FEDERAL RESERVE BANK of MINNEAPOLIS

Community Affairs Officer's note - Summer 1997

Community Affairs Officer's note - Summer 1997

July 1, 1997

AUTHOR

JoAnne Lewellen

Community Affairs Officer

This issue of *Community Dividend*addresses a key challenge for those involved in community development: finding enough money to assist the small business owners and housing developers who create the jobs and affordable housing that make your community a more desirable place to live.

We profile two organizations in this issue: the Community Reinvestment Fund (CRF) and the Anoka County Economic Development Partnership (ACEDP). Both organizations have developed innovative strategies to finance local economic and community development. Although CRF and ACEDP serve very different functions, each is notable for its ability to tap and create new funding sources for community development lending.

We hope this issue of *Community Dividend*offers you some ideas on how to think and act creatively to stretch your community development resources.

Recycling resources

The Community Reinvestment Fund links economic development financing more closely with capital markets and gives community-based lenders a funding option other than uncertain sources of government money.

July 1, 1997

Reduce, recycle, reuse. This familiar slogan appears on everything from waste baskets to milk jugs and reminds us to be conscious about the wise use of scarce resources. The Community Reinvestment Fund (CRF), an innovative Minneapolis-based organization, has a new twist on that philosophy for the community development lending field: increase the number of community development loans, sell the loans on the secondary market and recycle the proceeds, and reuse that money for more loans. CRF, which promotes this lending cycle as a way to stretch community development resources, is a leader in showing how a secondary market for community development loans can help build stronger and healthier local economies.

CRF works to develop a well-functioning secondary market for community development loans in three ways. First, it promotes access to a steady source of funds for borrowers by purchasing loans from community-based lenders (such as local revolving loan funds, city governments, and housing and economic development authorities) that use the sale proceeds to fund more loans. Second, its loan-servicing organization, Community Reinvestment Services, works to ensure that borrowers repay their loans as agreed. Finally, it issues loan-backed securities with competitive rates and a low risk profile, factors that are attractive to investors and promote the long-term viability of the market.

This article discusses the forces behind the creation of CRF, its three-part strategy to develop and expand the secondary market for community development loans and its plans for the future. CRF is a success story that provides interesting insights and ideas for readers seeking new opportunities to improve their communities.

Getting started

Increasing demand for community development funds and important tax law changes provided the impetus for creating CRF in the late 1980s. The organization's founders, Frank Altman and Warren Hanson, were seeking new sources of funding for economic development projects when they developed the idea for a new secondary market for these loans. Both men were working in government on economic development issues and recognized the importance of changes in the Tax Reform Act of 1986. The new tax code put limits on the issuance of industrial development bonds, which had provided a substantial source of economic development financing. There was no obvious funding source to replace the bonds, and other government grants and subsidies were beginning to dry up.

CRF started operations using foundation grants and a $200,000 matching grant from the Minnesota legislature (the $200,000 is the only government money CRF has ever received). Altman, who has served as CRF president since its inception, and the foundation supporters strongly believed that CRF should be a new model for financing community development, that it should not be a government agency and that it should be market-driven. The goal, according to Altman, was to "demonstrate, create and operate a secondary market for economic and community development loans."

