Profitwise
News and Views

Published by the Consumer and Community Affairs Division

Special Edition ▪ August 2007

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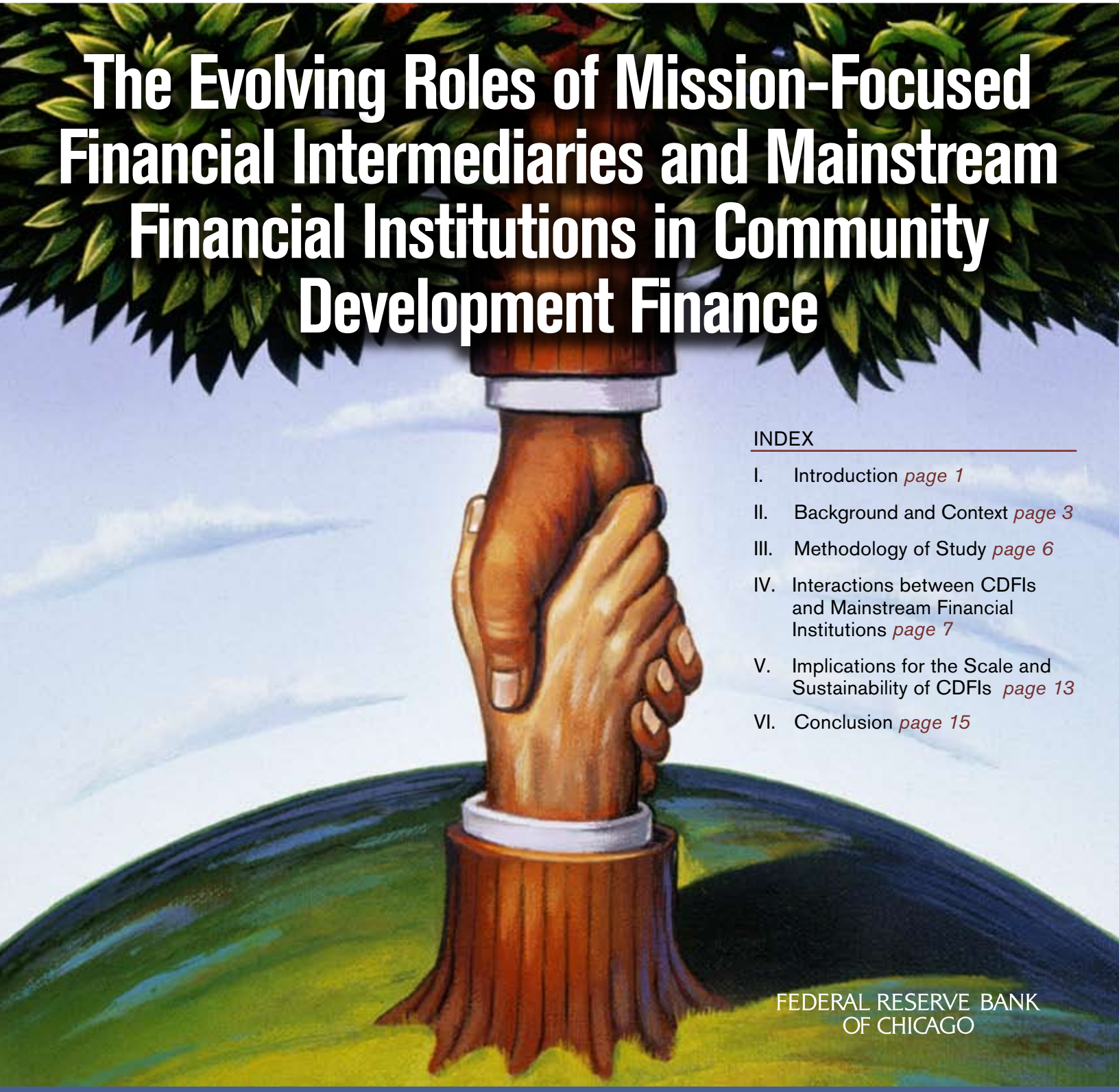

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The Evolving Roles of Mission-Focused Financial Intermediaries and Mainstream Financial Institutions in Community Development Finance

by Michael Berry, Kirsten Moy, Robin Newberger, and Gregory A. Ratliff

I. INTRODUCTION

In 2005, the Federal Reserve System and the Aspen Institute's Economic Opportunities Program launched a national conference series to explore the state of the community development finance industry. A further goal was to document lessons and practices primarily from the for-profit sector, and introduce organization, product- and industry-level innovations to increase the impact of community development financial institutions (CDFIs) and other community development organizations.[1] Prior research by Moy and others formed the basis for the series. This research showed that environmental changes related to public policy, changes at the point of community development impact[2] (where, how, and why community development investments occur), and sweeping advances in the mainstream financial services industry have significant implications for community development financial intermediaries. The research identified types of strategic partnerships and creative business models that the industry should consider to achieve greater scale (though not necessarily organizational size) and effectiveness. The conference series and attendant industry design/discussion sessions among practitioners, researchers, and policy groups have given rise to new research initiatives, of which this is one.

Financial Industry Developments and Trends

The purpose of this article is to provide new insights into the ways that community development finance organizations are adapting their relationships with the mainstream financial system and the implications for CDFIs to serve more people and communities as a result. Changes impacting the community development finance field, notably reduced federal funding and greater focus on CDFI performance by potential financial partners, as well as dramatic changes in the mainstream financial sector, have brought CDFIs face-to-face with strategic questions about how they relate to the mainstream financial system.[3] In the past, mainstream financial institutions and CDFIs were separated by the populations they served and the products they offered. The dominant sentiment within the community development finance field was that banks were the perpetrators of disinvestment, and the first partnerships between banks and CDFIs were greeted with suspicion and doubt. Over several decades, that thinking has changed almost completely. Today, development finance organizations are fluent in the language of business and command more and better resources to achieve their mission. Many have adapted market-oriented practices to deliver their products and services and have achieved, or are close to achieving, self-sustainability.

Today, development finance organizations are fluent in the language of business and command more and better resources to achieve their mission.

At the same time, financial markets have evolved to securitize credits and supply liquidity to credit markets once considered too risky or obscure. Mergers, continually refined risk-modeling capabilities, and heavy reliance on specialized, outsourced services, have significantly impacted the role of mainstream financial institutions in supporting and directly financing

community development and providing financial services in low- and moderate-income communities. Public sector support of community development has come increasingly in the form of federal tax credits to induce investments by banks, other corporations, and individuals. The mainstream financial sector has arguably become the most important source of funding for community development. These developments have blurred the line between mainstream and development institutions, at least in terms of their support for community development.

Future Niche of CDFIs

The participation of conventional lenders in the community development field is in many ways a symbol of achievement for the development finance industry. The case is often made that the goal of development is not only to initiate and fund projects in lower-income neighborhoods, but also to attract traditional commercial lending through the success of nontraditional capital.[4] However, the success of the development finance industry raises new questions about the appropriate mission and scale of development finance organizations in today's market. Banks now efficiently fill many financing gaps that were once the sole purview of CDFIs, and banks are arguably the most important CDFI partners, particularly in the current environment. Some mainstream with CDFIs. The growing involvement of mainstream financial institutions in markets that were previously underserved has created the need to redefine and reposition community development financial organizations.

Banks now efficiently fill many financing gaps that were once the sole purview of CDFIs, and banks are arguably the most important CDFI partners, particularly in the current environment.

This paper uses case studies of a variety of long-standing CDFIs with differing business models, as well as interviews with officials at mainstream institutions, to describe the roles and relationships from both the perspectives of development finance intermediaries and those of mainstream financial institutions. The nine institutions are the Nonprofit Finance Fund, The Reinvestment Fund, Community Preservation Corporation, the Community Reinvestment Fund, the Low Income Investment Fund, Self-Help Credit Union, ShoreBank Corporation, the National Community Investment Fund, and ACCION New Mexico.

Through interviews with representatives of CDFIs, as well as with officials at mainstream institutions, this article addresses the ways integration and collaboration currently take place and how roles have been recast based on the inflow of bank dollars and the vehicles (e.g., tax credits) that encourage investment. It explores the CDFI characteristics that mainstream financial institutions value in forming relationships and touches on some of the challenges to CDFIs from this interaction with respect to profitability and sustainability. The paper is not intended as an exhaustive industry analysis, but a look at some key trends.

