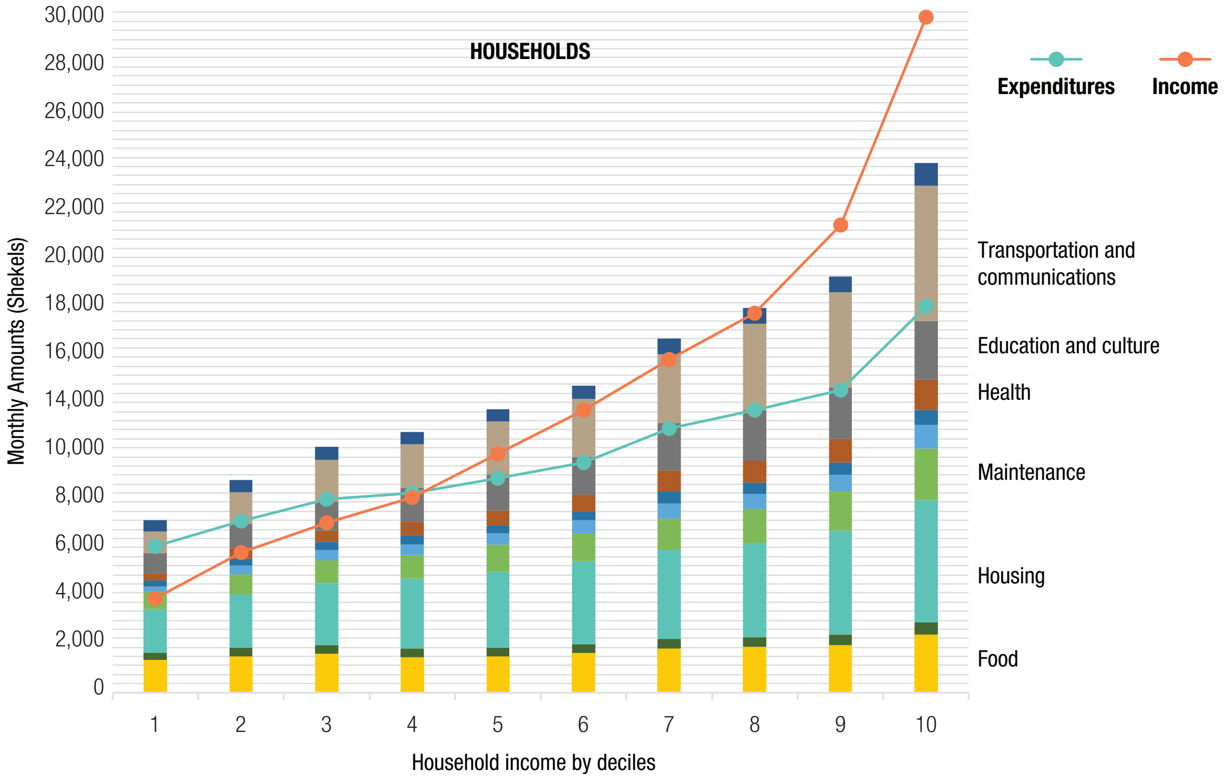
Lab participants agreed that the development of both mainstream and community-based credit unions is important to create a critical mass of financial services in this new client sector. Market-based, mainstream credit unions usually attract customers from traditional banks, while community-based credit unions target a mix of low- and moderate-income customers who may not have any access to the financial services at traditional banks

Indeed, immediately following the Lab, the Supervisor of Banks proposed the creation of a new type of banking entity, called a banking union. For purposes of this Lab report, however, we will refer to the companies as credit unions, as they are called in the U.S., U.K. and elsewhere.

BARRIERS

Financial exclusion stymies business and household income, and adds negligible benefit to the national economy. It produces chronic, multigenerational financial distress, and is aggravated by longstanding structural and regulatory barriers to economic participation. As seen in figure 3, the structural gaps between income and expenses for the lowest 40 percent of the population perpetuate asset poverty among this group.

FIGURE 3 Gap between income and expenses for lowest 40 percent of households



Source: Israel Central Bureau of Statistics, 2013.

The Lab did not concern itself per se with the underlying societal causes of poverty, the primary barriers to financial inclusion. This is the purview of other specialized institutions and organizations. Participants here turned their attention to structural and regulatory issues; recommendations pertaining to the banking sector; and ways to develop the kinds of community-based financial institutions that exist in other countries, but not in Israel, and which provide services to low-income communities.

BARRIER 1

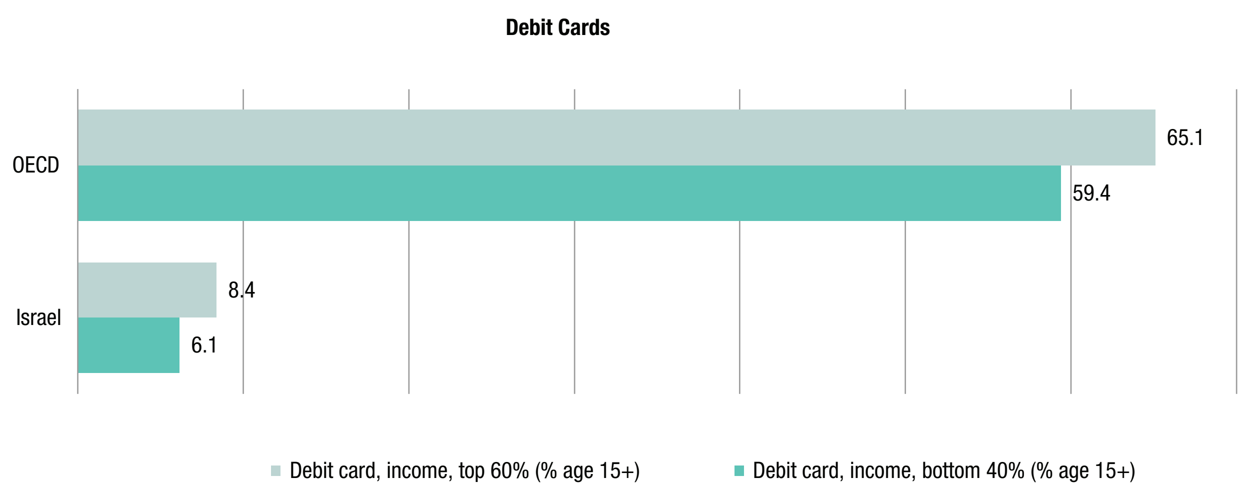
STRUCTURAL BARRIERS

As noted earlier, only 20 percent of all bank loans are extended to micro and small businesses. Furthermore, 95 percent of all trade credit and 65 percent of all commercial credit (also known as line of credit) is carried by only five banks, with the two largest banks holding about 60 percent of all banking activity.

The highly concentrated banking sector makes it difficult for competitors to enter the system, even as the main banks within it become less competitive among themselves.[4]

Israelis also tend not to use bank debt cards (similar to U.S. bank debit cards, they are tied to accounts and are not true credit cards, with payment made possible over time), even though this is one way to secure quick access to funds. This is the case both for upper- and lower-income population segments, at 6.1 percent and 8.4 percent, respectively. In other OECD countries, upper- and lower-income populations save at 59.4 percent and 65.1 percent, respectively.

FIGURE 4 Debit card usage, Israel vs. other OECD countries



Source: World Bank.

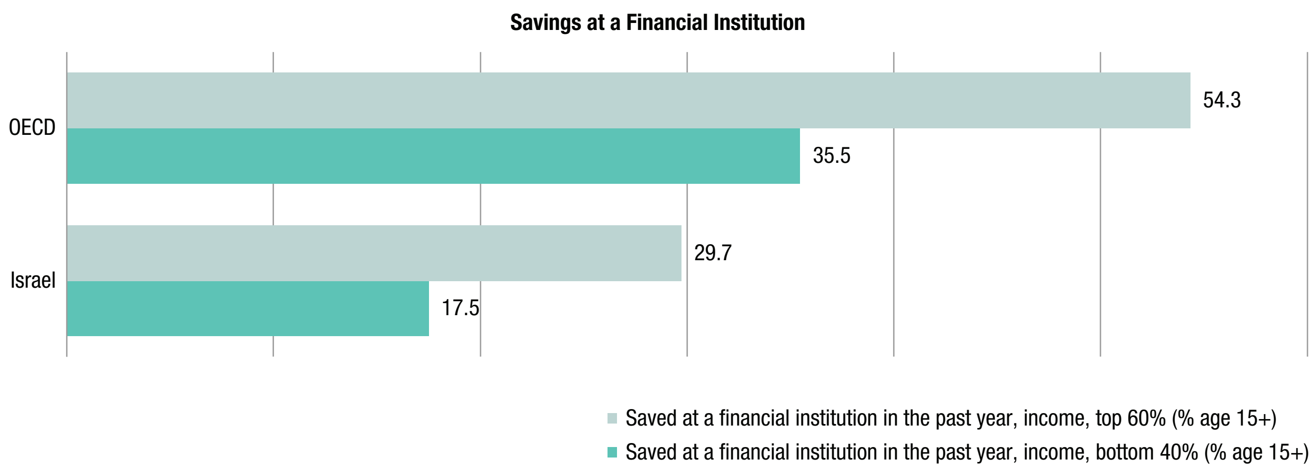
The low usage is in part due again to the high concentration of the banking sector. The same five banks that control most of the access to loans also issue debit cards, and this—as well as issues of transaction and maintenance fees—has slowed their widespread introduction.

More recently, third-party card providers, such as Cal-Israel Credit Cards Ltd., are entering the market, and usage among Israelis is likely to increase. However, Israeli banks still do not issue credit cards either, which would enable monthly payment options.

Yet Israelis aren't using banks for savings, either. Of households in the lowest 40 percent income measure, only 17.5 percent had savings with a financial institution. This significantly trails behind the 35.5 percent of their counterparts in other OECD countries who hold savings in a financial institution. Even among Israeli households whose incomes fall in the top 60 percent, only 29.7 percent had savings with a financial institution—still far behind their OECD counterparts, of whom 54.3 percent held savings in a financial institution.

Again, high transaction and maintenance fees, and barriers even to opening an account, may help explain these low numbers.