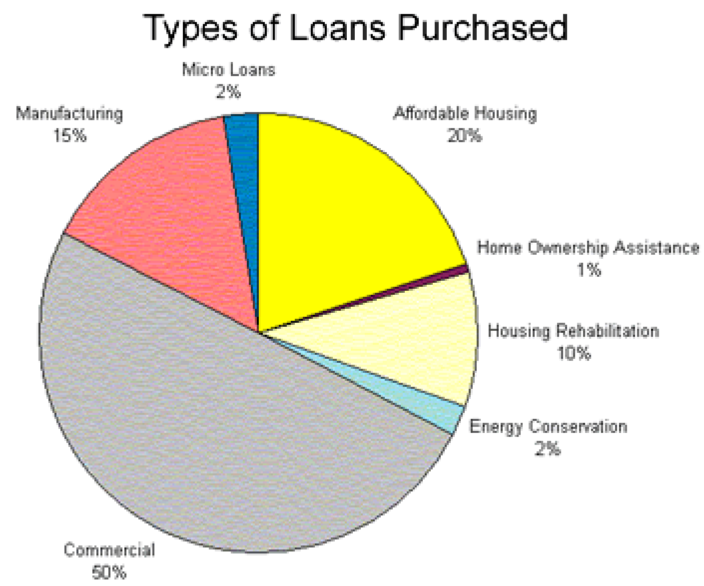
Promoting increased access to loans

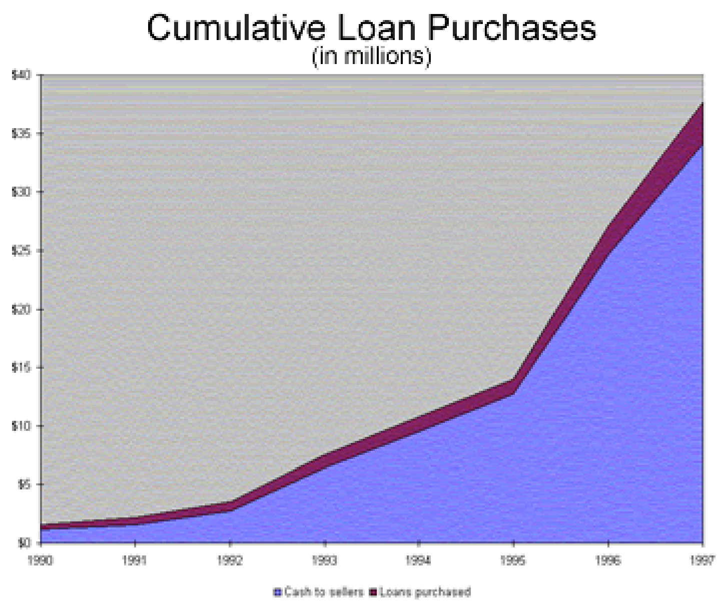
CRF was designed to address a fundamental problem most community-based lenders face: demand for loans often exceeds the available supply of funds. After a community-based lender has loaned out its initial pot of money, new loans can only be made from loan repayments. These repayments are often not adequate to replenish the loan fund to meet new borrowers' credit needs. Excess demand for loans is generally a "good" problem to have, since it indicates an active and developing community and because lenders can choose the strongest credits. However, if the supply of funds is too scarce, qualified borrowers who could be creating housing or jobs in a community do not receive funding. Community-based lenders often find it difficult to raise additional capital to make loans, especially in times of increasingly limited government grant funds.

By purchasing loans from these organizations, CRF provides community-based lenders with new funds they can then lend to other borrowers. The loan sellers must agree to relend the proceeds of the sale for economic and community development projects. They cannot use the proceeds to fund other local needs, such as street repair, which can be tempting in budget shortfall times.

Carol Anderson is the executive director of Community Development of Morrison County, Inc., a nonprofit economic development corporation with a revolving loan fund that serves manufacturing businesses in rural, central Minnesota. Her reason for involvement with CRF is fairly typical, especially among the small community loan funds that have sold loans to the organization. "I sell loans when I don't have any more money to lend," Anderson says. "If there are no good prospects waiting for loans, we try to build up our fund through loan repayments rather than selling our existing loans. But sometimes there is a company that needs money right away, and selling loans to CRF gives us access to funds to make the project happen."

CRF purchases loans from a variety of organizations, but it is not intended to be a source of liquidity for banks. CRF has purchased participation loans from banks, but only from bank community development corporations (CDC) where the CDCs agree to reinvest the money in economic and community development loans or investments. However, many banks are involved in some way in loans sold to CRF, even if they are not the sellers. For example, Community Development of Morrison County requires private lender participation on all of its loans. In many cases, the bank loan would not have been made unless money from the revolving loan fund was also available to the business. Consequently, the more loans made by a community-based lender, the more likely local banks are to participate in community development projects.





Quality loan servicing

In its years of operation, CRF has determined that standardized loan documentation and specialized loan monitoring and servicing are vital to creating and maintaining a viable secondary market. As directors of community loan funds know, the challenge of lending in the economic development and affordable housing markets does not end when a loan is made. Ensuring that loans are being paid as agreed, known as loan servicing, can be a significant challenge. Loans may be structured with unconventional terms to meet the needs of the borrower, a situation that can make tracking payments and maintaining accurate loan files more difficult than a conventional loan. The staff of a small community revolving loan fund may lack the time and expertise to service loans properly or to work out new terms with a borrower who is having trouble making payments.