The remainder of this article is organized as follows: Section II reviews some of the main influences that have altered the relationship between CDFIs and banks in the 1990s; Section III outlines the interview process and includes an overview of each organization in our study group; Section IV reports out the findings of our interviews with CDFIs with respect to their roles vis-à-vis mainstream financial institutions; and Section V includes an analysis of the findings, which is followed by a conclusion in Section VI.

II. Background and Context

This discussion begins with a review of some of the main policy and industry influences that have changed the relationship between development finance and conventional financial institutions in the past two decades. This review provides historical and current context for the case studies in the following section.

CDFIs as an "Auxiliary" Banking System

In the early days, the CDFI industry had little connection to (the workings of) the mainstream financial sector. CDFIs grew out of government efforts in the late 1960s and early 1970s to address poverty and racial discrimination. The early CDFIs believed capital gaps materialized when mainstream financial institutions failed to supply capital to minority and lower-income individuals and communities.[5] In response to redlining, many of the early CDFI practitioners founded their organizations on the belief that they were creating an alternative to the mainstream banking system. The first-generation community development corporations were supported by the federal Office of Economic Opportunity "Special Impact Program," and later by the Department of Housing and Urban Development (HUD), the Economic Development Administration, and the Department of Agriculture.[6] Private capital came mainly from religious institutions and religious individuals.

When federal support for community development contracted in the 1980s, nonprofit community development corporations (CDCs) and for-profit housing developers took on pioneering roles in affordable housing and community development.[7] National community development intermediaries, such as the Enterprise Foundation, the Local Initiatives Support Corporation (LISC), and the Housing Assistance Council, mobilized crucial funding and technical assistance to many CDCs.[8] These intermediaries established a model for community development where community-based nonprofits are developers, managers, and financiers of affordable housing.[9] CDCs received grants and loans from private foundations, corporations, and the government.

Housing CDFIs and CDCs began to change the ways that community development intermediaries viewed mainstream financial institutions. The complexity of affordable housing finance often required complementary roles and a level of harmony between nonprofit, government, and banking institutions. CDCs focused less on their activist beginnings and more on the technical and professional aspects of community development.[10] The need for banks and bank consortia as funding sources, and to work in cooperation to get deals done, began to erode the idea of CDFIs as a distinct financial system. The CDFI trade association initially rooted itself in the idea of CDFIs as a parallel financial system with a mission focus.[11] A philosophical shift emerged in the late 1980s when a newly-seated chairman moved away from an all-embracing membership model towards screening development finance organizations based on their overall effectiveness, as well as financial performance. If the CDFI industry was going to gain access to larger sources of capital from banks and later conventional capital markets, the thinking went, financial performance was critical to achieving that goal.[12] This new direction cut to the heart of how development finance organizations would interact with the mainstream financial sector. A third of the membership quit the association in disagreement.

Impact of CRA

In the 1990s, federal policy reforms led to new levels of bank involvement in the community development field. One of the major factors behind the growth of the CDFI industry was the Community Reinvestment Act (CRA). In particular, 1995 revisions to CRA redefined the relationship between CDFIs and banks in a number of ways. In an obvious sense, the newly implemented lending and investment tests effectively mandated that (consistent with sound banking practices) banks and thrifts allocate money to low- and moderate-income areas, as well as to the intermediaries that would further this aim.[13] The lending test evaluated banks and thrifts based on the number and amount of mortgage and small business loans made in low- and moderate-income geographies. Investment tests were based on the dollar amount of qualified investments and their responsiveness to community development needs. A favorable CRA rating was essential to banks considering mergers, acquisitions and consolidations, since the regulation allowed community groups and other organizations to challenge these types of restructuring based on the institution's service to low- and moderate-income geographies.[14] Consistent with this notion and given the wave of consolidation in recent years, banks provided less than 10 percent of CDFI capital in the early 1990s, a ratio that increased to 56 percent in 2005.[15]

...1995 revisions to CRA redefined the relationship between CDFIs and banks in a number of ways.

The trend towards consolidations in the 1990s also led to the proliferation of institutions with greater capacity to undertake innovative and cost-effective lending to low- and moderate-income borrowers.[16] These institutions added large staffs and sometimes new departments devoted to handling targeted loans and community development projects. With growing expertise, many bankers, especially those affiliated with larger institutions, recognized that CDFIs represented a way for banks to serve otherwise

unprofitable customers (small credits with relatively high due diligence and servicing costs). Banks usually funded CDFIs in areas that would not compete with their own activities.[17] This perspective helped position CDFIs as brokers of transactions in low-income communities, building a bridge between community organizations and lending resources.[18] CDFIs increasingly served as a conduit between nonprofit housing developers and mainstream capital providers.

The 1995 changes also expanded the types of banking organizations, including wholesale banks, which would be evaluated for their community investments, as well as broadened the array of activities and the types of organizations for which banks could receive CRA credit. The community development test covered investments, grants or deposits in CDFIs, community development corporations, low-income or community development credit unions, Neighborworks organizations, and purchases of syndications in Low Income Housing Tax Credits.[19]

CDFI Fund

The creation of the Community Development Financial Institutions (CDFI) Fund, authorized by the Riegle Neal Community Development and Regulatory Improvement Act of 1994, was another important policy intervention that redefined the relationship between CDFIs and mainstream financial institutions. The CDFI Fund formalized the relationship in several ways. Bank regulators received clear guidance linking CRA performance with lending to certified CDFIs. In addition, the CDFI money was awarded as unrestricted equity, a type of financing in short supply for development finance organizations, but necessary to allow these organizations to leverage additional debt capital. The millions of dollars allocated by the fund also put a new spotlight on the sustainability of the CDFI business model, and in this respect brought CDFIs closer to the mainstream banking world.[20]

The fact that the CDFI Fund was housed in the Treasury Department was also important for consolidating the image of CDFIs as financial institutions, distinct from other community development programs administered through HUD. The CDFI Fund grantees had to demonstrate that they were credible, performance-driven entities to qualify. This imprimatur gave banks greater confidence in lending to them. An additional feature of the CDFI Fund that strengthened the relationship with mainstream banks was the creation of the Bank Enterprise Award Program. Along with the grant-making function of the CDFI Fund, a separate Bank Enterprise Award Program created monetary incentives for insured depositories to invest in CDFIs and economically distressed communities. The BEA Fund awarded approximately $46 million to banks in 2000 and 2001. In 2006, the total award pool was $12 million.

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Tax Credits

Low Income Housing Tax Credits (LIHTCs) developed in the mid-1980s but more widely used in the 1990s,[21] were another key policy instrument that attracted mainstream dollars to community development. The promotion of tax credits to finance community development represented a paradigm shift away from direct outlays from the federal budget in favor of private sector investment. By awarding a federal tax credit for investment in low-income housing developments, LIHTCs gave incentives to taxable investors to invest in low-income housing and rental projects.[22] As CDCs became more sophisticated and the risks of housing lending were reduced, conventional lenders became more active in financing affordable housing.[23]

With a broader community development purpose and similar effect, New Markets Tax Credits legislation was passed in December 2000 with an initial allocation of $15 billion over a seven-year period (2001-2007). The credits were available to taxpayers who make "qualified equity investments" in privately managed investment vehicles called "community development entities".[24] The impetus for New Markets Tax Credits came not only from the alternative mutual and investment fund network, but also from the business community that argued that the government should provide tax incentives facilitating the opening of inner city markets to mainstream businesses.[25] The credit is attractive to banks because it offers a profitable return as well as investment credit under CRA requirements. A number of investors have become "allocatees" as well—receiving the award directly. As of February 2007, 54 banks and bank holding companies had received $3.1 billion in NMTC allocations.[26]

Affordable Housing Goals at Government-Sponsored Entities

The affordable housing goals that HUD set for Freddie Mac and Fannie Mae were another inducement to conventional lenders to extend mortgage credit to nontraditional borrowers. Since 1992, when the current regulatory structure for GSEs was established through the Federal Housing Enterprises Financial Safety and Soundness Act, HUD has

established specific standards for Fannie Mae and Freddie Mac to fulfill its mission to provide secondary market assistance relating to mortgages for low- and moderate-income families. In turn, the decision by government-sponsored mortgage corporations to loosen their criteria for mortgage loans originated in lower-income areas gave an incentive to conventional lending institutions to adapt their products and underwriting criteria for lower-income borrowers.[27]

...until the mid 1990s, CDFI banks and credit unions had often been the only source of affordable mortgages for minority and low-income homebuyers... most of the home purchase lending on the part of CDFIs became loans subordinate to first mortgages held by more conventional financial institutions.