FIGURE 5 Bank savings, Israel vs. other OECD countries

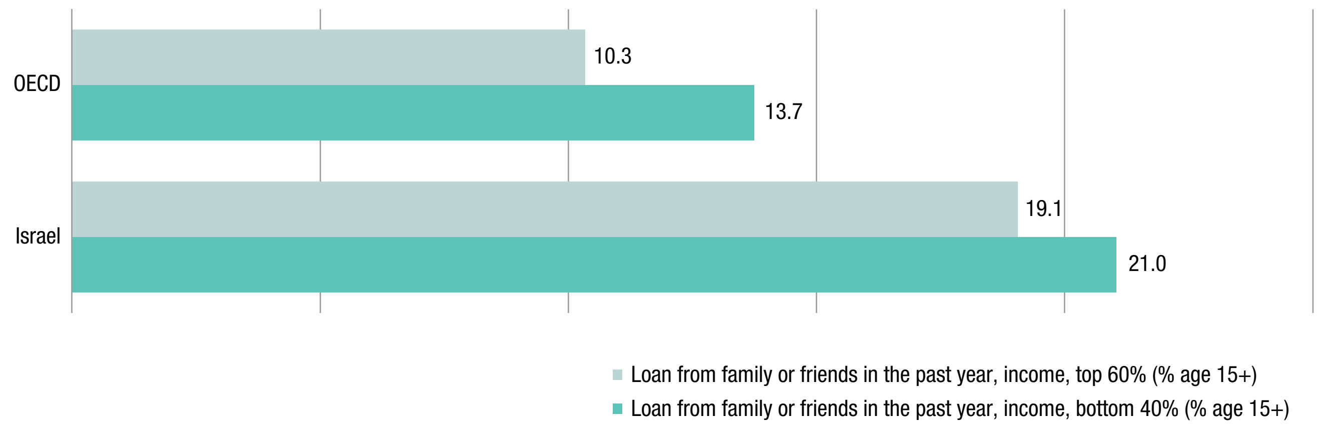


Source: World Bank.

As a result, many Israelis, and most of its marginalized populations, rely on other sources for credit. Not surprisingly then, Israeli households borrow more from family members than do their counterparts in other OECD countries. Twenty-one percent of lower-income households have credit from family members, compared with 14 percent of OECD lower-income households. And while families may be a good place to turn for loans, this kind of lending is neither scalable nor sustainable for long-term financial growth.

People with limited resources also turn to the "informal," or "gray," markets, where they must often pay excessive interest rates for shorter-term loans. Another important source of credit is community loan funds, often established and funded with philanthropic investments. These community loan funds have limited and sometimes informal funding bases, high overhead costs in servicing loans, and limited long-term financial feasibility or sustainability.

FIGURE 6 Family loans, Israel vs. other OECD countries



Source: World Bank.

BARRIER 2

REGULATORY BARRIERS

Lab participants agreed that developing the regulatory groundwork for the introduction of credit unions would serve two purposes: it would help open the highly concentrated banking system to increased competition; and it would provide services and education to the unbanked and underbanked populations.

Currently, it is impossible for credit unions of any kind to operate in Israel. Under existing banking regulations, any institution that takes deposits and makes loans must be licensed as a bank. As a "bank," it is subject to all the rules, obligations, and financial constraints of a bank (and acquires protections from the central bank and the government). But some of the rules—including the equity, reserve requirements, and technology platform services—would be difficult, if not impossible, for credit unions to meet.

Didi Lachman-Messer, former deputy attorney general for economic and fiscal laws, reviewed the major banking laws and regulations that, however well-intentioned they may be, have resulted in financial exclusion. These rules that are barriers to the creation of credit unions because they mandate (1) account restrictions that affect existing and new account holders; (2) requirements for disclosure of credit information; (3) credit information and credit scoring; and they impose limitations on nonbank lending practices.

(1) Account restrictions that affect existing and new account holders

Banks may not generally refuse to open a bank account, but they are not obligated to provide credit or other financial services, such as checking accounts or payment services, to account holders.

- In addition, a bank must designate an account to be restricted if the holder bounces 10 or more checks within a 12 month period. In this case, the account holder may not open any other account for one year. In effect, these account holders are excluded from financial services, including check writing, and bank card services.
- The bank must designate the account to be severely restricted if the account holder who is already restricted in one account should bounce 10 checks in a different account or, within three years after removal of the first restriction, again bounce checks in the original account. In this case, banks may put a credit limit upon all checks and other obligations.
- As a result of restrictions, the account holder is unable to withdraw checks as a means of payment either from the restricted account only or, in the case of severe restrictions, from all accounts for a period of up to two years.
- New accounts may also undergo restrictions.
- Banks may impose very low restrictions on existing or new account holders who did not repay their debts in formal collection proceedings and were thus declared to be “debtors evading payment to their creditors.”
- The same law also forbids the restricted customer or account holder from withdrawing checks on an existing or new account, and imposes a criminal penalty of up to two years’ imprisonment or a fine four times the amount withdrawn on such action.

In 2013 more than 292,532 restricted bank accounts were recorded. Bank customers who are restricted under these laws are considered as financially excluded, even though they hold bank accounts.

(2) Requirements for disclosure of credit information

- The Bank of Israel discloses information about restricted account holders to all banks and any other users of credit information. Yet it doesn’t release positive information, such as payment histories, loan repayments, or account balances.
- The Bank of Israel discloses this same information to credit card companies, whether they are owned by the banks themselves or owned separately. All credit card companies are barred from extending credit cards to restricted customers. (As a result, the only method of payment is cash, and the only credit source is families or friends, either directly or as guarantors to gray-market lenders.)
- This information from the Bank of Israel remains at the banks and affects credit ratings for up to three years, long after restrictions are removed. In effect, these account holders are excluded from financial services, including check writing, bank card services, and payments services for a much longer period of time than was intended in the law and regulation.

(3) Credit information and credit scoring

Under current laws, credit information and credit scoring require licensing and are supervised by a special regulator under the Ministry of Justice (MOJ).

- The MOJ is also responsible for privacy and data protection from nonbank loans, i.e., those given by commercial lending companies.
- Because the privacy of the account holder and/or borrower is of the utmost concern, explicit consent is needed for the gathering of “positive” consumer information.
- Few companies are engaged in gathering credit information under the existing Credit Information Act, which defines what kind of information they can gather and how it may be disclosed. As a result, since permission is required for the release of “positive” information, “negative” information is what is generally disseminated. The result is an incomplete picture for financial service companies, and this again results in financial exclusion.
- Community activists have long argued that credit scoring harms the poor, who have little financial exposure and for whom no data exist.

(4) Nonbank lending practices

There are no licensing requirements and very little regulation of the “nonbank credit providers” that can vary from reputable community and business loan funders to gray-market lenders and loan sharks; the consumer must fend for himself in making distinctions among them. A gray-market lender may market itself as a “bank,” for example, without having the obligations imposed on banks to meet financial standards or protect the consumer.

In fact, the Nonbank Loans Act,[5] the single piece of legislation that governs nonbank credit providers, only addresses interest limits on these loans. That limit is set by the Bank of Israel and caps at two and a half times the prime interest set by the central bank.

Three problems exist with the act:

- Credit card companies are not subject to the interest limit, and they tend to offer loans at higher interest rates.
- Consumers have little protection in the courts against unscrupulous lenders. The courts will not *enforce* the higher-interest agreements, but that in itself offers little protection against gray-market collection systems.
- Lenders have found ways to circumvent the interest limit laws by drawing up several loan agreements (with varying terms) and setting much higher interest rates.

In light of these banking regulations that effectively exclude the poor from financial engagement, Lab participants discussed the creation of a type of institution that could take deposits and make loans but would not fall under the definition of a bank.

This new type of institution would require a new regulatory classification, new capital requirements, revised interest and fee structures, new deposit rules (and protection of those deposits), and the ability to offer credit transparency in credit scoring and rating.

Areas for discussion included how credit histories are built, how credit is scored, and what incentives for the banking sector would make engagement attractive.

LESSONS FROM ABROAD

Many countries, including the United States and the United Kingdom, have taken steps to improve access to capital by augmenting the traditional financial system with a range of products, ranging from community lending and community banking (credit unions) to other financial service programs for the unbanked and the underbanked.

U.S. commercial banks are regulated and funded (through wholesale banking services) under a layered, complex, and robust national structure, including the Federal Reserve Bank and the U.S. Treasury. They benefit from a federally regulated and bank-funded insurance program—the Federal Deposit Insurance Corporation—which insures deposits up to a designated amount. The federal government grants a complicated set of tax benefits to market and philanthropic investors and donors who establish (and obtain certification for) community development financial institutions (CDFIs), including community banks, community loan funds, and CDFI-certified credit unions. CDFIs specifically target underserved communities and populations. Credit unions are member-owned and -controlled financial institutions that generally compete with banks to provide credit and other financial services. If they are certified as CDFIs, they benefit from tax-advantaged equity investors and provide community development services.

LESSON 1 — MAKE SMALL CREDITS AVAILABLE

Gina Harman, president of Accion U.S. Network, which provides loans to startups and small businesses, talked about the principles of community lending. A successful, sustainable community development financing system must be responsive to community borrowers, she said, and must focus on building capacity (including helping them build personal and small-business credit, and offering financial education). She reminded the group that small businesses are the biggest net new-job creators, and create sustainable wealth in communities.

LESSON 2 — BE TRANSPARENT AND ACCOUNTABLE TO THE CUSTOMER

Cathie Mahon of the U.S. National Federation of Community Development Credit Unions explained the structure of community development financial institutions in the United States.

As background, she explained that the Federal Credit Union Act was enacted in 1934, formalizing credit unions role to promote savings and credit. Their mission was to meet the credit and savings needs of consumers, especially those of modest means. Credit unions were designed to be member-owned, democratically operated, not-for-profit financial institutions, exempt from federal and state taxes.

In the U.K., similarly, credit unions have evolved into a particularly important role. Credit unions are identified as a needed component of the financial services industry to ensure access to financial services.[7]

ACCION HIGHLIGHTS

- Fairly priced loans from $200 to $300,000 (amounts and interest rates vary by market), allowing for a wide range of small businesses in the U.S.[6]
- Training opportunities ranging from in-person counseling and group training to online resources that help business owners discover new opportunities for growth.
- Referrals to banks, training organizations, and local networks for resources beyond what Accion provides.

RESULTS

- $394 million since 1991
- 48,000 loans
- 5,817 active loans totaling $60.9 million
- $10,000 average loan size
- 5.6 jobs created for each 10,000 loan
- 5 percent delinquency/default rate

The Accion US Network is a branch of Accion International, which operates in 32 countries and is one of the largest nonprofit micro-loan and community lenders in the world.

Through social investments (made with the dual goals of a social and financial return), these lenders invest in the community, recover their investments, and recycle the funds within the community.

U.S. credit unions are regulated either by the federal National Credit Union Administration or by state banking regulators. Deposits are federally insured by the National Credit Union Share Insurance Fund (NCUSIF) up to $250,000, just as insured bank deposits are. To date, 6,800 U.S. credit unions serve 96 million consumers with slightly more than $1 trillion in assets. Worldwide there are 54,000 credit unions in 97 countries, according to the Israel Credit Union Association.

Credit unions have no outside stockholders, so after reserves are set aside, earnings are returned to members in the form of dividends on savings, lower loan rates, or additional services. Typically, credit unions serve groups of members who share a "common bond" with the credit union founders, such as employment at a company or membership in an association or community. In the U.K., the common bond requirement has been relaxed to allow credit unions to set their own limits. This feature has the benefit of preventing customers from losing access to financial services when they change their jobs or homes.

LESSON 3

REACH THOSE IN NEED

Credit unions, however, don't translate directly into financial inclusion. In the U.S. and elsewhere, they do help; almost 2,000 U.S. credit unions have been designated by regulators as "low-income" credit unions, in which more than 50 percent of their members are defined as "low-income". Credit unions have also adapted to serve communities with high percentages of low-income residents. These credit unions fit into the category of CDFIs.