In response to these concerns, CRF is developing Community Reinvestment Services (CRS) as a separate division to provide specialized monitoring and servicing for community development loans. According to Dennis Sonnek, CRF vice president and chief financial officer, CRF recognized a need for an entity to service as well as purchase loans. Previously, CRS only serviced loans sold to CRF but has expanded to offer loan servicing to community-based lenders on a contract basis. CRS currently services about 1,500 loans. Community-based lenders can contract with CRS to service their loans even if they are not interested in selling the loans to CRF.

CRF and CRS provide training and information to loan fund managers to teach them about proper loan documentation and servicing. Some organizations have had difficulty selling their loans because of inadequate documentation, which also makes proper loan servicing much more difficult. To address these problems, CRF developed a manual with detailed information about proper documentation needed to improve servicing and obtain the highest sale price for a loan. Even if an organization chooses not to have CRS service its loans, the loan fund managers will have learned valuable skills.

The Family Housing Fund of Minneapolis and St. Paul (FHF) has a contract with CRS to service its loan portfolio. This private, nonprofit group makes affordable housing loans, frequently with 30-year deferred terms. Selling the loans on the secondary market is not feasible because they don't generate revenue streams, but they still require servicing.

According to Anita Pierce, office manager at FHF, CRS provides an important service. "CRS monitors insurance requirements and reviews the financial statements for the projects we fund," she says. "We have some loans with 15-year balloon payments, which means we need to monitor the financial status of those projects to protect our investment. We also have some loans made several years ago that are amortizing (meaning they require regular payments by the borrower, like a home mortgage), so CRS ensures that payments are being received on those loans."

FHF receives a monthly report from CRS on the activities in its portfolio. Pierce is the only staff member available to monitor the loans, so having CRS do the loan servicing saves her substantial time.

CRS also works with the local lenders to handle more difficult servicing situations, such as defaults, write-offs and recoveries, even if they have sold the loans. CRS believes it is important to keep the local sellers involved in such decisions because they have a direct effect on economic conditions in their communities.

CRF purchased the loan made to Northern Cap Sewing, Little Falls, Minn. The loan allowed the manufacturer to expand operations from Minneapolis and create 60 jobs in this central Minnesota community.

Issuing attractive loan-backed securities

The sale of securities to investors completes the cycle of reinvestment that begins when CRF purchases the loans from the local sellers. To accommodate the needs of smaller local organizations, CRF purchases their loans and holds them until they have enough to package together for a security sale. Altman noted that although larger loans may require less work to package, CRF has a special commitment to work with small organizations.

According to Altman, CRF believes that the investors in its securities must get a competitive return. CRF purchases below-market rate loans at a discount and prices them to yield a market return. As of July 1997, CRF has purchased 753 loans worth $37.6 million, with $34.1 million in proceeds returned to the sellers. This means that, on average, sellers get about 91 percent of the value of their loans, a figure not surprising since many of these organizations offer loans at below-market rates. This discount pricing is necessary because CRF believes it will not be successful if it is treated as a charity or if investors are asked to take a below-market return.

CRF securities are attractive to investors because of their low risk profiles. CRF has successfully solicited foundations for money to fund a credit reserve. This reserve allows CRF to overcollateralize its bonds and maintain loan cash flows of at least 120 percent of bond debt service. In less complex terms, the extra cash flow provided by the credit reserve gives investors a cushion to ensure they receive full payment even if some loans are not paid as agreed. The reserve also allows CRF to provide the sellers with the highest possible price for their loans while still maintaining attractive rates and a low risk profile for the securities.

Foundations are willing to fund the credit reserve because it enables them to leverage their resources. Philanthropic organizations that have financed the credit reserve include the Northwest Area Foundation, US West Foundation and McKnight Foundation. Program-related investments have also been provided by the Metropolitan Life Foundation, Ford Foundation and MacArthur Foundation.

Maintaining an active market for its securities is an integral component of CRF's success as a secondary market. Loan servicing provided by CRS minimizes loan defaults, which helps to maintain the attractiveness of the securities. CRF uses the proceeds from the securities sales to purchase more loans from local organizations, which provides a capital infusion in communities and renews the reinvestment cycle.