Secondary Loan Markets

Whereas until the mid 1990s, CDFI banks and credit unions had often been the only source of affordable mortgages for minority and low-income homebuyers, with the arrival of mainstream financial institutions into this market, most of the home purchase lending on the part of CDFIs became loans subordinate to first mortgages held by more conventional financial institutions.[28] The private secondary market afforded banks and/or their mortgage subsidiaries the opportunity to enter a profitable but inherently risky market at scale, as well as an additional means to meet CRA requirements. As late as the early 1990s, less than half of all mortgages were securitized and sold into the secondary market.[29] As of 2004, the rate was nearly 70 percent.

A parallel trend in the 1990s was the proliferation of subprime mortgages, and expansion of a private secondary market to securitize them. From 1993 to 1998, subprime loans originated grew from 70,000 to 10,540,000, or roughly 1,400 percent.[30] As of 2006, subprime lenders affiliated with a major mainstream financial institution held about a third of total subprime market share.[31]

Technology

Of equal importance, new technologies in the 1990s changed the traditional bank model, enabling new providers and products to enter the market, opening new distribution channels, and creating new partnerships to provide financial services.[32] Automated loan processes reduced transaction costs, allowing mainstream financial institutions to offer credit and services more directly and efficiently in low- and moderate-income communities and thereby changing the nature of capital gaps. The instantaneous transmission of data across distances 'de-localized' capital and made loans and other financial products available anywhere in the country, including communities with no banks.

Advances in technology such as computerized systems and automated credit scoring were a key driver of these changes, affecting the speed and scale of information flow. They broadened the scope of products and services that conventional financial institutions could offer to traditionally underserved households. Using financial "engineering" techniques, almost any pool of assets – most notably subprime mortgages – could be securitized and sold.[33] New stored value cards, transfer payment tools, employer-based services, expanded and less expensive access points (such as locations of ATMs), and other practices all reduced costs and increased productivity in ways that enabled the market to provide more services to previously underserved consumers.[34]

Today, virtually every commercial bank would affirm its commitment to investment in products to serve disadvantaged communities.[35] "Megabanks" have opened distinct lines of financial services (or financed them) for lower-income and ethnically distinct customer bases. A number of large mainstream financial institutions have introduced products specifically aimed at lower-income and immigrant markets that have traditionally transacted in cash, such as stored value cards, collateralized credit cards, and inducements, such as low-cost wire transfer services, to attract this market cohort. Smaller banks, including minority- and ethnically-owned banks, have filled several special niches in cities across the U.S. All the while, conventional financial institutions have been the main channels for Small Business Administration (SBA) and Federal Home Loan Bank loans to small businesses and lower-income home buyers. The SBA 7(a) and 504 programs continue to be utilized by both conventional and CDFI lenders to support their small business activities.

III. Methodology of Study

The CDFIs interviewed in this study were selected for their long operational histories and diverse set of relationships with their mainstream financial partners. The group includes the Community Reinvestment Fund (CRF), Community Preservation Corporation (CPC), the Low-Income Investment Fund (LIIF), the Nonprofit Finance Fund (NFF), The Center for Community Self-Help (Self-Help), ShoreBank Corporation, The Reinvestment Fund (TRF), ACCION New Mexico (ACCION-NM), and the National Community Investment Fund (NCIF). All have weathered numerous changes in the mainstream financial services market, public policy, and the general economic climate, and adapted to these environmental changes. Two of the subject organizations are mission-focused depository institutions, and as such, have at least one steady capital source (deposits). ACCION-NM and NCIF, which were both established in the mid-1990s, provide interesting cases of the use of existing banking infrastructure, and perhaps insights for a possible future state of the development finance industry.

The CDFI roles presented in the next section are based on personal interviews with the CEO and senior staff of each of the organizations, as well as background research and literature reviews on each. We asked representatives of each CDFI to narrate the history of their association with mainstream financial institutions and identify important examples of collaboration through time. While we worked from a list of questions covering organizational history and financial relationships, each discussion went in its own direction. We also spoke with representatives of banks, foundations, and government agencies, to gain some external perspective on these relationships. All interviews were conducted between June 2006 and May 2007. (See page 17 for a list of interviews.)

Brief Descriptions of CDFI Organizations Interviewed

Nonprofit Finance Fund (NFF) provides loans, credit enhancements, and grants to nonprofits nationwide. Increasingly, the organization is moving away from facilities financing, and toward lending (and other funding), training, and consulting services that build capacity of its nonprofit clients. NFF is headquartered in New York City.

The Reinvestment Fund (TRF) is a national leader in the financing of neighborhood revitalization. TRF finances housing, community facilities, commercial real estate, and businesses across the Mid-Atlantic. TRF also conducts research and analysis on policy issues that influence neighborhood revitalization and economic growth. TRF is based in Philadelphia.

Community Preservation Corporation (CPC) is a nonprofit bank consortium that facilitates affordable housing development and redevelopment. CPC offers construction, rehab, and refinancing loans, and provides technical assistance to borrowers, which include public, private, and nonprofit developers. CPC is sponsored by 80 banks and insurance companies, and its geographic scope includes the states of New York, New Jersey, and Connecticut.

The Center for Community Self-Help (Self-Help) focuses on mortgage and small business lending to people of color, women, rural residential, and low-wealth families and communities that are not served adequately by other financial institutions. Self-Help operates the Center for Responsible Lending, a nonprofit created to explain and promote responsible lending advocacy at the national level. Self-Help is based in Durham, North Carolina. It operates offices in cities across North Carolina as well as Washington, D.C. and Oakland, California.

The Community Reinvestment Fund (CRF) is the development finance industry leader in opening channels to capital markets. CRF operates a national secondary market for community development loans, more broadly connecting local development lenders with capital markets to increase their liquidity and impact. CRF is headquartered in Minneapolis.

The Low-Income Investment Fund (LIIF) provides capital and other assistance for affordable housing, child care, education, and other community building facilities and initiatives. LIIF finances all development phases, including permanent mortgages, as well as operating lines of credit for nonprofit organizations. LIIF operates mainly in three metropolitan areas: San Francisco, Los Angeles, and New York City.

ShoreBank Corporation was the first community-development bank in the nation. It is a multi-state banking and community development organization comprised of two banks and seven nonprofit subsidiaries in Chicago, Detroit, Cleveland, and Ilwaco, Washington. Having pioneered the concept of community development banking and the "double bottom line" of both mission and profit goals, ShoreBank developed in the 1990s the concept of a "triple bottom line" that also encompasses environmental goals.

The National Community Investment Fund (NCIF) was established in 1996 as an independent fund to make investments in depository institutions around the country. These institutions are community banks, thrifts, and some credit unions that have a primary mission of community development. NCIF is based in Chicago.

ACCION New Mexico (ACCION-NM) provides business credit, microloans, training, and other resources to further the goals of emerging entrepreneurs in the state of New Mexico. ACCION-NM is part of an international network of independent organizations that use the name ACCION.

For more detailed overviews of each organization, see: www.chicagofed.org/appendices

IV. Interactions between CDFIs and Mainstream Financial Institutions

This section presents findings from our interviews with the subject group and provides examples of collaboration with banks, government-sponsored enterprises such as Fannie Mae, and investment banking organizations. While we identified a range of CDFI activities vis-à-vis mainstream institutions, we focus here on roles and activities that represent reasons for organizational success in attracting and deploying capital, and on those that represent advancements or innovations with ramifications for the community development finance field. We also, in summary fashion, demonstrate the ways CDFIs align the interests of multiple actors, including lenders, investors, and government agencies, and thereby increase and better leverage resources that go to development projects in impoverished communities.