With recent changes in the U.K. to the Credit Unions Act,[8] credit unions will no longer have to prove that potential members share something in common. This will open their rolls to new client bases. Credit unions can also provide services to community groups and social enterprises. As a service to savers, they can provide interest on savings, instead of dividend payments.[9]

These changes in the U.K. law will allow savers to compare rates of returns available from credit unions and other savings providers. This is particularly helpful to individual savings accounts (discussed in the following section) and is important in marketing credit union savings programs and attracting more capital.

The following table identifies key features of programs, incentives, and practices of the community loan funds and credit unions under discussion.

TABLE 1 What are the characteristics of community loan funds and credit unions?

	Community development loan funds	Community development credit unions	Mainstream credit unions
Purpose	Aggregate capital from individuals and institutional social investors at below-market rates and lend this money primarily to nonprofit housing and business developers in urban and rural lower-income communities.	Promote community ownership of assets and savings; affordable credit card and retail financial services to lower-income individuals; take deposits and make loans within communities.	Promote community ownership of assets and savings; affordable credit card and retail financial services to lower-income individuals; take deposits and make loans among their members.
Startup	Flexible startup requirements.	Must organize communities with affinities, including geographic locations and ethnic and religious groups; compliance with regulatory agencies.	Must organize communities with affinities, such as a common employer, common occupation or labor union; compliance with regulatory agencies.
Governance and ownership	Nonprofit, democratic; community investors, borrowers, and technical experts serve on the board and loan committees.	Nonprofit financial cooperatives owned and operated by individuals who are members	Nonprofit financial cooperatives owned and operated by individuals who are members.
Regulation	U.S.: Self-regulated; except for nonprofit 501(c) (3) restrictions and state securities law where applicable.	U.S.: Federally and state-regulated; insured by the National Credit Union Administration.	U.S.: Federally and state-regulated; insured by the National Credit Union Administration.
Borrowers	Nonprofit community organizations, social service provider facilities, and small businesses.	Members of the credit union (usually individuals), and eligible non-members.	Members of the credit union (usually individuals).
Capital sources	Foundations, banks, religious organizations, corporations, the government, insurance companies, and individuals.	Member deposits and non-member deposits from social investors, government, and private investors (in return for tax credits).	Member deposits and limited non-member deposits from social investors, the government.

LESSON 4 START SMALL, SCALABLE AND SUSTAINABLE

McMahon provided data from the National Federation of Community Development Credit Unions about the characteristics and financial performance of various types of credit unions: community development credit unions, low-income certified credit unions, and regular credit unions.

Based on this data (see Appendix III), Milken staff analyzed and estimated the impacts based on size for each type of credit union. The sizes include institutions of 1,000 to 4,000 members. Depending on the type of institution, these memberships translate into asset sizes of $3.5 million to $19 million for community development credit unions, and $7.9 million to $35 million for regular credit unions.

Community development credit unions generally lend at higher numbers than do either low-income-designated or mainstream credit unions, in part because they are more responsive to their clients who tend to be more creditworthy. Similarly, the loan deployment rate (the use of capital for loans) is considerably higher in the community development credit unions than in low-income-designated or mainstream credit unions. And despite higher delinquency and charge-offs (still less than 1 percent), the income and returns on assets at community development credit unions are higher than for low-income-designated credit unions (which for all but the smallest groups are generally higher than mainstream credit unions).

Asaf Zilberstein, a Milken Fellow assigned to the Bank of Israel[10] during the period of the Lab research, had conducted additional analysis of the financial statements of the broad category of U.S. credit unions.[11] He divided them into three categories based on asset size: less than $20 million; between $20 million and $100 million; and over $100 million. He also compared their financial performance to the five major Israeli banks. Based on his analysis, Zilberstein found the following:

- **Net profit:** While credit unions are not profit-based and no dividends are paid on the basis of profits, for accounting purposes, net profit is still an important measure of stability and capacity for growth. Net profits are correlated to scale, with the larger institutions having the highest level of profitability, in accounting terms.
- **Net returns:** This is a ratio of net income to total average assets. Average returns among credit unions were 0.43 percent, compared with Israel's major banks at 0.73 percent.[12] Again, the scale of the credit unions is important, with the larger credit unions yielding a net return of 0.63 percent.
- **Loan interest rates:** As expected, the interest rate charged by credit unions is higher than the interest rates charged by Israeli banks. These interest rates are risk-adjusted, owing to the combination of the cost of funds and the risk premium for lending to their target populations. The low interest rates among Israeli institutions may also be based on the limited risk premiums component of their loan portfolios.
- **Equity to total assets:** U.S. credit unions have higher ratios of equity to total assets than do Israeli commercial banks. This measure demonstrates how the bank can absorb losses, if needed. For credit unions, the larger equity to total assets is not regulated; rather, it is at least in part due to the fact that since profits are not distributed, equity is retained in the credit union, thus boosting the levels of relative equity.
- **Liquidity:** While Israel banks maintain higher levels of cash than U.S. credit unions, the largest institutions had the lowest rates of cash and cash equivalents on their balance sheets. This is a significant finding, especially when arguing for lower thresholds for credit unions in Israel than the commercial institutions.
- **Credit efficiency:** Expenses for credit servicing among credit unions are almost twice the level of Israeli banks, again owing to the small credits and high turnover likely among credit unions.
- **Credit deployment:** Credit unions deploy their capital for loans more efficiently and effectively, with the largest credit unions having the highest levels. All three groups of credit unions, including the smallest institutions, lend at higher levels (adjusted for asset size of the institution) than do Israeli commercial banks.

Zilberstein's analysis illustrates that larger size does matter for profitability, efficiency (scale), credit deployment (turnover), and net returns (revenues on net assets). It also illustrates the relative performance comparison between U.S. credit unions and Israeli banks. However, the amount of equity is scalable to the size, structure, and activities of the institutions, allowing smaller institutions to operate with less equity.

The following table explains various terms used in the U.S. financial services system.

TABLE 2 Key financial tools to support community development credit unions in the United States

Tool	What it is	Why it is important	Examples
Tax deduction	A deduction against income for a taxable investor.	1. Expands the base of potential investors. 2. May increase the amount of equity available, improving cash flow. 3. Boosts the returns to investors by reducing their general tax liability.	New Markets Tax Credit
Tax credit	A credit against the general tax liability of an equity investor in designated financial institution.	1. Expands the base of potential investors. 2. May increase the amount of equity available, improving cash flow. 3. Boosts returns to investors by reducing their general tax liability.	New Markets Tax Credit
Corporate tax exemption	The corporation is exempt from paying a portion or all of the corporate tax on net income from operations.	1. The tax exemption will improve financial performance and sustainability.	Private activity bonds; tax-exempt financing; 501(3)(c) tax-exempt financing
Bond guarantees	A pledge to cover part or all of the debt on a bond, transferring a share of the risk for the debt from the lender/bond buyers to the guarantor.	1. Guarantees may lower the risk of the borrowing, saving between 50 and 200 basis points on the debt, improving the financial feasibility of the project. 2. Guarantees may make borrowing possible.	CDFI Bond Guarantee Fund
Bonds	Debt issued in the public or private capital bond markets.	1. Longer terms for repayment; flexible repayment schedule, and fixed-rate, lower-cost interest improve the liquidity. 2. Loan pools can be structured to improve the collateral and credit quality of the bonds. 3. Financing costs are financeable.	CDFI Bond Fund
Deposit insurance	Deposit insurance is a guarantee that the amount of the deposit will be available to the depositor on demand from an eligible financial institution.	1. Deposit insurance shifts the risk from the depositor to the insurance provider, provides an assurance to each depositor that its principal is protected. 2. The insurance improves the opportunity for financial institutions to raise capital by expanding their deposit base. 3. The deposit insurance is funded by membership fees.	National Credit Union Share Insurance Fund (NCUSIF)

Each feature is important to consider for the development of credit unions in Israel. For example, the capital base and the services to the underbanked and unbanked for a credit union may be too limited if it is restricted only to members (with membership fees).

LESSON
5

EXPAND SOURCES AND USES OF CAPITAL

Lab participants discussed needs of those unserved or underserved by current financial services. These needs require flexible sources of capital that allow for adaptation of the capital structure, including amounts, terms, and conditions, according to the makeup and economics of specific projects. The costs of these adaptable sources of capital for community projects are high and include the structuring and servicing costs. Several models have evolved to address these concerns. For example, crowdsourcing, which provides technology platforms, allows projects to make calls for capital and facilitates investors to fund specific projects on a project-by-project basis with relatively low transaction cost.

Keren-Or On of Fundrs presented some examples of crowdsourcing platforms and described how they can provide sources of equity and credit for promising projects.

One model of crowdsourcing, however, with a specific community-based focus, is the Calvert Community Note Program. The private, nonprofit Calvert Community Notes Program matches nontraditional capital markets with targeted economic and community development projects. The program opens capital market access to eligible projects through a form of "crowdsourcing," using retail market channels. The program provides a credit enhancement through philanthropic investments into a first-loss pool, allowing the funds to be targeted to projects in distressed areas and for unserved populations. The program is an innovative way of providing access for nontraditional capital market investors to nontraditional community-based projects.

…we can build the on-ramp to financial services for the unbanked in Israel…

—Bob Annibale, Citi

Financial and Policy Solutions

After discussing barriers and best practices, Lab participants then came back to the four-track "on-ramp," suggested by Citi Community Development's Robert Annibale, that would form the basis for a business model and the means by which the unbanked and underbanked could ultimately access full financial services.

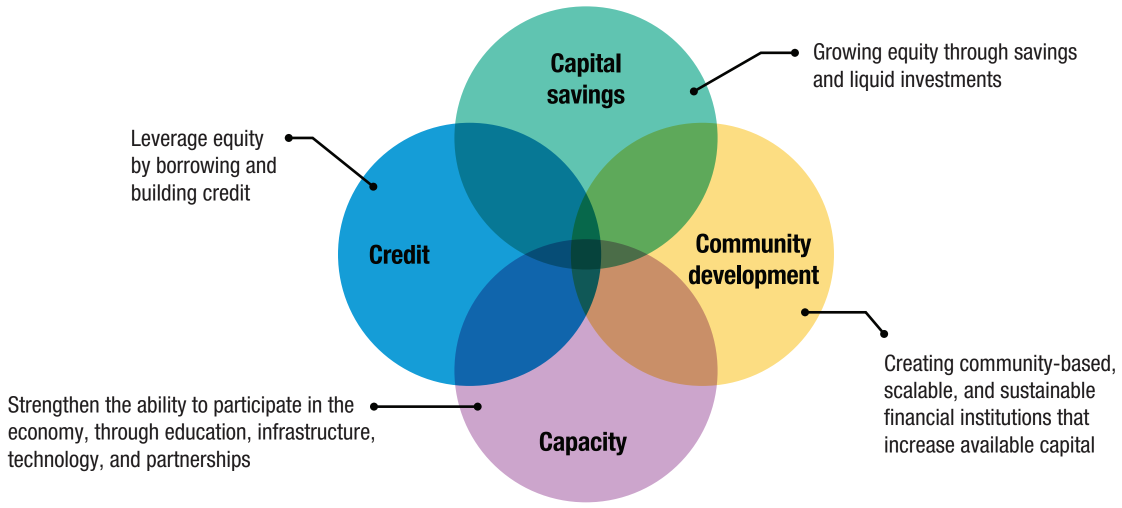
1. **Capital and asset building:** Developing tools, such as savings programs, individual savings accounts, child savings accounts, and low-cost savings programs.