Looking to the future

CRF has substantially increased its loan purchases and its presence in the community development lending field since 1988, and it plans to continue growing. It has purchased loans in 10 states and the District of Columbia and has attracted investors from across the country. Although there are other private affordable housing secondary markets, the secondary market for economic development loans is very limited. CRF is concentrating on states west of the Mississippi River, but its eventual goal is to become a national organization.

Targeting innovation

As resources for community development decline, revolving loan funds will need to look for innovative ways to continue making investments that create jobs and housing in their communities. Altman estimates that $4 billion to $5 billion dollars is currently tied up in revolving loan funds. While not all of these loans are salable, selling only a portion of these loans on the secondary market could free up a substantial amount of money. Organizations like CRF are likely to continue to grow as community-based lenders recognize the valuable opportunities provided by secondary markets to recycle and reuse scarce resources for more community development loans.

For more information, visit the CRF website at www.crfusa.com.

C O M M U N I T Y

D I V I D E N D

Livable Communities exposition draws large crowd

Representatives from scores of Twin Cities-area organizations gathered Tuesday, Sept. 9, at the Minneapolis Convention Center for Livable Communities: Finance and Technical Assistance Expo. This event provided bankers, community leaders, government agency officials, nonprofit developers, and others an opportunity to learn the latest techniques in the community development process, build partnerships, learn about available programs and establish networks. If you attended the expo, we are interested in your opinion. Please be sure to return the evaluation form from your attendee packet. Send or fax it to Richard Jamieson, Community Affairs analyst, at the Federal Reserve Bank of Minneapolis, Banking Supervision Department, 90 Hennepin Ave., P.O. Box 291, Minneapolis, MN 55480-0291; fax (612) 204-5163.

If you need another evaluation form, please call Mr. Jamieson at (612) 204-5073 to have a copy sent to you.

FEDERAL RESERVE BANK OF MINNEAPOLIS

Federal Reserve Bank moves to new site

The Federal Reserve Bank of Minneapolis moves into its new headquarters along the Mississippi River.

July 1, 1997

The new headquarters of the Federal Reserve Bank of Minneapolis is located at the north end of downtown Minneapolis along the Mississippi River.

According to the building's designers from Hellmuth, Obata & Kassabaum, a St. Louis architectural firm, the structure strikes a balance between the stability, security and strength of the Federal Reserve and the physical and historical significance of the site itself. The design respects Minneapolis' Warehouse District to the south and west and the Mississippi River to the north while meeting the functional needs of the Bank.

The building actually consists of two structures: an eight-story office tower and a four-story, terraced operations center. The structures are connected by an outdoor courtyard and underground and above-ground passageways.

Spotlight on success: The Anoka County partnership

The Anoka County Economic Development Partnership has allowed many groups and individuals to join forces and help launch and nurture businesses.

July 1, 1997

Partnerships. All of us in the community development field recognize that we will succeed only through partnerships. After all, none of us has the money to do the job alone, and when one sector has tried, such as when the federal government built public housing in the 1960s, the result was not even close to optimal. We all know that community development will work only when all the "stakeholders" have a say in the means and the end.

But partnerships can be messy and time-consuming. Each partner may have a slightly different concept of community development or, at least, of the methods to use to get there.

This article outlines a successful economic development partnership: The Anoka County Economic Development Partnership (ACEDP). Through ACEDP, bankers and other local business leaders, investors, county officials and a local entrepreneur have come together to help launch and nurture businesses.

Anoka County facts and figures

Anoka County, a suburban county located just north and east of Minneapolis, is predominantly middle income. In Anoka County, 86 percent of the census tracts were classified as middle income as of the 1990 census, compared with 56 percent for the Minneapolis-St. Paul metropolitan statistical area (MSA) as a whole. Only 12 percent of the census tracts in Anoka County were classified as low or moderate income as of the 1990 census, compared with 26 percent for the MSA as a whole. Similarly, only 2 percent of Anoka County tracts were classified as upper income, compared with 19 percent of the tracts for the MSA.

The county is composed of older suburbs, developing outer-ring suburbs and small towns. While the outer-ring suburbs and small towns have prospered, the older suburbs have not kept pace. In one of these suburbs, Columbia Heights, the 1989 median household income was just 83% of the median for the MSA as a whole.