The CDFI roles are grouped into five broad areas. These are: (1) extend through diverse constructs the ability of mainstream institutions to lend beyond profitability constraints to nontraditional borrowers in the primary market; (2) expand capital markets to include community development credits; (3) develop new areas of lending that mainstream institutions eventually serve independently; (4) perform civic intermediary functions by helping to contextualize public and private investments from regulatory and economic development viewpoints, and capture public funds to attract mainstream participation in community development; and (5) help to build the community (development) banking field by leveraging existing infrastructure and capital, and increasing the number of CDFI banks. We explain the importance of each strategic area, and then provide examples of activities that reflect the function at selected CDFIs. Many of these functions are common, in some form, to more than one organization in our subject group. Some of the activities we describe illustrate several functions or roles in the same example. In addition, not all the broad strategic functions apply to all of the organizations in our study group. ShoreBank, the only (community development) bank in our sample, has larger banks as investors, but the relationship has little in common with that of loan funds or even the only other depository in the group, Self-Help.

1. Primary market: extend the ability of regulated, mainstream financial institutions to lend and invest in community development beyond profitability and risk constraints through diverse CDFI/bank constructs

Extending the ability of mainstream financial institutions to lend and invest in community development is a classic function of CDFIs. CDFIs (more precisely, community development loan funds) borrow bank and other funds to lend at below-market rates to 'higher risk,' less experienced or unproven customers, at a small profit. These loans are often smaller, riskier, more specialized, and comparatively less profitable than typical bank products; many banks cannot underwrite such loans on a continual, cost-effective basis. Borrowers include nonprofit organizations and developers who cannot meet underwriting criteria at conventional institutions.

Lending Consortia, Pools, Syndications

In addition to one-on-one relationships between CDFIs and mainstream financial institutions, CDFIs organize lending consortia, pools, syndications, and other forms of risk sharing that make use of their specialized lending, local/regional market, and policy expertise. These arrangements bring more capital to bear for community development and enable CDFIs to generate more and larger loans. They allow banks to participate in and thereby spread risk across portfolios of community development loans, earn profit, and earn CRA credit. They extend further than one-on-one relationships the ability of mainstream financial institutions to lend and invest in community development beyond profitability constraints, potentially to a broader geographic area, and with greater impact.

The Community Preservation Corporation (CPC) is one of the earliest examples of a loan consortium for community development purposes in the nation. Unlike other examples we cite, where a nonprofit lender uses consortia as one of multiple strategies, its organizational structure is a loan consortium. CPC was founded in the 1970s in response to the long-term deterioration of the affordable housing stock in New York City boroughs. CPC traces its origins to a study conducted under the auspices of (David Rockefeller at) Chase Manhattan Bank that looked to redress almost three decades of disinvestment in the housing stock of neighborhoods in Brooklyn and the South Bronx. After much earlier middle-class flight to the suburbs from these areas, banks had become leery of lending in them. Thrift institutions, which served some blighted areas, did not have the capacity or expertise to finance and carry out large rehabilitations. The study concluded that only a nonprofit funded with bank capital and dedicated to improving specific neighborhoods could turn around this long-term deterioration. A consortium of about 60 banks provided lines of credit to CPC. Today, these lines total about $460 million, are renewed every five years, and a single agent bank, (Deutsche Bank) lends to CPC directly under a revolving credit arrangement.

Another example of a pioneering consortium was developed by the Nonprofit Finance Fund in the mid-1990s. When wholesale banks came under CRA regulation in 1995, banks such as JP Morgan recognized that working with an intermediary was the best and perhaps the only way to meet CRA lending requirements. Wholesale banks were not structured

to make small, customized loans. With an understanding that these loans would not be profitable for banks to do on their own, NFF structured a loan syndication with wholesale banks as funders. This arrangement was pivotal to NFF's growth; at the same time, it was a relatively straightforward relationship. All the banks lent with the same set of covenants. A single bank, JP Morgan, acted as the syndication agent. The terms of the consortium made NFF the underwriter. Banks lent to the consortium unsecured, without collateral, but with full recourse, meaning that NFF could be compelled to make good on (i.e., buy back) non-performing loans. They made the loan decisions and decided the terms of the loans, incurring the related due diligence and servicing costs.

Variations of the pool/consortia model have allowed CDFIs to move away from making relatively small loans to one where larger pooled arrangements facilitate financing that banks would still not underwrite alone, sometimes for specific purposes, such as construction, or for specific types of collateral, such as charter schools. In 1994, the Reinvestment Fund organized a consortium of bank lenders, called the Collaborative Lending Initiative, to finance large construction projects – larger projects than TRF could finance using solely its own capital. The Collaborative Lending Initiative (CLI) is a direct lender to housing, community facilities, and commercial real estate projects. Starting at $13 million and growing to $30 million, the CLI marked the first time TRF turned ad hoc loan participations into a system. The consortium initially consisted of 22 different lines of credit managed by TRF. At its start, small banks were most interested in participating because the consortium gave smaller institutions that did not have their own real estate departments a way to receive CRA credit. When the CLI turned into a true syndication in 2002, larger banks joined with a very different motive: they wanted to outsource the smaller deals (less than $500,000) that they could not do profitably on their own. Chase eventually assumed the role of managing these credit lines in 2002.

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Deploy Off-balance Sheet Capital

The broad goal of community development loan funds to grow their lending and impact has in some cases pushed individual institutions past the point where it remains practical to borrow and then deploy money. Two principal obstacles inhibit lending growth among loan funds: they have finite core capital (and sources of funding available to grow capital have diminished); and second, bank funding above a certain level is too costly. Banks can often underwrite credits that in the past required an intermediary, reducing their incentive to lend at any discount to market. Some CDFIs accordingly engage in "off-balance sheet" lending, deploying funds of other institutions directly. This model enables the CDFI to increase its lending impact in an environment where growing internal capital is more difficult. It also enables a mainstream partner to leverage the local market knowledge, expertise, and high-touch servicing of a CDFI, but usually with some level of recourse.

The Low Income Investment Fund (LIIF) provides an example of this type of arrangement. Within the past few years, LIIF determined it could realize its goal of increasing its lending capacity more efficiently by lending funds of other entities that it need not control directly. LIIF originates and services loans for mainstream financial institutions, which are held on the books of the mainstream institutions. For example, LIIF originates and underwrites charter school loans for Royal Bank of Canada, one of the most active banks in the California charter school financing market. Another source of off-balance sheet capital for LIIF is the Fannie Mae American Communities Fund. Fannie Mae reviewed and approved LIIF's underwriting standards, and LIIF sells loans under the program to Fannie Mae without review, but with five percent recourse, meaning Fannie Mae can compel lenders to buy back that portion of (non-performing) loans sold to the fund. Currently, about 60 percent of the $300 million in capital LIIF has available to finance community development projects is not on its balance sheet, but under the CDFI's (sole) purview. LIIF's CEO described the organization's role as moving more toward one of supplying intellectual capital (market expertise) in isolation, versus expertise that is coupled with financial capital that it raises and deploys.

Employ Variations of Traditional Partnership Roles to Facilitate Broader CDFI Reach

A very different way of partnering with banks is the ACCION New Mexico (ACCION-NM) model. In 1999, after five years of operation, ACCION-NM expanded its geographic footprint from the greater Albuquerque area to the entire state of New Mexico. ACCION-NM recognized that small business lending and microlending was badly needed among cash-starved entrepreneurs with blemished credit

histories or none at all, but traveling great distances to originate and close very small loans would create too much expense for ACCION-NM to survive. Therefore, ACCION-NM became adept at using the network of offices of banking institutions around the state (Wells Fargo, First State Bank, a First Community Bank subsidiary, and more recently First National Bank of Santa Fe) to identify borrowers, often would-be bank customers, who do not meet bank underwriting criteria. These banks have become the principal distribution system for ACCION-NM, even representing the organization at loan closings. In some instances, credit is extended without any face-to-face contact between ACCION-NM staff and actual borrowers; the bank office serves as a communication and funding channel, but ACCION-NM underwrites and funds the loans. These relationships between ACCION-NM and banks have set up the opportunity for ACCION-NM's customers to "graduate" to a direct relationship with the bank at a later time.