2. **Credit:** Developing programs that target personal and micro/small business needs, including ways to build credit history; looking at ways to help in the continuing evolution of credit bureaus and relevant regulations.

3. **Community development:** Introducing community-based financial institutions (CDFIs) that serve specific communities, and the underbanked and unbanked. These could include specialized loan funds, community banks, or credit unions, and would involve introducing legislation or new regulations (in the case of banks and credit unions) that would allow for their establishment.

4. **Capacity:** Developing economic participation, including helping individuals build credit histories, find access to financial education, and use affordable technologies.

FIGURE 7 | Four components of a successful business model



Lab participants agreed that a roadmap will require careful approaches, innovative programs, and targeted incentives. In addition, they emphasized that CDIFs would target a brand-new market—one that has not been served by traditional banking institutions. The demand in this market must be allowed to “pull” the innovation of new and appropriate services; CDFIs must tailor their services to their markets.

SOLUTION 1

ADDRESSING CAPITAL

One of the key drivers of community banking success is the way these banks help their customers save and build assets, particularly liquid assets. This source of capital in turn provides the needed fuel for the growth of the bank, which again strengthens the financial capacity of its customers and the community in a virtuous circle.

Supported savings programs, i.e., programs matched by public and philanthropic investments, can jump-start savings among community customers.

Andrea Levere of the Corporation for Enterprise Development discussed the benefits of individual savings accounts from a U.S. perspective. These could have numerous applications in Israel:

- Children’s savings accounts raise educational aspirations for young people and increase their parents’ expectations for higher-level educational attainment.
- Studies show that a low- to moderate-income student with a college savings account in his or her name is three times more likely to attend college, and four times more likely to graduate, even with under $500 in the account.
- Children’s savings accounts bring adults into the financial mainstream: “Parents will do for their children what they won’t do for themselves,” said Levere.
- Success of the program is leading to growth of children’s savings programs across the U.S..

Itamar Yakir, a Milken Institute Fellow assigned to the Ministry of Welfare, proposed a voluntary “designated savings account” for children of low-income families.

- Participants would make deposits on a monthly basis into the account, with the amount based on a combination of resources, including the current monthly child allowances from the government, current household income, and contributions from extended family and friends.
- The monthly deposit would be matched (1:1) up to a yearly cap of 750 NIS by the government.
- The account could remain active up to 22 years, with a possible linkage to the grants and deposits given during national or public service.

PA’AMONIM

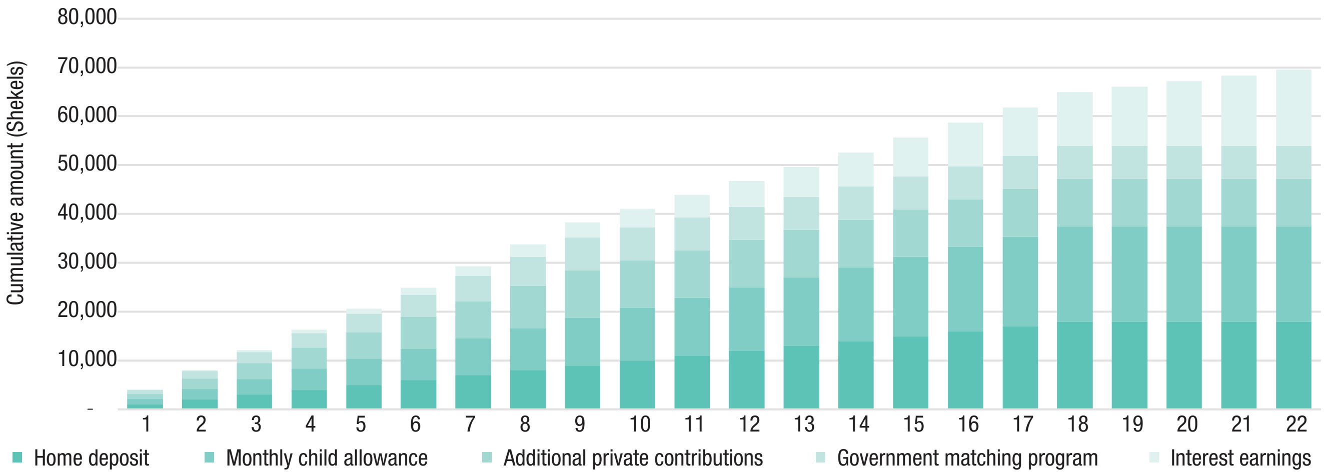
Pa’amonim is an Israeli nonprofit organization founded in 2002 with a mission to provide financial education and services that help individuals, families, and small businesses achieve financial independence. The organization provides training in conjunction with a financial education initiative from the Ministry of Finance. It focuses on long-term solutions to debt and poverty, providing a financial roadmap for families. Pa’amonim also provides small loans to its clients. As of 2014, it services approximately 2,600 families with various forms of technical assistance and training each year.

- The bank would handle the funds. As the participants grow older, the bank would perhaps extend additional financial services, based on the savings account.
- Social organizations would provide financial guidance and training, and even savings clubs.

Savings would be designated for the participant's higher education and entrepreneurship.

Through such a program, children would watch their liquid assets grow. The projection for these assets, including initial deposits, the monthly child allowance through age 18, additional private contributions, and government match through nine years, and interest earnings over 22 years, is estimated at approximately NIS 70,000 per participant.

FIGURE 8 | A targeted saving plan for out-of-home students



Source: Milken Institute.

While compound interest is an important component of childhood savings, financial education is equally important. In the U.S., Levere said, the Financial Literacy and Education Commission (FLEC), created in 2003, is developing a national strategy for financial education; and the President's Advisory Council on Financial Capability for Young Americans, created in 2013, targets education and training in financial literacy programs for young people.

An Israeli savings program could be integrated into the larger framework of the community bank that includes deposits, financial education, and small credit.

The U.S. Corporation for Enterprise Development (CFED) uses the framework of interacting services: families learn financial skills and build their human capital. They earn income and public benefits; they save for emergencies and the future; they invest in assets that will generate returns and income; and they learn how to protect the gains they have made through insurance and avoid predatory practices.

SOLUTION
2

ADDRESSING CREDIT

Given the Bank of Israel's concern for risk in startups, and assuming there would be some minimum capital thresholds, Mahon recommended that Israel initially focus on credit unions ranging from $10 million to $50 million in total assets (with net worth of $2.3 million to $2.7 million). Some of the most dynamic and innovative credit unions are coming from this moderate-range group, she said. With access to the right infusions of capital over time, these credit unions are moving into untapped markets and scaling up services, which enables them to continue to grow and thrive.

She suggested that since Israeli institutions would not be able to start with this level of capitalization, the Bank of Israel might consider a phased-in equity threshold that would allow them to become more complex at later growth stages and with demonstrated competency and performance.

Capitalization

The sources of capital for the new bank would include memberships, private or social investments, and stock sales. Existing banks use private investments and stock sales for capitalization. However, for new community credit unions, the approach is a balance between memberships and private and social investments. This approach leads to smaller organizations with invested shareholders related to the community and the new institution, with levels of capitalization, equity, reserves, investment activities, and earnings distributions based on a community banking models (i.e., modest scope of business activities with limited investment and less systemic risk). Ultimately, as the institutions grow, they may consider stock sales. Nevertheless, each of these capitalization approaches has limitations involving representation, finance, reporting, and returns (distributions and dividends).

OFEK

Ofek was founded in 2012 as a membership-based cooperative, with the goal of taking deposits and making personal and small business loans. Ofek has engaged management and staffing to implement its financial services and capitalization plans. It is engaged in the process of raising memberships in anticipation of receiving Bank of Israel approval to operate. As of September 2014, Ofek has 2,770 memberships with a total of 8.3 million shekels. Its goal is to raise the memberships to meet the capital requirements set by the Bank of Israel, which is a challenge, given the high level set by the bank.

Incentives

Lab participants discussed several possible incentive and support programs that could facilitate the startup and scaling of community and mainstream credit unions. Some of these programs are designed to benefit customers (and indirectly help the credit union). Other programs are directed at the institutions themselves and their investors. Lab participants agreed that there is no single program or solution. Rather, in order to create sustainable institutions in this new market, a combination of programs and incentives may be necessary.

TABLE 3 Financial incentives and programs

	Community development credit unions	Mainstream credit unions
Startup financing	During the membership and initial funding phase, startup financing to provide a financial bridge to meet the capital requirements and the initial infrastructure (e.g., IT) costs required by regulation; secured by cash flow.	During the membership and initial capitalization phase, startup financing to provide a financial bridge for the initial infrastructure (IT) costs required by regulation; secured by corporate guarantees and cash flow.
Deposit guarantees	Limited guarantees on deposits up to 50 percent of the principal, for a period of seven years.	Limited guarantee on deposits up to 50 percent of the principal, for a period of three years.
Tax deductions	Membership fees are tax deductible.	Membership fees are tax deductible.
Tax credits	20 percent of the investment amount by qualified investors may be used as a tax credit over a five-year period on the investor's Israeli personal or corporate income tax; the tax credit may be sold to other qualified investors.	
Social equity	Social equity investors may invest in the community credit union. The returns to the social equity investors are subordinated to the community shareholders. No distributions may be made to social equity investors for a period of ten years from the date of investment.	
Data collection, credit scoring	Maintain individual account and credit status, and bank performance data in compliance with the Bank of Israel. Provide access to individual credit performance, subject to agreement by customer.	Maintain individual account and credit status, and bank performance data in compliance with the Bank of Israel. Provide access to individual credit performance, subject to agreement by customer.

Regulation

Lab participants discussed applicable roles for various regulatory bodies that would enhance the effectiveness and efficiency of the credit unions. Regulatory bodies include the Bank of Israel, Supervisor of Banks (bank program and financial performance), the Ministry of Justice (consumer protection and privacy), the Ministry of Welfare (special populations), the Ministry of Finance (guarantees, tax exemptions, and capital market financings), and the Ministry of Economy (small- and micro-business financing). Lab participants emphasized that the application of regulations be calibrated to the size and financial complexity of the new community development financial institutions—simple depository and credit institutions require less stringency than international banks with public stockholders, foreign currency holdings, and business credit exposures based on international investments.

SOLUTION 3

ADDRESSING COMMUNITY

Lab participants underscored the importance of designing a new form of a bank based within the target community and building assets and providing credit to community residents, business, and projects. Within the Lab discussion, two tracks evolved—one with a focus on the creation of community development credit unions to target low-income populations and disadvantaged locations, and the other one focusing on mainstream credit unions. Both forms of credit unions would be modeled on U.S. and U.K. forms of credit unions.