In 1985, a group of Anoka County officials and business leaders got together to decide how to address economic development for the entire county, particularly the older inner-ring communities. One of those leaders was the late Walter Rasmussen, founder of Northeast State Bank in northeast Minneapolis.

According to Rasmussen's son, Ben, "My father believed that small business would be the catalyst for growth in Columbia Heights and the greater Anoka County area. He was a believer that small businesses drive job creation and build community goodwill. With that in mind," says Rasmussen, "he got together with local leaders in the private and public sectors and they came up with the ACEDP." This partnership of government and business continues to be integral to ACEDP and is reflected in the membership of its board of directors, which includes representatives of area corporations, banks, utilities, service groups and public officials.

Investing in emerging technologies

Since its beginning, ACEDP's focus has been on emerging technologies companies based in Anoka County. The partners thought these companies were likely to create living-wage jobs. The partners also wanted to focus on job creation in Anoka County, not simply enticing existing companies to move from other communities.

As ACEDP gained experience, the partners soon realized that businesses needed two types of help: technical assistance and capital. According to Dave Rader, vice president of commercial loans at Norwest Bank in Anoka and ACEDP board member, "Two important components drive the success of ACEDP programs and activities: the availability of capital and a solid technical-assistance package." He says, "As a commercial lender at Norwest Bank for over 15 years, I've seen many capable small businesses collapse because of inadequate capital or a lack of technical or strategic management advice. Just because a business can generate sales is not an indicator of whether the company will survive." Rader goes on to assert, "A solid business has to be well capitalized, with management understanding the concepts of small business operations. To lenders, good management and sufficient capital are just as important for a company that generates $200,000 in sales as they are for a company with $2 million in sales."

ACEDP currently offers programs and activities that advance its goals and provide technical assistance and capital. *Community Dividend* has chosen two ACEDP programs to profile: the Anoka/Sherburne County Capital Fund (ASCCF) and Genesis Business Centers Ltd. ASCCF is a multi-investor community development corporation (CDC) that involves 10 area banks, utility companies and the county in providing equity funding for area small businesses. Genesis is a for-profit business incubator that offers micro businesses technical and managerial assistance, introductions to potential investors and office or industrial space in exchange for stock in the company.

Anoka/Sherburne County Capital Fund

ASCCF is a multi-investor CDC created in 1993 to provide venture capital for small businesses in Anoka County; adjacent Sherburne County small businesses became eligible for funds in 1997. Its stated mission is to stimulate in these counties the development of entrepreneurial ventures, the retention and expansion of existing businesses and the attraction of new business activity consistent with the character of Anoka and Sherburne counties.

According to Roger Jensen, ACEDP executive director and ASCCF manager, "This fund makes small investments in start-up and expanding businesses that are primarily technology-intensive or manufacturing-related. Our average investment is between $25,000 and $50,000, small by the standards of many venture capital firms."

The fund has four goals:

- to draw together Anoka and Sherburne county stakeholders, including banks, utility companies and other investors, to improve the area's economic condition and stimulate job creation by strengthening its manufacturing- and technology-based industries;
- to provide a source of capital for small businesses, including women- and minority-owned businesses, that are located or will locate in Anoka or Sherburne county;
- to retain existing businesses and their planned expansions; and
- to generate a cash return to fund investors.

Championed initially by Norwest Bank Minnesota, N.A., Northeast State Bank and Anoka Electric Cooperative, eight local financial institutions and utility companies provided the ASCCF's original funding of $400,000. By the end of 1996, ASCCF had funding of $700,000 and the number of fund members had increased from the original eight investors to 22. By year-end 1997, the CDC expects to have raised $1 million. As of July 1997, the fund has invested in 15 companies. Of these firms, 12 are still in business and have created 60 jobs. ASCCF has not yet generated a cash return to fund investors but expects to do so in about two years.

ASCCF is governed by a board composed of the fund investors. While this board reviews the fund's goals regularly, it does not have authority to approve or deny investments. Instead, it is the ACEDP board of governors that has the final approval authority, guided by the recommendations of the ASCCF Technical and Investment Advisory Committee, a group of 11 experienced investment, financial and technology experts who volunteer their services. Using this approach, potential conflicts of interest between investors and funding recipients are mitigated.

Genesis Business Centers Ltd.