2. Secondary market: open channels to capital markets for community development loans to facilitate greater liquidity and reliable funding sources for community development lenders

Much of the dialogue related to scaling and to some degree mainstreaming the development finance field revolves around the topic of liquidity, and access to reliable, stable, and predictably-priced sources of capital. Capital markets create liquidity and reduce pricing once risks associated with an asset type are identified and quantified. The CDFI industry has made significant inroads toward accessing secondary market capital on a continual, if not yet broad, basis. There are still numerous challenges to this endeavor. Many of the loans originated by CDFIs do not fit normal secondary market criteria, loan volume is insufficient to attract interest among investment bankers, and there is a scarcity of data to inform risk management models. To the extent CDFIs can adapt their lending practices, capital markets represent an efficient and ready funding source for an industry that has historically depended on uncertain government and foundation funding, and specialized relationships with banks.

Create Capital Markets Channels For Non-SBA-qualifying Small Business Loans

As an organization founded on the principle of bringing capital to community development lenders through the secondary market, the Community Reinvestment Fund (CRF) works to demonstrate and develop secondary markets for various types of loans that do not fit current secondary market criteria. For many years, the SBA-insured portion of qualifying loans was the only secondary market for business loans. The lack of similarity between business loans was a barrier to secondary market sales. CRF saw a niche in devising ways to pool non-SBA-insurable loans – loans to small business owners originated through revolving loan funds, whose growth would otherwise be constrained because of the slow return of funds to re-lend to subsequent borrowers. CRF purchases loans under specified agreements from nonprofit or publicly sponsored small business lenders around the country and packages them into securities. These loans are secured by real estate, but typically their loan-to-value ratios are too high or the collateral has a second lien, and therefore they do not qualify for SBA 504 guarantees. CRF sells these securities, predominantly, to banks investing for CRA purposes. In 2004, CRF reached an important milestone, receiving an S&P rating for its roughly $50 million securitization, 87 percent of which was AAA (highest) rated. Buyers included institutional money managers and insurance companies. Another rated security followed in 2006. Banks seeking CRA credit continued to invest in the lower-rated tranches of these issues.

Securitize Nonconforming Mortgages

Another important innovation for accessing the secondary market is one developed by The Center for Community Self-Help (Self-Help). Self-Help began its secondary mortgage market program in 1994 to address the need for greater liquidity in the lending market to nonconventional mortgage customers. In Self-Help's secondary mortgage market program, the supplier network is mainstream financial institutions. Self-Help purchases nonconforming "CRA-qualifying" mortgage loans and securitizes them through Fannie Mae. These are high LTV mortgage loans to households that may have blemished credit histories and/or difficulty documenting income, and do not qualify for conventional ("A credit") mortgage financing.[36] This program began with Self-Help's purchase of Wachovia's $20 million nonconforming portfolio. The terms of the transaction required Wachovia to re-lend the sale proceeds of their portfolio in low- and moderate-income communities. Funding from the MacArthur Foundation in 1997 allowed Self-Help to buy additional loans from Wachovia and other institutions. In 1998, this pilot led to a national program to sell nonconforming loans to Fannie Mae. Fannie Mae made a $2 billion dollar commitment to securitize the loans originated by 22 financial institutions. Self-Help obtained a $50 million Ford Foundation grant to serve as a loss reserve. The $2 billion mark was reached in 2003, and the commitment was renewed at $2.5 billion with a new five-year term. Presently, the mortgage-backed securities derived from these loans (issued by Fannie Mae) account for about two-thirds of Self-Help's portfolio.[37]

Expand Loan Securitization to New Types of Assets

An even more recent development in CDFI secondary market activity is exploratory work on securitizing charter schools loans. CDFIs have been making charter school loans since about 1997. Planning is now underway among members of the Housing Partnership Network (HPN), a consortium of affordable housing developers, lenders, and other development finance organizations, to explore the feasibility of a bond securitization program for charter schools. Five of the CDFIs involved in HPN are among our subject group: CPC, CRF, TRF, Self-Help, and LIIF. Under the direction of Minneapolis-based consultant Wilary Winn, which also advises CRF individually, the group has assembled data about its loan portfolio, and is working with potential investors and partners. The expected launch of a pooled transaction is the second half of 2007.[38]

3. Innovator/pioneer: develop new areas of lending that mainstream institutions can eventually take on with or without intermediaries, in part by identifying and helping to address related risks

Over the years, a case has been made that a key role that CDFIs play relative to mainstream financial institutions is that they demonstrate the viability of the community development finance market. Indeed, CDFIs often see themselves as laboratories, and regularly adapt their products in response to economic, social, and institutional changes. They make the case for lending and investment in under-served communities, demonstrating the value of the collateral they are creating, so that a part of this market can later be taken over by mainstream financial institutions. CDFI innovations are shared or 'spun-off' to larger, often private, financial players that are better able to commercialize fully a promising new product or service. Some in the development finance industry have a goal of changing not just the behavior of lenders in the primary market, but of investors in the secondary market as well.

Mortgages to Lower-income Households

A classic example of this "demonstration effect" is nonconforming and subprime mortgages. Community development banks and credit unions, as well other intermediaries, began underwriting mortgages to lower-income households as early as the mid 1970s. Though the subprime market is currently in a turbulent phase stemming from, as lenders competed vigorously during the recently past housing boom, overly relaxed underwriting standards and aggressive marketing of nontraditional (e.g., low/no documentation, interest-only, 2/28) subprime loans, CDFIs were among the first to demonstrate that non-government-insured mortgages could be extended to lower-income households that do not qualify for prime, conventional loans. The secondary market for subprime mortgages expanded widely in the 1990s, and GSEs began purchasing the least risky segment (so-called 'A-minus' credits) of these loans. Today, mainstream institutions have overtaken mission-oriented organizations in providing mortgage loans to low- and moderate-income borrowers. Construction and permanent financing for affordable multi-family housing now comes frequently from banks and less often from CDFIs.

Loans to Charter Schools

A more recent example is loans to charter schools. In the early days of charter schools, there was no connection made to CRA by banks or, formally, by bank regulators. Banks moved slowly into the field through participations organized by CDFI intermediaries. Later, CDFIs noted that some of the banks they worked with started making these loans directly. For example, Citibank was one of the banks to help The Reinvestment Fund negotiate its first charter school loan pool. It took that knowledge and then made five or six charter school loans as the sole lender. Despite some idiosyncrasies, the larger loan sizes (some over $5 million) help banks clear at least one profitability hurdle common to community development loans.

The concept of CDFIs as demonstration organizations can be over-simplified, however. Often, CDFIs do not exit a market after mainstream banks have joined. As The Reinvestment Fund explains, it does not cede lending markets to banks once the related risks and idiosyncrasies are commonly understood. TRF remains a player, financial and otherwise, and works to inform and integrate aspects of public policy, civic involvement/awareness, and related development and services to the betterment of its local markets. For some CDFIs, the justification for remaining in a market relates to sustainability; the time and energy to understand and develop a lending market represents a significant investment, and CDFIs seek a return on that investment. Others question

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whether it is in the best interest of the community development borrower to hand over the market to mainstream financial institutions. According to some development finance experts, the charter school market is still an emerging, inefficient market and CDFIs have a duty to consider whether a bank loan of five to seven years is necessarily the best type of funding for a charter school.

CDFIs also consider the permanence of mainstream institutions in these niches. As profit-motivated institutions, banks may temporarily or permanently vacate a product line if a certain margin is not met, or the bank changes its orientation after a restructuring or merger. CDFIs have seen this as an argument for staying in a particular market or product line to ensure that certain types of credit remain available. Leaving a market when banks move in during strong economic times creates the risk of leaving a lending vacuum that cannot be easily filled during weaker economic times if the CDFI has divested itself of the infrastructure and capacity to operate in that niche. ShoreBank, for example, competes with mainstream banks for market share in the rehab loan market, and remains the dominant lender for this product in the bank's original market, Chicago's South Shore neighborhood, even as other banks have entered and left the market over time.