In some cases, the design guidelines are the same or similar for both the community and mainstream credit unions. In others, such as financial incentives, membership, capitalization, distributions, and eligible savings and loans activities, the designs may differ. A description of the major features and some of the differences follow:

Minimum capitalization: The size of a community bank should not be fixed; rather, it should grow relative to amount of equity raised. Thus, for example, initial equity contributions for Tier 1 (highly liquid assets) and reserve funds invested in medium-term assets might be 15 percent of total community bank assets, net of debt and current expenses. Thereafter, the equity might decline to 10 to 12 percent, but Tier 1 assets should not be less than 7 percent.

Capital reserve: Commercial banks that have exposure to a wider range of banking activities—foreign currency transactions, international trade credits, foreign investment, complex financial structuring, large corporate loans, and letters of credit—are regulated according to Basel III requirements. Community banks, in contrast, have less exposure, and thus should be permitted to set aside less capital for their capital reserve requirements. This would accord with U.S. and European regulatory practice in relationship to Basel III compliance, which phases in from January 2015 through December 2019. For community banking organizations, the rule in final form provides some relief, though initial drafts had failed to recognize the lower exposure for community banks.

Legal organization: There are two legal structures available in Israel. One possibility is incorporation through the Cooperatives Law, under the Registrar of Cooperative Societies; the second is through the Corporation for Public Benefit Law.[13] Each has benefits and drawbacks. Originally, the Cooperatives Law was used to organize collective farms and joint cooperative ventures among agricultural-based settlements. Structuring under the Cooperatives Law could easily be applied to membership organizations, such as credit unions, that organize to share costs and revenues, and distribute net income to members. It would be more difficult under the law for the Corporation for Public Benefit. The following table compares the two legal forms:

TABLE 4 Financial incentives and programs

	Corporation for Public Benefit Law	Cooperatives Law
Distributions/dividends	No distributions, including dividends, are allowed.	No distribution as dividend will be allowed, even in winding up; share redemption is allowed in special circumstances of adequate equity.
Public objectives	Bylaws define public objectives only as they bar the distribution of profits or other distributions to shareholders.	No specific public objective other than serving its members' interests for limited financial services, such as credit savings and payment services.
Ownership	Shareholders have limited ownership of the enterprise or of their shares, which they cannot sell or transfer.	Shareholders ownership are limited to members buying a share: one share and one vote per member. Shares are not transferable. Members can be only individuals or small businesses as will be defined by the special legislation
Board members	Board members are paid a stipend for attending meetings.	Special election process of board members recommended by a public committee. In some cases, board members may be paid.
Corporate taxation	The association is exempt from corporate taxes but must pay salary taxes.	No exemption.
Value-added taxation	The association may sell services without charging VAT; VAT must be paid on revenues (fees, interest).	No exemption.
Dividend taxation	The association must pay dividend taxes on profits from any for-profit subsidiary.	No dividend [proposal does not prohibit for-profit subsidiary, of which dividends are taxable].
Current examples	Community loan funds.	Kibbutzim, commercial cooperatives with special dividend limitations.

Financial services: Lab participants agreed that credit unions should be permitted to engage in both deposit and lending services. Deposits (demand and time deposits) would create a source of capital for lending activities. Deposit services would only include direct deposits from employers and/or receivables. They would also provide banking card services, debit and credit on the lending site, and loans for personal, home,[14] and small-business uses. While there are service choices between community development and mainstream credit unions, the goal is to ensure that policy guidelines and regulations will allow for these services to meet the needs of the underserved markets.

TABLE 5 Services

	Community development credit unions	Mainstream, or market, credit union
Deposits	Community members and local deposits.	Memberships.
Savings	Interest-bearing time deposits (after an initial startup period).	Interest-bearing time deposits, demand deposits (after an initial startup period).
Individual savings accounts	Personal limited access interest-bearing savings accounts for eligible customers (children and adults) matched by government matching contribution.	Personal limited access interest-bearing savings accounts for eligible customers (children and adults) matched by government matching contribution.
Personal loans	Small, short-term loans, unsecured.	Small, short-term loans, unsecured.
Home mortgages	None, amounts too high, maturities too long.	Not initially (probably not until five years).
Home equity loans	Limited amounts.	Up to amount allowed by Bank of Israel for applicable loan to value ratio (up to 30 percent to 40 percent of property value).
Small-business loans	Limited, secured by assets and personal guarantees of principals.	Limited, secured by assets and personal guarantees of principals.
Micro loans	Subject to third-party guarantees for up to 90 percent of principal loaned.	Subject to third-party guarantees for up to 90 percent of principal loaned.
Subordinated loans	Provide packaging and servicing for third-party community loan funds, including subordinated loan funds.	Not applicable.
Financial education	Required for personal loans.	Required for personal loans.
Bank cards	Only contracted to third-party provider.	Only contracted to third-party provider.
Technical assistance	Required for small-business loans.	Required for small-business loans.
Risk mitigation	Eligible for limited third-party credit enhancement (funded by government and/or philanthropic investors).	Eligible for limited government credit enhancement during startup phase (up to three years).

In the absence of full deposit and lending services, Lab participants emphasized that community based credit is key to building wealth and ultimately gaining access to financial services in traditional banking institutions.
Equity: Membership fees would be one source of equity. Minority equity (less than 50 percent) could come from private or public social investors, e.g., corporate investors interested in the social returns and possible tax benefits; and philanthropic investors, such as endowments and philanthropic funds.

Customers: Ordinarily, a credit union will lend only to its members. But in a community development credit union, membership would not always be required for loan activity, though it would be encouraged. This would accommodate participants without funds for a deposit account. Therefore, customers would be members with or without deposit accounts.

Dividends: Depending on the type of legal organization, dividends could be deferred and reinvested in the community development credit union or distributed to shareholders. Typically, dividend distributions do not begin for the first five years or so of operation.

Information system: This is the single largest capital expenditure. Indeed, Lab participants reported that technical requirements—adaptation, security, access, training, and management costs—are prohibitive. In the U.S., the National Federation of Community Development Credit Unions offers shared IT development and support, especially during the startup phase of the credit union. There are several options: leasing existing bank systems, buying and adapting proprietary systems, and developing and sharing new appropriate technologies. The appropriate solution must be a balance between flexibility, cost, and ease of use.

The information technology (IT) requirements imposed on commercial banks, meanwhile, may be more streamlined to handle deposits, loans receivables, and accounting/reporting to Bank of Israel standards. This streamlined IT may reduce costs across the board. In addition, community development credit unions could pool their needs and buy the services from a qualified (and certified) third-party or even another bank. Lab participants recommended that IT requirements be scaled to meet the institution's activities.

Deposit insurance: Unlike the U.S., Israel has no deposit insurance program for bank savings customers. Given the scale of the market, a self-insurance program among banks and/or credit unions of any type is infeasible. Therefore, Lab participants recommended a compromise: the government and/or a philanthropic investment could provide a partial guarantee for community development credit unions, at least for the initial period of operations, to give some surety to depositors that their savings would be safe. Importantly, empirically, it is not clear if full deposit insurance is needed or would even work.[15]

Tax benefits: Lab participants recommended that investors in qualified community development credit unions be eligible for tax credits on their corporate or individual income returns for up to five years or longer. The amount of the credit should be no more than an annually prorated share of a credit based on some portion (15 percent to 20 percent) of the investment. The investor must maintain his investment in the facility for 10 years. Any returns of the investment or sale of shares will trigger a claw-back of the tax credit, prorated for the period of the time the individual maintained the investment in the credit union, as well as a tax penalty.

Members: Individuals would join the community development credit union by paying a membership fee. The fee would include the amount for a single share of the member's equity in the credit union, to be deposited in the credit union. It could be sold back to the credit union after a set period of time, perhaps six months. Members would have all the rights as shareholders, including payment of dividends, distribution of net assets, and participation in the governance of the facility.

Startup financing: The initial period of operation could require a special bridge loan, allowing the facility to build and sustain operations during the member/shareholder recruitment phase. The ramp-up financing could be relatively short term.

SOLUTION 4

ADDRESSING CAPACITY

Lab members noted that the links between technology (digital and mobile communications), big data (capturing more granular data to understand payment behavior), and innovative financial products and services (through micro and community finance) could help overcome information asymmetries about underserved customers and make credit easier for them to obtain.

Data collection and reporting: A database is needed to quantify and monitor poverty conditions by location, population groups (northern and southern regions, women, Arabs, religious communities, etc.). This data would track liquid asset poverty, household income and expenditures, and household and small-business credit and savings. With such a database, it would be possible to measure, monitor, and manage poverty-reduction programs. This data could be made available at the Bank of Israel, though it is not aggregated or reported in this way at the present time.

Consumer protection, development, and asset building: Policies and guidelines are needed for the use of credit information and transparency. Lab members outlined specific methods that would allow for the customer to determine how credit data would be released; that would make it feasible to review and improve financial education programs; provide technical assistance for small credits; and work with various ministries to design asset development programs for children. These programs already operate through the Ministry of Finance, Bank of Israel, and the Ministry of Welfare.

For example, along the lines of U.S. models,[16] it should be possible to disseminate credit information quickly, and to multiple targets, and to use alternative data—e.g., rent and utility payments—in credit scoring. Throughout the world, data services are aggregating available payment data—from cellphones, social media connections, utility payments, government statistics, and elsewhere—in order to extend financial services, such as loans, savings vehicles, and insurance to otherwise marginalized financial service customers.

YEDID

Founded in 1997, Yedid is a nonprofit organization that focuses on community and economic empowerment among Israel's poor. By combining legal, economic, financial, and community development assistance, Yedid provides both direct services to the poor and the tools for community engagement, organization, and development. Yedid focuses its services on the most distressed members of the community, providing, for example, financial management courses to illiterate women in Bedouin and Ethiopian communities, youths, and single mothers. Other activities include advocacy for public services, including water and electric services, for low-income Israelis.

The group reviewed regulatory barriers to building consumer credit and credit transparency, and identified potential solutions:

- Restricted accounts. The government can adjust the regulations to limit the amount of time that information about restricted accounts is maintained and made available on credit checks.
- Credit rating transparency. The government can accelerate the creation of a credit information database and provide wider access in the credit market. The proposed unit would collect credit information from lenders, both negative and positive, and develop a comprehensive, transparent credit scoring system. While individuals may opt out of the database, it would offer access to credit previously denied to the unbanked and underbanked.
- Lack of financial experience and assets. The government could launch programs to build and strengthen assets, such as individual savings accounts. This is a particularly important element in the strategy to build the positive savings records that would be reflected in the credit information database described above.
- Unregulated gray market. The government could impose licensing requirements, supervision, and enforcement on gray market credit providers. Through proper supervision, the government could remove the reporting and disclosure burden and disincentives from the victims of financial services abuse, including usurious interest rates, collateral covenants, and collection practices. At the same time, the regulations of this market could allow for risk-adjusted interest rates and appropriate and transparent fees.