Genesis Business Centers Ltd. is a for-profit business incubator with offices in Columbia Heights and Elk River, Minn. It is owned and operated by Harlan Jacobs, a local corporate finance veteran. Established in 1993, it began its collaboration with ACEDP in 1994. Genesis furnishes office and production space and access to business, technical and financial services in exchange for stock in its incubator companies. Also, because of the relationship Genesis has with ACEDP, small businesses in the incubator are introduced to potential investors, including ASCCF.

In addition to the businesses being nurtured at the incubator, the incubator itself is a business. Its Columbia Heights office is housed in a building that would likely be vacant were it not for having ACEDP and Genesis and its clients as tenants. Thus, an underutilized property was converted to productive use. As incubator tenants "graduate" and begin to pay cash rent, the building becomes a source of economic growth for the county and for Columbia Heights in particular.

During the past four years, Genesis has provided a nurturing environment for entrepreneurs of high-tech, start-up companies. Of the 15 companies that have been tenants of the incubator, seven have graduated and are paying cash rent. These seven companies employed 110 workers as of the end of 1996, and they expect total annual revenues of $6 million in 1997. Jacobs says, "We've tried to create an environment that is comparable to many of the successful corporate projects in which I've been involved." But, he says, "It's not magic. We look for serious entrepreneurs. It does require certain individuals who are determined to succeed and will pour in their life savings and work 80 to 90 hours per week for what they believe in."

One such tenant is Med Link Medical, a manufacturer of surgical microscopes. Med Link founder and Chief Executive Officer Lynn Keller came to the incubator in need of space when her operations had outgrown her garage. In addition to the technical and managerial assistance Keller received from the incubator, Med Link also received investment funds from ASCCF.

According to Keller, who began her business career when she was a widowed mother of five, the services provided as a tenant of the incubator helped her move Med Link Medical into its next growth phase. "Cash flow is a big problem for small businesses, particularly high-tech companies," says Keller. "Being part of the incubator has increased my cash flow and allowed my company to grow."

For more information on Genesis and ACEDP, visit www.genesiscenters.com/ and www.co.anoka.mn.us/EconomicDevelopment/ed-home.asp.

C O M M U N I T Y

D I V I D E N D

Federal Reserve System publishes CDC guide

The Federal Reserve System now has available an annual guide and directory entitled *Community Development Investments: A Guide for State Member Banks and Bank Holding Companies* and *Community Development Investments Directory*.

The guide was published to provide information to state banks that are members of the Federal Reserve System and bank holding companies about the formation of community development corporations (CDC) and other opportunities for equity investments in community development projects. It also offers valuable information to anyone interested in CDCs. Topics covered in the guide include Federal Reserve policies and guidelines governing bank and bank holding company CDCs and equity investments, key issues that banks and bank holding companies should address when considering investments for community development purposes, the notice or approval processes for state member banks and bank holding companies, and regulatory treatment of community development investments.

The directory lists all CDC and limited partnership/project investments made by bank holding companies and state member banks across the country. Information is included on how long the organization has been operating, amount of investment, project description and a contact person. It is a good resource for community organizations and lenders seeking new ideas and community development partnership opportunities.

The guide and directory are free; obtain copies by contacting Connie Stewart, Federal Reserve Bank of Minneapolis, at (612) 204-5148.

C O M M U N I T Y

D I V I D E N D

Annual housing conference slated for October

The Federal Reserve Bank of Minneapolis, the South Dakota Housing Development Authority and South Dakota USDA - Rural Develop-ment are proud to cosponsor the **Seventh Annual South Dakota Housing Development Authority Conference**. The theme of this year's conference is "Partnering for Housing Development . . . One Community at a Time." The conference will be held **October 16-17, 1997**, at the Ramkota Inn in **Pierre, S.D.**

Seminars will be held on a diverse set of topics, including site development, acquisition/rehabilitation, homeownership options, building capacity in nonprofit housing organizations, bank community development corporations, and housing lending and development in Indian Country. There will be a special focus on the challenges and opportunities for housing development and affordable homeownership in smaller communities.

This important conference is sure to offer value information to lenders, real estate agents, tribal lenders and housing officials, private and nonprofit housing developers, local and state government staff, community lenders and others interested in increasing housing opportunities in their communities.

For more information or a registration form, contact the South Dakota Housing Develop-ment Authority at (605) 773-3181.