4. Civic intermediary/aggregator of public funds and resources: capture and manage available public moneys to enable and/or enhance community development finance

By virtue of their social missions and nonprofit status, as well as their expertise and market awareness, CDFIs are positioned not only to attract subsidy capital, but also to provide input on government subsidy program design and deployment. Generally, to bring deals or programs to fruition, CDFIs must assemble subsidy, nonfinancial commitments, community support, and form long-term (and informed) relationships with government officials, investors, and clients. CDFIs often assume the role of subordinate lender and take the first-loss risk, and/or apply for and bring public, foundation, or other ancillary funding to bear to provide loss reserves and mitigate risk to their mainstream partners. The CDFI intermediary assumes the role of trustee (of sorts), and must assure not only the highest level of integrity and skill in deploying public (subsidy) resources, but also use them efficiently, leverage private capital, and align the interests of all parties toward achieving the desired outcome. In the majority of CDFI deals, banks would not otherwise lend or invest.

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As the Community Preservation Corporation (CPC) explains, one of its key roles is to devise finance structures that dovetail private finance with tax incentives, grants, or low-interest loan subsidies. CPC has also addressed barriers to investing in multifamily housing by, for example, aligning guidelines common to city subsidy programs with its own underwriting criteria, eliminating the need for developers to meet multiple sets of criteria and benchmarks, and providing technical assistance and a variety of other supportive services for borrowers/developers and building residents. These efforts have attracted more private sector investors in affordable housing.

CDFIs also help to shape policy priorities. For example, NFF played a major role in broadening the types of loans for which banks receive CRA credit beyond housing finance. A breakthrough aspect of NFF's initial loan syndication in the 1990s was that it brought together bank funds to support community development activities outside of the housing sector. Prior to the early 1990s, banks did not expect to earn CRA credit for financing, for instance, arts facilities, or providing an operating credit line to a nonprofit. NFF argued that nonprofits that support homeless shelters, drug treatment centers, community centers, should all be included in CRA. With some help from the New York and San Francisco Federal Reserve Banks, which held forums to raise awareness of NFF's efforts, the definition of "CRA-qualified loans" was extended beyond mortgages. NFF's advocacy led to increased bank lending to nonprofits in New York and across the country.

CRF's work to open capital markets to community development finance provides another illustration. CRF was the first to envision ways that the New Markets Tax Credit might be used as part of a strategy to enable capital markets funding. CRF applied for tax credit allocations and sold the credits to persons or organizations with sufficient federal tax liability, in order to raise subordinate capital and reduce costs to end borrowers. (CRF has been allocated roughly $400 million in credits in three rounds.) Even though CRF's National New Markets Tax Credit Fund Inc. (the entity that receives the tax credits) is a for-profit institution, and it purchases loans from public loan funds (not uniquely nonprofits), it qualified for New Markets funding because it sought and received a private letter ruling that allows CRF to buy loans from non-CDEs as long as they are subject to an advance commitment (i.e., CRF reviews the loans and issues

commitment letters). CRF was the first multi-investor fund in the marketplace to use the credit in this way. The fund creates additional capacity to purchase loans, and the structure allows CRF to improve pricing to end borrowers by roughly 150 basis points compared with market-rate pricing for the typical borrower. The NMTC-financed limited partnership ultimately facilitates investment-grade ratings for the largest portion of CRF's securitizations.

Further, CDFIs see themselves as having a responsibility to protect consumers or play a "watchdog" role in the community development finance field. For example, Self-Help launched a subsidiary, the Center for Responsible Lending, to counter predatory lending practices through research, studies, and policy work. More recently, to counter predatory lending in the subprime market, two prominent organizations in the development finance industry are rolling out new subprime mortgage programs positioned as alternatives to predatory lenders in 2007 that include secondary market components and fair-pricing policies. The Housing Partnership Network is forming a conduit for "responsibly priced" subprime mortgages and the Opportunity Finance Network, a trade association for CDFIs, is planning to offer a 'turnkey' mortgage lending platform for CDFIs that wish to participate. TRF's self-described role as a civic intermediary goes to the heart of CDFI's oversight role for community development projects in their service areas. From city and state politicians to local venture capitalists, local leaders seek TRF's advice and participation based on TRF's network of civic and policy relationships as well as its expertise and experience.

5. Demonstrate community banking models and work to expand the development banking industry

The relationship between the community development bank in our sample, ShoreBank, and mainstream institutions, is distinct from that of the other organizations in this study. Even banks such as ShoreBank that identify themselves as 'community development' institutions do not typically get funding from or co-finance with larger, mainstream banks, and may compete directly with mainstream banks in the same market for certain credits. If one metaphor for a CDFI is that of a bridge that connects community development borrowers to capital, CDFI loan funds start on one side of the river and CDFI banks on the other. CDFI banks are regulated depositories attempting to create a new business model for community banks. In effect, they are redesigning the financial system for low- and moderate-income populations and places from the inside. They serve customers who may find traditional banks intimidating or not welcoming, and who may need some counseling or technical assistance to use the banks' account services, and borrow and repay loans successfully. Community development banks are organizations with mission goals as well as profitability goals. ShoreBank has a triple bottomline of profit, community development, and the environment.

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For ShoreBank, a bank is a very different 'change-agent' than other types of community development intermediaries. All banks must comply with an array of regulations, which flow from federal deposit insurance, relating to their liquidity, management, earnings, and exposure to market and interest rate risk, as well as CRA and consumer regulations. These requirements, the need for substantial initial capital, and the relevant expertise and experience to open a bank, represent high barriers to entry. However, a community (development) bank can leverage capital to a greater degree than a loan fund, and has a ready funding source in deposits (given at least a moderately healthy local economy and/or methods of drawing deposits from other areas). These characteristics allow community banks to have greater overall impact per dollar of core capital. Leverage is seen as an important tool to operate at scale.

ShoreBank operates with a distinct philosophy, as well. From its perspective, the individual and the private sector, not the nonprofit, are the most important agents of change. Few bank borrowers identify themselves as 'community developers.' They usually have a profit motive. Therefore, ShoreBank does not generally consider whether a prospective borrower is engaged in a textbook definition of economic development. If a loan can give people the opportunity to own a home that they might not otherwise, and the bank can make the underwriting work, ShoreBank will provide it. Through its purchase/rehab lending in South Shore, ShoreBank has helped to create substantial wealth for some of its clients.

Another key aspect of ShoreBank's strategy is that it bundles nonprofit affiliates within a larger holding company structure. The ShoreBank structure includes nonprofit and for-profit affiliates that complement the

bank work, much like nonprofit CDFIs complement the work of mainstream financial institutions. ShoreBank's management recognized early on that regulatory requirements would constrain the bank from extensive lending to nontraditional borrowers with blemished (or no) credit profiles and/or insufficient assets. Establishing affiliates within the same bank holding company enables ShoreBank to reach deeper into low- and moderate-income populations. ShoreBank's affiliates have complementary roles to those of the bank, and exist to help the bank achieve its mission goals as opposed to simply facilitating community development lending to meet regulatory requirements. The nonprofits raise grants and supplemental funding for redevelopment projects, provide technical assistance and training to entrepreneurs and others, and provide financing that the bank could not easily make directly. The nonprofits also benefit from the expertise, infrastructure, and underwriting discipline that come from affiliation with a regulated bank.

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Finally, ShoreBank's effort to remodel at least a segment of the mainstream financial system is evident in its mission to create examples of profitable products and services that other banking institutions can emulate. ShoreBank is the principal advisor and trustee to the National Community Investment Fund (NCIF), which makes investments in community banks serving low-income populations and underinvested communities nationwide. ShoreBank has no ownership interest in NCIF, but helped create the organization after NationsBank (now Bank of America) approached ShoreBank in the mid-1990s for ideas as to how to invest in community banks. NCIF looks to leverage the existing infrastructure and delivery system of community development banks to have greater community impact, but, like ShoreBank, is focused on profitability and disciplined management as well as mission goals.[39] The rationale is that many community banks around the country already have many characteristics of community development and mission focused institutions, even if they do not identify themselves as such. As financial institutions with existing funding infrastructure, insured deposits (and delivery systems), these institutions have higher barriers to entry and are accordingly fewer in number, but control a much larger collective pool of assets than other CDFI types.[40] NCIF makes direct investments in community banks, and encourages them to seek the CDFI designation, thereby availing themselves of resources available through the CDFI Fund. In addition to direct investment, NCIF, which is a Treasury designated CDFI and a New Markets Tax Credit Community Development Entity, also aggregates NMTCs on behalf of banks and credit unions with a community development focus. NCIF conducts workshops and extensive training for community banks that wish to pursue the CDFI designation. Research efforts by NCIF and others are ongoing to demonstrate the impact of community banks in community development lending, whether or not they identify themselves as having a mission focus.