Proposed Guidelines

The Bank of Israel, Supervisor of Banks, issued a draft guideline following the Financial Innovations Lab in June 2014 for licensing and establishing credit unions, referred to as "banking unions." Following are the key provisions in the guidelines and recommendations for changes to be considered to the guidelines based on the Lab discussions and follow-up.

Topic	Proposed banking union guidelines	Lab recommendation
1. Purpose	▪ Creation of new financial association to provide competitive financial services for its members only.	▪ Creation of new banking institutions to provide low-cost, effective financial services to populations and communities.
2. Eligible applicants	▪ Corporation for Public Benefit. ▪ Cooperative Society (preferred). ▪ Nonprofit organization.	▪ Corporation for Public Benefit. ▪ Cooperative Society. ▪ Nonprofit organization.
3. Eligible activities	▪ Bank accounts. ▪ Management services. ▪ Savings services. ▪ Loans. ▪ Other basic banking services, including payment services. ▪ Members and immediate family members are eligible customers. ▪ Members may be individuals and corporations (small business). ▪ Securities and investment services are ineligible activities.	▪ Personal loans. ▪ Micro and small-business loans. ▪ Savings. ▪ Payment services. ▪ Targeted credit programs for affordable housing. ▪ No bank card. ▪ Members and other residents in community or target population are eligible customers. ▪ Members may be individuals, corporations (small business), NGOs, and social enterprises. ▪ Securities and investment services are ineligible activities.
4. Financial terms and conditions	▪ Low credit fees. ▪ No deposit or withdrawal fees. ▪ Market interest rates (p+2 percent–4 percent). ▪ Simple amortizations. ▪ Short terms. ▪ Low payment service fees. ▪ No prepayment penalties.	▪ Low credit fees. ▪ No deposit or withdrawal fees. ▪ Market interest rates (p+2 percent–4 percent). ▪ Deferrals and accruals. ▪ Medium terms. ▪ Adjustable interest rate options. ▪ Low payment service fees. ▪ No prepayment penalties.
5. Ownership and shares	▪ One voting share per member. ▪ Member shares are non-negotiable. ▪ Shares are redeemable subject to the bank union meeting the required capital threshold. ▪ Redemption of shares will not exceed the purchase price paid by the member at the time of joining, linked to Consumer Price Index (CPI).	▪ One voting share per member. ▪ Shares are redeemable subject to the bank union meeting the required capital threshold. ▪ Redemption of shares will not exceed the purchase price paid by the member at the time of joining, linked to CPI.
6. Termination and dissolution	▪ Upon termination, payment of debts and remittances to shareholders. ▪ Shareholders due membership fee, plus interest. ▪ Distributions of net assets after obligations will not be distributed to shareholders. They will be used for public/cooperative purposes. ▪ May not become commercial bank.	▪ Upon termination, payment of debts and remittances to shareholders. ▪ Shareholders due membership fee, plus interest. ▪ Distributions of assets after obligations distributed to shareholders on a pro rata basis. ▪ May be acquired by commercial bank to continue and/or expand services to target communities and populations.

Topic	Proposed banking union guidelines	Lab recommendation
7. Reporting	▪ Comply with all Bank of Israel Supervisor's requirements.	▪ Comply with all Bank of Israel Supervisor's requirements.
8. Management		
a. Board	▪ Board of directors elected from among members.	▪ Board of directors elected from among members.
b. Committees	▪ Standing audit, credit, and investment committees. ▪ Members of committees: 50 percent from members; 50 percent from professionals.	▪ Standing audit, credit, and investment committees. ▪ Members of committees: 50 percent from members; 50 percent from professionals.
c. Management team	▪ Subject to fitness review and approval by Bank of Israel, Supervisor of Banks.	▪ Subject to fitness review and approval by Bank of Israel, Supervisor of Banks.
d. Technology	▪ Comply with Bank of Israel Supervisor's requirements. ▪ May lease or license existing system from bank or provider. ▪ Internet banking permitted. ▪ May enter into existing inter-bank arrangements allowing the use of Israel's banking system infrastructure.	▪ Comply with Bank of Israel Supervisor's requirements. ▪ May lease or license existing system from bank or provider. ▪ Internet banking permitted. ▪ May enter into existing inter-bank arrangements allowing the use of Israel's banking system infrastructure.
9. Review process		
a. Selection	▪ Board and committee experience. ▪ Professional expertise and experience. ▪ Systems and operating plan. ▪ Marketing plan. ▪ Financial feasibility.	▪ Board and committee experience. ▪ Professional expertise and experience. ▪ Systems and operating plan. ▪ Marketing plan. ▪ Financial feasibility.
b. Capital	▪ Capital adequacy ratio: 15 percent of capital is liquid net of debt, expenses, and shareholder distribution obligations. ▪ No minimum during initial two years and limited services.	▪ Capital adequacy ratio: 15 percent of capital is liquid net of debt, expenses, and shareholder distribution obligations. ▪ No minimum during initial two years and limited services.
c. Process milestones	▪ Six months: initial review of plan, financial feasibility, and team members. ▪ One year: startup and capitalization, trial license, membership recruitment, marketing, and time savings and payment services. ▪ Two years: operating review, audit and performance assessment, credit services; launch demand savings services. ▪ Three years: bank audit and operations evaluation, credit services launched, Internet services launched.	▪ Six months: initial review of plan, financial feasibility, and team members. ▪ One year: startup and capitalization, trial license, membership recruitment, marketing, and time savings and payment services. ▪ Two years: operating review, audit and performance assessment, credit services; launch demand savings services. ▪ Three years: bank audit and operations evaluation, credit services launched, Internet services launched.
d. Approval	▪ Licensed to operate pursuant to supervision.	▪ Licensed to operate pursuant to supervision.

Conclusion

The path toward creating a sustainable framework to foster new community development financial institutions will require a combination of careful approaches, innovative programs, and targeted incentives. These new financial institutions will target a previously unserved market, and the demand in this market must be allowed to "pull" the innovation of new and appropriate services. Eventually, these services could include savings, credit, and financial services geared to increase the financial capacity of the customers. This policy roadmap must find a balance between leveraged public investment, financial stability, and affordable, accessible services.

Israel's existing banks will not solve the problems of financial exclusion. The poor and vulnerable populations and communities will not be able to lift themselves up by willing it so. Rather, new approaches, innovations, experimentation, and collaborations are needed. This Financial Innovations Lab points a spotlight on the boundaries of the problems and the possibilities to change the course and chart a new future.

The government must lead the way forward with new regulations, programs, and tools. The Bank of Israel and the ministries of Welfare, Economy, and Finance have recognized this opportunity and are taking deliberate steps in the right direction. More is needed. Stakeholders in the community, including organizations serving these vulnerable populations and communities, and existing financial service companies have been involved in financial programs, processes, and new products. Still, more is needed.

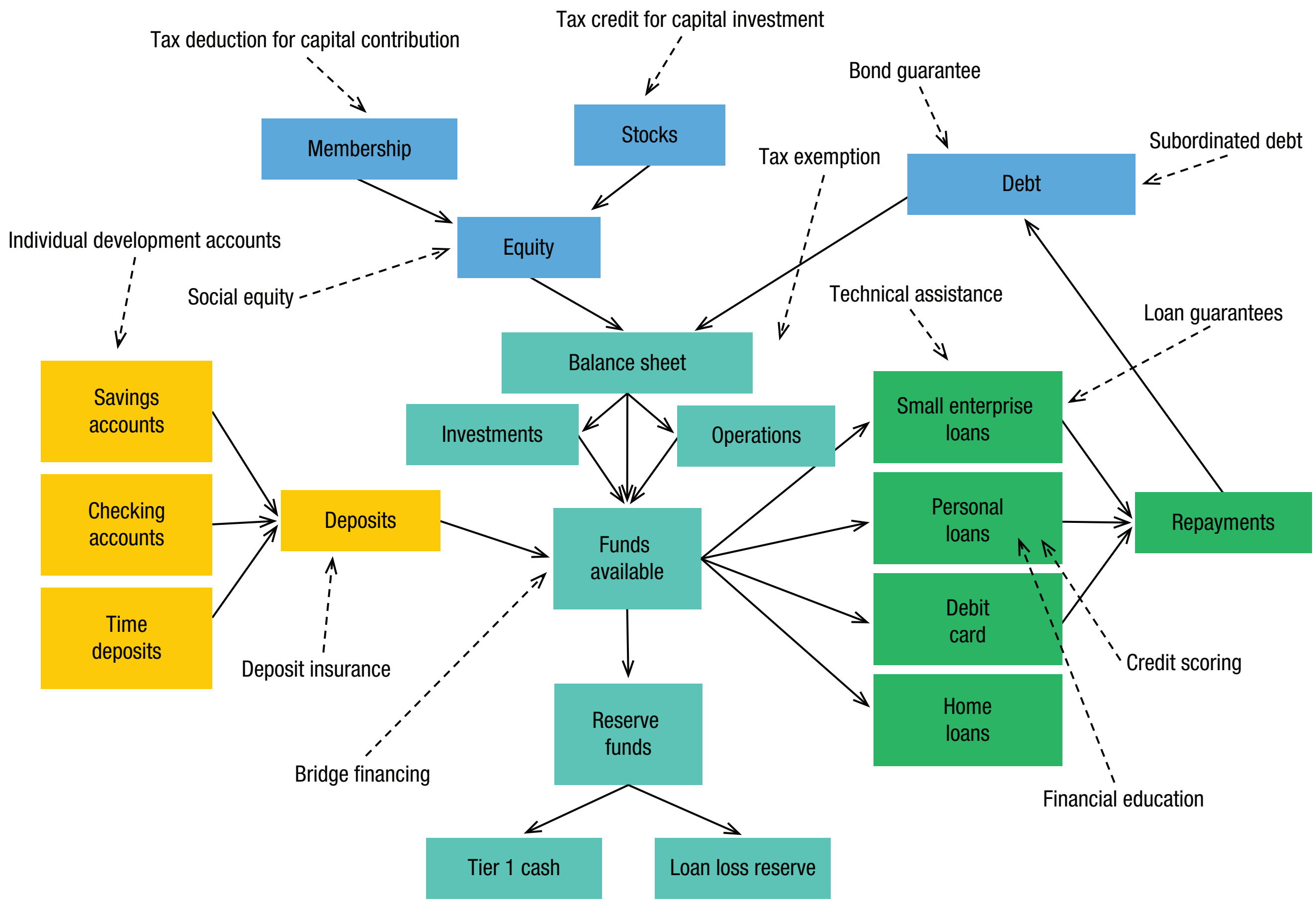
The path forward is before us, though it is filled with regulatory burdens, vested interests in the status quo, and competing priorities. As poverty rates climb and pockets of community distress deepen, the need is now, the solutions are possible, and the outcomes are compelling.

APPENDIX I

Banking context for financial innovations

Within the structure of a bank, with deposits and loans supported by a financially feasible operating entity with investors and equity, there is potentially a wide variety of financial tools and programs. Lab participants emphasized the use of "the right tool for the right problem." Following is a schematic of the context for a "bank" operation with the appropriate relationship for each financial innovation tool or program.