V. Implications for the Scale and Sustainability of CDFIs

Funding Innovations Impacting Scale

Despite many differences among the organizations in this study, they share a common understanding that collaboration with mainstream financial institutions is a key strategy to attract and deploy capital for community development. In each of the examples provided above, collaboration enables CDFIs to serve more people and communities, and ultimately have greater financial, geographical, and political reach. Collaboration generates greater impact, while operating 'at scale' itself provides greater access to mainstream capital.

However, their collaborations take many forms, and there is not a single, or even dominant, approach that CDFIs take to working with mainstream financial institutions. Beginning with lending consortia, CDFIs have developed a series of innovations to attract funding from banking institutions for community development purposes. Off-balance sheet financing – essentially brokering loans for banks and others while still bringing market and program expertise to bear – has become a way for CDFIs to increase their lending impact when they cannot grow internal capital rapidly enough to pace their own lending goals. The expanding use of secondary market mechanisms to fund community development loans is an important, more recent industry trend. It is one way that CDFIs are working to institute efficient, reliable funding sources that ostensibly will lead to, in addition to greater scale, less reliance on customized, one-off financial relationships between CDFIs and banks. For CDFI depositories, the link between the financial mainstream and CDFI expansion follows a different model. Self-Help has forged key relationships with banks and Fannie Mae, but banks make up the distribution system more

than the funding base. ShoreBank's integration of nonprofit and for-profit entities and support of the community banking industry have ramifications for the growth of development finance.

Some of these measures, particularly efforts to use capital markets, are not intended to grow only the capacity of individual CDFIs, but community development lending capacity broadly speaking. Indeed, CDFIs often position themselves to help mainstream institutions expand their customer base as well as meet their CRA obligations. A number of the CDFIs in this study market themselves as organizations with high caliber talent, large balance sheets (that carry sufficient loan loss reserves), and the know-how to ensure that projects get completed. Similarly, CDFIs highlight their ability to act as the local community development face for large financial institutions. As large banks have grown even larger, the resources and personnel devoted to affordable housing and other community development activities have decreased relative to the increasing size of these institutions. CDFIs offer themselves as partners to mainstream financial institutions, to develop "hand-crafted" deals based on specialized market knowledge and qualitative personal relationships with customers. CDFIs play the role of "retailers" who complement the role of large-bank "wholesalers." The most efficient partnerships are often viewed as those with organizations that can deliver broad impact at a regional or national scale.

Importance of CRA

Both CDFIs and banks note that the Community Reinvestment Act (CRA) is a primary motivator for banks to work with CDFIs. Most large institutions look to earn a top CRA grade through a combination of in-house lending and investment, and, usually, more specialized lending requiring certain market expertise and often more thorough oversight (loan servicing) through CDFI intermediaries. CRA does not compel banks to support CDFIs, but its requirements motivate banks to seek efficient methods to meet credit needs. CRA provides the impetus for nuanced and meaningful dialogue between CDFIs and mainstream banks that has led to successful community investment.

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For CDFIs situated in places that are not big bank CRA markets, however, CRA and bank support may never really be a factor for achieving scale. Put differently, where local conditions diminish the CRA incentives – that is, areas with low population density outside of large bank service areas – mainstream financial institutions may not be the path to scale and impact. Mandates within the socially responsible investment industry may create a more promising source of institutional funding for CDFIs in these markets. Among the CDFI depository organizations we interviewed, for example, socially-responsible investors are an important source of capital not derived from CRA.

Similarly, the intensity of CRA enforcement varies over time with the vagaries of politics and relevant trends within the financial system. Revisions to the CRA passed during the Clinton administration led banks to pull ahead of insurance companies in their support for community development finance institutions. In the past five years, the broad view of consumer advocates is that enforcement of CRA has been less stringent, and there are fewer banks seeking out CDFI partnerships. With the slow-down of merger activity in the mainstream financial sector, there is also less incentive in the banking sector to focus on the punitive consequences of a low CRA grade. CRA enforcement – more than simply the existence of the regulation – may affect the propensity of banks to seek out relationships with intermediaries.

Challenges to Sustainability

In addition to impact, another motive for CDFIs to work with mainstream financial institutions is financial support. However, a long-term CDFI strategy that requires below-market (or grant) funds from financial institutions to sustain the organization is likely untenable. When financial institutions gave their support to CDFIs in the mid-1990s, they tended to see these relationships more as philanthropic gestures than profit-making ventures. In the current climate, banks avoid giving below-market-rate money to CDFIs, and often screen development loans – even those for which banks receive CRA credit – for performance metrics and profitability. The community development borrower is compared to every other customer. For the mainstream financial institutions that still provide below-market loans, internal discourse on pricing is increasingly contentious. The ability to deploy community development assets in a prudent way is a key reason the CDFIs in this study have succeeded in attracting the support of mainstream financial institutions. They have been sensitive to changing environment in the mainstream financial industry, and adapted accordingly. The diverse organizations in our study also represent

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become adept at financial management. They have hired former bank officials as their chief financial and lending officers. Many of the organizations have adopted risk-management and administrative practices that closely resemble those of mainstream institutions.

These accomplishments notwithstanding, CDFIs have expenses that mainstream institutions do not – counseling, technical assistance, high-touch loan servicing – which they cannot, or do not always cover with loan pricing. CDFIs also generally need low-cost, supplemental funding for credit enhancements in order to achieve end pricing goals for unproven and (often) lower-income borrowers, and mitigate otherwise unacceptable credit risk for large financial institutions. New Markets Tax Credits have been used creatively and efficiently for this purpose, but may not be available in sufficient quantity or at all at some later time.

In addition, CDFIs cannot always extract or recapture the value they create for mainstream financial institutions. Despite the direct and indirect assistance that CDFIs provide to mainstream financial institutions, many institutions do not always recognize, let alone pay for these services. Part of the problem may derive from the nonprofit culture. CDFIs, like many nonprofits with a mission to help people, are not as cost conscious as for-profit ventures. If CDFIs don't quantify their unit costs, their value, they cannot convey the value to others, nor expect to recover these costs, although some organizations in our subject group, such as The Reinvestment Fund and Community Preservation Corporation, have worked to quantify and recover their costs. Community development depositories such as Self-Help and ShoreBank have a funding source, and thereby a sustainability edge, in the form of deposits. ShoreBank's Development DepositsSM, drawn from individuals and organizations worldwide, make up almost half of the bank's deposits. Arguably, CDFIs would need less subsidy if they were properly compensated, and more adept – industry-wide – at quantifying their various costs, or phrased differently, their value added.

Efforts originating from the broader initiative promulgated by the Aspen Institute and the Federal Reserve System that gave rise to this study are addressing some of these issues directly. One area of work draws lessons from organizations in the private sector that support various types of businesses with a range of services and scaled purchasing power allowing low-cost access to insurance, data processing, wholesale goods, training, computer hardware, software, training, and more. Various organizations are discussing or establishing associations to reduce costs by partnering with existing cooperatives and/or exploring the feasibility of forming new types of alliances. These and other areas of work are intended to help move the development finance industry to a more self-sustaining state, with more impact in underinvested communities.

VI. Conclusion

The CDFIs in our sample have managed to survive, and even thrive, in the vastly changing financial services environment. The idea of change is so much a part of the environment in which CDFIs work that one CDFI describes it not as of changing ground, but as a river. Banks that might have stood on a far shore at one time now stand on the same ground as where development finance entities once stood, offering similar products potentially at much greater scale. This has led today's community development finance industry to be more integrated with the conventional financial system than ever before. However, nothing prevents banks from retrenchment – market conditions or bank reorganizations may indeed precipitate banks' abandoning product lines and services.

The future of the community development finance industry more broadly hinges on determining the appropriate relationship(s) with the mainstream financial industry, perhaps a more symbiotic association not entered into (or maintained) due to regulatory requirements. Our goal with this study was to explore some of the work that has occurred and is ongoing to move the development finance industry toward a future state that approaches this ideal. The overriding goal for development financial institutions is to produce organizations that can reach more people, tap into economies of scale, become more sustainable and ultimately do more to redevelop low-income communities.

NOTES

[1] We use the acronym CDFI in some instances to refer broadly to organizations that provide their financial services to lower-income or special-needs populations, or to organizations that serve those populations, whether or not they have the Treasury Department designation of Community Development Financial Institution and its benefits.

[2] Borrowing from the well-known motto of The Reinvestment Fund, "Capital at the Point of Impact."

[3] Pinsky, 2001.

[4] Bogart, 2003.

[5] Moy and Okagaki, 2001.

[6] Moy and Okagaki. 2001.

[7] Stoutland 1999.

[8] Stoutland, 1999.

[9] Moy and Okagaki, 2001.

[10] Stoutland, 1999.

[11] The CDFI trade association, the National Association of Community Development Loan Funds was formed in 1985. The name of the organization later changed to the National Community Capital Association and then to the Opportunity Finance Network.

[12] Interview with Mark Pinsky, 2006.

[13] Belsky, Lambert, and von Hoffman, 2000. Examinations became contingent on financial size. For larger banks, the examination was organized into three parts: lending, investment, and service. The lending test would account for 50 percent of the bank's CRA rating, and the investment and services tests would each account for 25 percent of the bank's CRA grade. For smaller banks, the examination was a more streamlined process, considering among other aspects lending within a bank's service area, income dispersion of borrowers, and loan-to-deposit ratio.

[14] Schwartz, 1998. The easing of restrictions on interstate banking in the Riegle Neal Act had set off a wave of mergers.

[15] CDFIs also raise capital from insurance companies, state and local governments, religious institutions, foundations, nonfinancial corporations, and wealthy and often socially conscious individuals.

[16] Belsky, Lambert, and von Hoffman, 2000.

[17] Interview with Clara Miller, 2006.

[18] Benjamin, Rubin, and Zielenbach, 2004

[19] Litan, Retsinas, Belsky, and Haag, 2000.

[20] Interview with Clara Miller, 2006.

[21] Chamberlain, 2006.

[22] As Freeman (2004) explains, the federal government enacted the LIHTC to provide ten years of tax credits to investors who back developments in which a portion of units are made affordable for lower-income renters for at least 15 years. The Internal Revenue Service administers the program. Each state has an agency, often the housing finance agency, that manages its LIHTC program. Developers apply to the agency to receive tax credit allocations in exchange for building units that are affordable to low-income households. Developers or property managers are responsible for marketing the units to eligible households.

[23] Benjamin, Rubin, and Zielenbach, 2004.

[24] The New Markets Tax Credit was a provision of the Community Renewal Tax Relief Act of 2000. The credit provided to the investor totals 39 percent of the investment in a community development entity, and is claimed over a seven-year credit allowance period. In each of the first three years, the investor receives a credit equal to five percent of the total amount paid for the stock, or capital interest at the time of purchase. For the final four years, the value of the credit is six percent annually.

[25] Dymski, 2005. The impetus came from a Harvard Business Review article by Michael Porter in 1995, "The Competitive Advantage of the Inner City."

[26] Comptroller of the Currency Community Affairs Department, 2007.

[27] Benjamin, Rubin, and Zielenbach, 2004.

[28] Benjamin, Rubin, and Zielenbach, 2004.

[29] Apgar and Calder, 2004.

[30] Pennington-Cross (2002), based on figures from the Joint Center for Housing Studies at Harvard. While the GSEs were purchasing loans with lower down payments and slightly higher credit risk, they did not enter (and still have not entered) the so-called B and C credit market.

[31] Lehman Brothers, 2007.

[32] Weissbourd, 2002.

[33] Moy and Okagaki, 2001.

[34] Weissbourd and Bodini, 2005.

[35] Dymski, 2005.

[36] Traditionally a conforming loan had a loan-to-value ratio of not more than 80 percent. Over time, the GSEs have purchased and securitized higher LTV loans, with proper documentation and mitigating (underwriting) factors.

[37] This arrangement illustrates how access to the secondary market can reduce the cost of capital to a CDFI. Rather than sell the securitized loans to Fannie Mae for cash, Self-Help takes the mortgage-backed securities (MBS) themselves – a highly liquid form of collateral that allows Self-Help to borrow from the Federal Home Loan Bank (system) at the most favorable rates. With rated MBS, Self-Help can obtain relatively low-cost financing through the repurchase ("repo") market. Under a typical repo transaction, an investment bank accepts the securities as collateral for a loan of a specified term. At the end of the term, Self-Help "repurchases" the security for the amount of the loan plus interest.

[38] Source: HPN Web site at www.housingpartnership.net/lending/mortgage_conduits.

[39] CDFI banks represent about 8 percent of all CDFIs, but over 50 percent of CDFI assets. NCIF Web site at: www.ncif.org/aboutus.php?mainid=2&id=27, visited 5/2/07.

[40] See www.cdfifund.gov for numerical breakdown of CDFIs by type.

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Mr. Berry joined the Federal Reserve Bank of Chicago's Consumer and Community Affairs division in 1995 as a researcher and special project leader. He now manages the division's Emerging Consumer and Compliance Issues unit, and serves as managing editor of and periodic contributor to the division's economic development publication, *Profitwise News and Views*. Prior to joining the Fed, Mr. Berry, from 1987 to 1995 worked for RESCORP, a real estate development and consulting organization specializing in urban revitalization, heading its market research unit, and from 1985 to 1987 for The Balcor Company, a real estate investment banking subsidiary of American Express, in its investment research unit. Mr. Berry holds a B.A. from Susquehanna University, and an MBA from DePaul University.

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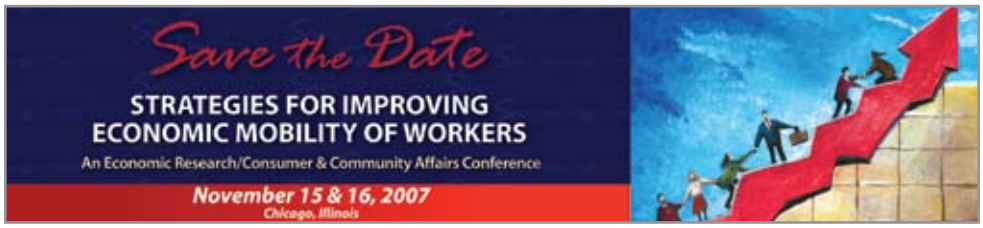
Upcoming Events



On November 15 and 16, 2007, the Federal Reserve Bank of Chicago's Economic Research and Consumer and Community Affairs departments, in partnership with the W.E. Upjohn Institute for Employment Research, will host a conference titled, "Strategies for Improving Economic Mobility of Workers." The conference is to be held at the Federal Reserve Bank of Chicago.

The goal of the conference is to bring together researchers and practitioners to discuss some of the key issues regarding policies impacting disadvantaged workers and their communities. Topics to be discussed include trends and future outlook on work, wages, and occupations, spatial mismatch between jobs and workers, job training and education, and other state and federal assistance for low-income workers. We will also feature panel discussions by practitioners that will highlight practical experiences with running workforce development programs.

On December 11 and 12, 2007, the Federal Reserve Bank of Chicago, Consumer and Community Affairs Division, in co-sponsorship with the University of Wisconsin Extension, and the Wisconsin Housing and Economic Development Authority (WHEDA), will host a conference titled, "An Informed Discussion of Nontraditional Mortgage Products and Escalating Foreclosures." The conference will be held at the Country Springs Hotel in Waukesha, Wisconsin.

"Nontraditional," "alternative," or "exotic" mortgage products are residential loans that include interest-only and payment option features that allow borrowers to defer repayment of principal and sometimes interest. These products allow borrowers to exchange lower payments during an initial period for higher payments later. Participants will gain valuable insights from experts who will explore the risks posed by nontraditional mortgage products as well as issues stemming from Wisconsin's rising number of foreclosures. A further goal of the conference is to initiate an effective community response to address the rising tide of Wisconsin foreclosures.

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Profitwise News and Views is published by the
Consumer and Community Affairs Division of the
Federal Reserve Bank of Chicago
230 S. LaSalle Street
Chicago, IL 60604-1413