FIGURE 9 Conceptual banking functions and tools



Source: Milken Institute.

APPENDIX I

An explanation of each of these tools and programs, including what it is, how it works, why it is important, and who pays for it, follows:

TABLE 6 Financial tools and programs

	What it is	How it works	Why it is important	Who pays for it
Individual development accounts	▪ A matching savings program targeted to asset-poor populations.	▪ An eligible family will enroll their children (started shortly after birth) in a government-sponsored saving program. ▪ The family will establish a bank account for each child and make a nominal monthly contribution. ▪ The government will remit a matching contribution to each account. ▪ The amount will earn interest on an open-ended, long-term time-deposit basis, with all interest earnings being reinvested in the account. ▪ Upon reaching an eligible age, either 18 or 21, subject to applicable national service obligations, the youth will be able to access the savings account for eligible uses (e.g. education, training, housing, etc.).	▪ Creates asset base for youths in poverty. ▪ Begins the process of savings and asset-building. ▪ Opens deposit accounts with financial institution and capitalizes deposit base. ▪ Targets use of savings for investments with long-term returns for the individual, families, (e.g. education, depreciable assets, etc.) and government (e.g. tax-paying citizens).	▪ The monthly contributions to the account are jointly sponsored by the family and the government on a 1:5 to 1:10 ratio, depending on the community.
Tax deduction	▪ A deduction against income for a taxable investor.	▪ A CDFI is organized as an eligible nonprofit entity or has a related party that is a nonprofit entity. ▪ A taxable investor makes a contribution to the CDFI or related party. ▪ The contribution can be used to pay for eligible program expenditures (e.g. related to financial inclusion activities). ▪ The tax investor claims the tax-deductible contribution on their corporate or individual tax returns, reducing their reportable taxable income.	▪ Expands the base of potential investors in CDFIs. ▪ May increase the amount of equity available for the CDFI, improving cash flow. ▪ Boosts the returns to investors by reducing their general tax liability.	▪ The government forgoes the amount of tax on the corporate or personal income taxes based on the reduced taxable income. However, there is no direct government expenditure.

TABLE 6 Financial tools and programs *(cont'd)*

	What it is	How it works	Why it is important	Who pays for it
Tax credit	▪ A credit against the general tax liability of an equity investor in CDFI.	▪ A CDFI organizes according to specific standards, providing services to targeted communities and populations. ▪ An eligible investor provides equity funding to the CDFI, according to terms and conditions (amount, timing). ▪ The CDFI reports the investor's investment to the tax authority. ▪ The tax authority issues a certificate confirming the amount of the tax credit available to the investor based on the amount of the investment. ▪ The investors claim the amount of the credit against their tax liability for the period of the tax credit. If the CDFI does not comply with the requirements of the tax credit program at any time, the tax credit is prorated.	▪ Expands the base of potential investors in CDFIs. ▪ May increase the amount of equity available for the CDFI, improving cash flow. ▪ Boosts the returns to investors by reducing their general tax liability.	▪ The government forgoes the amount of the tax credit on corporate or personal income taxes from the tax credit beneficiaries for the period of the tax credit. However, there is no direct government expenditure.
Tax exemption	▪ The corporation is exempt from paying a portion or all of the corporate tax on net income from operations.	▪ A CDFI meets specific performance thresholds, including cost of services, maintenance of service levels to target populations, leverage, and loan activities. ▪ Based on interest and non-interest income and expense, and payment of obligations and debts, a CDFI may have net operating income. ▪ If the CDFI meets the specific performance thresholds, its cash flow will be exempt from corporate income tax. ▪ Distributions of dividends to shareholders or members in any form will be treated as taxable income on the shareholders' or members' tax obligation.	▪ The tax exemption will improve the financial performance and sustainability of the CDFI.	▪ The government forgoes the amount of the exempted taxes on corporate income taxes. However, there is no direct government expenditure.

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TABLE 6 Financial tools and programs *(cont'd)*

	What it is	How it works	Why it is important	Who pays for it
Bond guarantees	▪ A pledge to cover part or all of the debt on a bond, transferring a share of the risk for the debt from the lender/bond buyers to the guarantor.	▪ A guarantee is a contract to pay the lender/bond buyers a designated amount (all or a portion) of the debt in the event of a delinquency or default. ▪ The guarantor makes the payment, which may be a first-loss payment up to a certain amount, or a pro rata payment based on the guarantees coverage of the loan. ▪ The borrower must repay the guarantor for the advance of the guarantee. ▪ The borrower assigns rights of the assets to the guarantor to cover a portion of the loss. ▪ The guarantees are a limited obligation, capped at the agreed upon guarantee amount, and are non-recourse to the guarantee providers (e.g. philanthropy, government, etc.).	▪ Guarantees may lower the risk of the borrowing, saving 50-200 basis points on the debt, improving the financial feasibility of the project. ▪ Guarantees may make a borrowing possible.	▪ The fee is paid by the borrower on the basis of 0.5 percent to 1.25 percent of the outstanding principal. ▪ The guarantee funds are provided by a combination of philanthropic investments, standby social investments, and government funds.
Bonds	▪ Debt issued in the public or private capital bond markets.	▪ A CDFI issues bonds secured by its loan receivables portfolio. ▪ The bond issuer sells the bonds publicly (e.g. sophisticated investors) or privately (e.g. pension funds, corporate investment funds, etc.). ▪ The bonds proceeds are used to capitalize the loan portfolio of the CDFI, counted as debt to be paid after its net operating income. ▪ Depending on the creditworthiness of the CDFI, the bonds may require letters of credit, guarantees, or special insurance.	▪ Longer terms for repayment; flexible repayment schedule, and fixed rate, lower cost interest improve the liquidity of the CDFI. ▪ Loan pools can be structured to improve the collateral and credit quality of the bonds. ▪ Financing costs are financeable.	▪ The source of funds come from the public and private bond markets. ▪ The projects may be guaranteed in part by public or philanthropic sources, with recourse to the portion of the CDFI's loan portfolio.

TABLE 6 Financial tools and programs *(cont'd)*

	What it is	How it works	Why it is important	Who pays for it
Loan guarantees	▪ A pledge to cover part or all of the debt on a project, transferring a share of the risk for the debt from the lender to the guarantor.	▪ A guarantee is a contract to pay the lender a designated amount (all or a portion) of the debt in the event of a delinquency or default. ▪ The guarantor makes the payment, which may be a first-loss payment up to a certain amount, or a pro rata payment based on the guarantees coverage of the loan. ▪ The borrower must repay the guarantor for the advance of the guarantee. ▪ The borrower assigns rights of the assets to the guarantor to cover a portion of the loss. ▪ The guarantees are a limited obligation, capped at the agreed-upon guarantee amount, and are non-recourse to the guarantee providers (e.g. philanthropy, government, etc.).	▪ Guarantees may lower the risk of the borrowing, saving 50–200 basis points on the debt, improving the financial feasibility of the project. ▪ Guarantees may make a borrowing possible. ▪ Guarantees improve creditworthiness, and possibly lower capital reserve requirements, thereby allowing the bank to deploy more capital.	▪ The fee is paid by the borrower on the basis of 0.5 percent to 1.25 percent of the outstanding principal. ▪ The guarantee funds are provided by a combination of philanthropic investments, standby social investments, and government funds.
Credit scoring	▪ Rating of individual credit performance on a uniform, open basis.	▪ An individual incurs financial obligations, including fees payments, checks, bank cards, auto loans, consumer loans, home loans, or business loans. ▪ Based on the performance on each of these obligations, banks evaluate the credit-worthiness of the individual. Each bank has its own proprietary methodology for evaluating creditworthiness. ▪ Banks are not required to disclose the credit score to the individuals or other financial institutions, even good credit scores. The Ministry of Justice prohibits the sharing of credit information (good or bad) to ensure confidentiality for the individual. ▪ When an individual moves to another financial institution, they do not take any financial performance information, forcing them to "start-again."	▪ A poor score prohibits new credit and financial services. A good score opens the door for a customer to continue to gain access to financial services within the same financial institution. ▪ By creating a uniform, universal method of credit scoring, and sharing positive and negative information, an individual will have access to broader, competitive financial services.	▪ Each financial institution has its own methodology for credit scoring. ▪ Creation of a uniform credit scoring method and database could be sponsored by the government with costs shared by financial institutions.

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TABLE 6 Financial tools and programs *(cont'd)*

	What it is	How it works	Why it is important	Who pays for it
Financial education	▪ Guidance about the use of and rules for financial services.	▪ Development of curriculum, including rights and proper use of saving accounts, use of credit, credit and bank cards, loans, pension products, insurance products. ▪ Integration of curriculum into schools, community centers, and colleges. ▪ Follow-up assistance to students in beginning use of financial products and services.	▪ Understanding and using financial services is a key to financial independence. ▪ Making decisions about the right use of credit, savings, and record-keeping can help with future opportunities.	▪ Bank of Israel and the Ministry of Finance have programs for financial education. ▪ The public sector will support the integration of the financial education curriculum in schools and make information and technical services available to the public.
Bridge financing	▪ Convertible loan to provide capital for startup, including set-up costs and startup working capital.	▪ Bridge facility is organized by government and/or philanthropic sources, providing a revolving credit line, convertible debt. ▪ CDFI prepares operating, market, and financial plan, raises initial equity, and begins the approval process through government regulators. ▪ CDFI secures bridge financing to provide set-up capital and initial working capital. ▪ Bridge financing loan terms are preferred, short-term and convertible to equity, based on approval of the lender.	▪ Raising initial equity/ members and initial deposits is difficult without sufficient capital in hand. ▪ Regulators require a sufficient level of capitalization to give permission to operate. The bridge financing can act as the needed capital to reach the required financial threshold.	▪ Bridge financing can be provided by a government source or a membership group, such as a cooperative industry group with an interest in jumpstarting CDFIs in the market.
Deposit insurance	▪ Deposit insurance is a guarantee that the amount of the deposit will be available to the depositor on demand from an eligible financial institution.	▪ A financial institution receives a certificate from the deposit insurance provider that it complies with appropriate financial practices. ▪ The deposit insurance provider pledges to cover the principal amount of each deposit up to a certain amount. ▪ In the event of a default by the financial institution and a claim by a depositor, the deposit insurance issues a payment to the depositor. ▪ The deposit insurance provider has a lien against the assets of the financial institution and may pursue recovery of the insurance claim.	▪ Deposit insurance shifts the risk from the depositor to the insurance provider, provides an assurance to each depositor that its principal is protected. ▪ The insurance improves the opportunity for financial institutions to raise capital by expanding their deposit base.	▪ Deposit insurance is paid for by insurance premium payments by participating financial institutions and the national government.

TABLE 6 Financial tools and programs *(cont'd)*

	What it is	How it works	Why it is important	Who pays for it
Subordinated debt	▪ Secured, amortizing debt paid from the project net operating income; applicable to revenue-generating projects.	▪ Independent private, community or government direct loans to eligible projects. ▪ Collateral and payments subordinated to senior debt, usually a bank loan. ▪ May include deferrals, lower interest cost and longer terms for repayment. ▪ Management through separate revolving loan fund or contract to financial institution for underwriting and loans management.	▪ Improves the debt coverage for senior debt, making conventional loan possible. ▪ Lowers the borrowing cost for the project, making projects feasible. ▪ Improves project cash flow and yields to investors.	▪ Initial loan fund capitalized by government and philanthropy investments and capital market loans (securitizing the repayments from loans).
Social equity	▪ An social investment in the equity of a CDFI that achieves at least a double bottom line (sustainable financial services to the unbanked and a financial return) for its investors.	▪ The social investor provides equity to the CDFI based on an expectation of specific services to the unbanked, such as deposit accounts, banking cards, micro loans, etc. ▪ The social equity becomes part of the total equity for the CDFI, paying for upfront capital and ongoing operating costs. ▪ The social investment equity is not secured or guaranteed. ▪ The social equity may be returned from the after-tax cash flows on a pro rata basis or on a subordinated basis to the other shareholders/members. ▪ Returns usually lower than market investors and over a longer term.	▪ Reduces the amount of market rate equity needed in the capital structure. ▪ May increase the amount of equity available for the CDFI, improving cash flow and financial ratios (Tier 1 capital, liquidity, etc.). ▪ Boosts the returns to market investors, allowing them to take their dividends first.	▪ Social equity is provided by philanthropic foundations and individuals and mission-based corporate investors, however, based on the structure and performance of the CDFI, they can expect to get their investment back. ▪ For U.S.-based philanthropies, social equity may be structured as an eligible program-related investment, allowing the investment to be from their "balance sheet" and counted as part of their mandatory annual grants.

APPENDIX II

Credit Union Financial Performance

The following table is for U.S.-based credit unions and all currencies are in U.S. dollars.

TABLE 7 Three kinds of credit unions, by membership size

	Community development credit unions	Percentage	Low-income-designated credit unions	Percentage	Mainstream, or market, credit unions	Percentage
Members	1,000		1,000		1,000	
Total assets	$3,503,749		$4,597,413		$7,922,445	
Shares and deposits	$2,951,686	84 of total assets	$3,899,870	85	$6,850,910	86
Loans	$1,722,281	49 of total assets	$2,222,894	48	$3,561,307	45
Net worth	$276,484	8 of total assets	$548,069	12	$953,682	12
Grants	$80,177	2 of total assets	$13,819	0	$77	0
Net income	$733	0.02 of shares and deposits	$3,811	0.10	$13,342	0.19
Total delinquencies	$42,954	2.49 of loans	$36,178	1.63	$31,270	0.88
Total charge-offs	$21,892	1.27 of loans	$13,290	0.60	$14,122	0.40

	Community development credit unions		Low-income-designated credit unions		Mainstream, or market, credit unions	
Members	2,000		2,000		2,000	
Total assets	$9,776,073		$13,419,842		$15,844,890	
Shares and deposits	$8,338,606	85	$11,732,830	87	$13,701,821	86
Loans	$5,165,199	53	$6,443,397	48	$7,122,614	45
Net worth	$1,044,946	11	$1,603,631	12	$1,907,365	12
Grants	$294,309	3	$40,212	0	$154	0
Net income	$33,627	0.40	$26,792	0.23	$26,685	0.19
Total delinquencies	$77,428	1.50	$70,471	1.09	$62,540	0.88
Total charge-offs	$50,493	0.98	$35,611	0.55	$28,243	0.40

	Community development credit unions		Low-income-designated credit unions		Mainstream, or market, credit unions	
Members	4,000		4,000		4,000	
Total assets	$19,552,145		$31,231,675		$35,033,817	
Shares and deposits	$16,677,212	85	$27,775,524	89	$30,630,749	87
Loans	$10,330,399	53	$18,268,609	58	$18,036,233	51
Net worth	$2,089,891	11	$3,373,699	11	$3,686,574	11
Grants	$ 588,617	3	$12,696	0	$220	0
Net income	$67,253	0.40	$152,571	0.55	$113,753	0.37
Total delinquencies	$154,856	1.50	$172,753	0.95	$156,973	0.87
Total charge-offs	$100,985	0.98	$85,137	0.47	$85,935	0.48

Source: National Federation of Community Development Credit Unions, Milken Institute analysis.

APPENDIX III

Community lending model

Calvert Community Fund – A community lending/crowdsourcing model

Organization: The foundation has a 12-member board of directors, responsible for its overall policy and direction. The board has established an investment committee that reviews due diligence and makes investment recommendations to the board. Board members are reimbursed for out-of-pocket expenses related to board activities.

Management: The staff consists of president and CEO, CFO, CLO (chief lending officer), president of community investment partners, and additional staff to maintain the day-to-day operations; investor, lending, and donor relations; and administrative duties.

Budget: Ninety percent of operating revenues is generated from portfolio investments.[17]

SOURCES OF FUNDS

1. The foundation's community investment program is funded by individual and institutional investors, as well as by several program-related investments, grants, and loans that are subordinate to the notes, providing a layer of credit enhancement. To create this credit enhancement, the Calvert Foundation received unrestricted grants from institutions, including, but not limited to, the Rockefeller Foundation, the Ford Foundation, the Case Foundation, the F.B. Heron Foundation, Child Relief International, the William and Flora Hewlett Foundation, and the Michael and Susan Dell Foundation.

2. Starting at just $20 per note, the Community Investment Note is available in various terms and interest rates up to 2 percent. By creating innovative financial products and services, retail buyers, not just institutions, are able participate in financial instruments that directly serve communities. Notes include various terms from three months to 10 years; rates from 0 percent to 3 percent.

Credit Issues: The notes are unsecured general obligations of the foundation and are not deposits or obligations of, or guaranteed or endorsed by, any bank, and are not insured by any federal or state agency. Calvert maintains approximately 20 percent in reserves to cover potential losses in its lending portfolio, composed of direct reserves by the foundation and standby guarantees issued by other philanthropies and public and private insurance funds. The portfolio carries a default rate of less than 1 percent of principal and has never drawn on its standby guarantees.[18]

History: Calvert Foundation was incorporated in September 1988 as an independent 501(c)(3) nonprofit corporation, though its current programs of issuing notes to the general public were launched in 1995, the result of a collaboration between Calvert Investments Inc. (formerly Calvert Group), the socially responsible mutual fund company, and the Ford, MacArthur and Mott Foundations. The notes primarily focus on direct investments in community development organizations.

OUTCOMES[19]

1. Calvert notes have been used to build or rehabilitate over 17,000 homes, create 430,000 jobs in the U.S., and in developing countries, and finance over 25,000 cooperatives, social enterprises, and community facilities.

2. As of 2013, Calvert Foundation has nearly $238 million invested in 168 community organizations in all 50 states and over 100 countries. Their portfolio, based on over 5,800 investors, includes direct investment in a diversified mix of high-impact organizations whose missions cover a range of social causes and innovations, including affordable housing, microfinance, fair trade coffee, small business development, and the establishment of essential community facilities, such as charter schools, daycare centers, and rehabilitation clinics.

APPENDIX IV

Financial Innovations Lab Participants

(Affiliations at time of Lab)

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Citi Community Development

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Lavi Capital Limited

Liat Ben Meir Shalom
Ministry of Justice

Nir Ben-Aharon
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Greeneye

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Steven Zecher
Milken Institute Israel Center

Merav Zohari
Ministry of Justice

ENDNOTES

1. OECD (2013), OECD Economic Surveys: Israel 2013, OECD Publishing., http://dx.doi.org/10.1787/eco_surveys-isr-2013-en, p. 6. Includes taxes and transfer payments.

2. “Credit Discrimination in Israel: A Proposal for Reform,” Aharon Mohliver and Eyal Seri, in *Economic Reform Studies*, 2005, No 4–6, Glenn Yago, editor.

3. “Community development financial institutions” are a broad category of non-traditional financial services companies, including community development banks, community development credit unions, community loan funds, community development venture funds, and micro-enterprise loan funds. They exist primarily in the U.S. and the U.K.. Various subsets of CDFIs, such as community development entities, for example, are certified by the U.S. Treasury Department, and utilize tax credits to promote equity investments for CDFIs that target low-income communities.

4. The central bank, as noted earlier, is clearing a path for the creation of competitive alternatives to commercial banks. However, at the time of the Lab, the Supervisor of Banks had not yet issued a guideline. Since then, the Supervisor issued a draft guidelines. Lab participants found issue with elements of the proposed draft, which is discussed below in the section Proposed Guidelines.

5. The Law for the Regulation of Nonbank Loans, 1993. קוח תרדסה תואוולה ץוח-תויאקנב, תשנ”ג-1993

6. About Accion in the U.S., US.ACCION.ORG., U.S. Impact, 9/30/13.

7. “Financial Inclusion in the U.K., Review of Policy and Practice,” Joseph Rountree Foundation, 2008. http://www.jrf.org.uk/publications/financial-inclusion-uk-review-policy-and-practice

8. Legislative Change for Credit Unions, Association of British Credit Unions Limited, website, 2012. http://www.abcul.org/media-and-research/briefings/legislativechange-briefing-january-2011.pdf

9. Based on the Legislative Reform to the Credit Unions Act of 1979 (Industrial and Provident Societies and Credit Unions) Order 2011, credit unions wishing to pay interest on savings must show that they have the necessary systems and controls in place and must hold reserves of at least £50,000 or 5 percent of total assets, whichever is the greater, according to the Association of British Credit Unions.

10. Asaf Zilberstein was a Milken Institute Fellow from October, 2013, to July 2014. He interned at the Bank of Israel’s, Office of the Supervisor of Banks.

11. Asaf Zilberstein, Milken Institute Fellows, forthcoming. The data used in this analysis is based on credit union and Israeli banking data for the period ending December 31, 2013.

12. For purposes of comparison, the pretax income for Israeli banks was used because the credit unions in the U.S. are exempt from corporate income taxes.

13. Companies Law 1991.

14. The Israeli market has a well-established home mortgage lending market. Because of the scale of capital required and the long terms for these loans, it is recommended that these community development credit unions do not provide home mortgages, except in cases where they are providing loans for affordable apartments, either owned or rented.

15. "Deposit insurance intensifies the moral hazard problem in banking because bank owners collect most of the benefits from making risky investments that succeed but share the losses with the deposit insurance fund if the investments fail." *Rethinking Bank Regulation, Till Angels Govern*, Jim Barth, Gerard Caprio, and Ross Levine, Cambridge University Press, p. 219.

16. Fair Credit Reporting Act (FCRA) and the Fair Debt Collection Practices Act (FDCPA) form the basis of consumer credit rights in the U.S.

17. http://www.calvertfoundation.org/about/reports

18. http://www.calvertfoundation.org/storage/documents/CF-Community-Investment-Note-Prospectus.pdf

19. http://www.calvertfoundation.org/storage/documents/social-impact-report.pdf

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