FEDERAL RESERVE BANK
OF SAN FRANCISCO

Community Investments Vol. 10, Issue 4 Financing Childcare: Challenges and Opportunities

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The passage of a dramatic welfare reform bill in 1997 intensified the nation's focus on the lack of childcare options for low-income families. As a partial solution to the childcare problem, federal daycare subsidies are now available to help keep the cost of operations down so that the price per child stays low. That's great news for welfare parents who are required to find income-generating work that will likely lead them outside the home. But it also presents a predicament for many communities, largely due to a shortage of available facilities.

This article will outline many of the benefits and challenges inherent in childcare development and financing. Think about these points as you consider the direction of your community development initiatives in the coming years. September Jarrett from the Low Income Housing Fund offers an urban perspective on childcare and discusses the newly inaugurated Childcare Facilities Fund (CCFF) in San Francisco. Roderick Marshall from Rural Community Assistance Corporation (RCAC) provides a rural perspective on the issue, and shares information on financing options available through RCAC. Armed with this information, childcare facilities finance may yet find its way into your community development strategy.

Four Good Reasons to Support Childcare Development

1) Unprecedented Demand for Childcare

Between 1977 and 1993, the number of children under five in non-parental care facilities more than doubled from approximately three to eight million. By 1995, there were almost 10 million children in non-parental care programs.[1] Since the enactment of welfare reform, this figure has swelled even further.

Affordability issues are also a problem, particularly for low-income families. Nationally, poor families with small children spend an average of 18 percent of their income on childcare, compared to seven percent spent by wealthier families.[2]

The situation in San Francisco illustrates key points about both the demand for care as well as affordability issues. Today, 4,000 San Francisco families are on a waiting list for subsidized childcare. To make matters worse, the Department of Human Services estimates there is a need for 2,736 new, licensed childcare slots to meet the demand for families transitioning from welfare to work.[3] San Francisco has received $20 million in new subsidies, but a lack of space (with a one to three percent vacancy rate citywide) is hampering the ability of families to use these subsidies.

2) Childcare Development Supports Local Economic Development

Childcare development is also job development. New childcare facilities result in the creation of jobs for program directors, teachers, teacher's aides, janitors and cooks. In addition, the National Economic Development Law Center estimates that each $1,000,000 invested in new childcare facilities development results in the creation of 23 "indirect" jobs (in construction, business services and retail) for the period of one year. And, unlike other

business sectors, virtually all jobs supported by the total dollars spent for childcare remain in the local community.

3) Childcare Investment Offers Great Social Returns

Well-publicized medical research has proven that important components of brain development occur during a critical window between birth and age three, and that human interactions and stimulation are essential to this development. Thus, participation in high-quality childcare can positively enhance a child's growth toward his or her full potential. This is especially important for "at risk" children, many of whom grow up surrounded by poverty. According to a recent report by the Rand Corporation, for every dollar spent on early childhood programs, society later saves several more dollars on social program and judicial system spending. One program cited a net savings of $25,000 per child by calculating how later earnings and tax contributions could offset welfare, education and criminal justice costs.[4]

Photo by Jon Klein of the Low Income Housing Fund

4) CRA Benefits

The revised Community Reinvestment Act (CRA) considers loans, investments and services that support childcare facilities to be qualified community development activities. The most recently published "Questions

& Answers" (Federal Register October 6, 1997) provides some flexibility as to the geographic location of facilities. That is, childcare centers do not necessarily have to be located in a low- or moderate-income geography to receive CRA consideration. A facility must, however, serve children from low- and moderate-income families.

The Challenges of Financing Childcare Development

Despite these reasons to support childcare development , there are several challenges to developing and financing early childhood facilities. Some of these challenges include:

Development Resources and High Costs

While capital resources may be more abundant in urban centers, the high cost of areas such as San Francisco make it especially difficult to develop new facilities. In rural areas, development costs for new facilities may be lower, but access to capital is much more limited.

In San Francisco, it takes an average of $16,000 per slot to create care for low-income children in nonprofit childcare centers. Development of home-based daycare centers costs an average of $3,000 per slot.5 Experts in San Francisco estimate that at least $30 million is needed to address the new demand presented by welfare reform. This doesn't include the funds needed to address the existing back-log of kids currently on waiting lists.

Low Reimbursements for Care

Subsidy rates are based on market rates for childcare in a given area. In San Francisco, the average subsidy for childcare is $120 to $185 weekly per child depending on his or her age.6 In some areas, this subsidy would be adequate, but it certainly leaves no room for facility improvements or the addition of programs, which help ensure long-term quality of care. In high-cost urban areas like San Francisco, this subsidy falls way short of the average $231 weekly per child to provide quality care. Providers are thus

forced to spend their time fundraising to ensure the ongoing viability of the facility. In addition, most typical operating contracts run year-to-year, posing both development and financing challenges. Furthermore, subsidies have become increasingly parent-based (as opposed to project-based) posing greater financial risk to potential lenders.

Joe Simmons, formerly of the Low Income Housing Fund, at the Tenderloin Child Care Center (photo by John Harding)

Lack of Financing Experience

The shortage of funding for childcare development often leaves providers unable to save to meet equity requirements. In addition, childcare providers may not have sufficient operating income to service debt, and may lack experience in sophisticated debt-management techniques. To date, the vast majority of early childhood facilities are fully grant funded from a mixture of public and private (primarily foundation and corporate) resources. Loan programs are emerging, but significant technical assistance and flexible financing is needed now to better serve providers into the future.

The San Francisco Childcare Facilities Fund (CCFF)

The Low Income Housing Fund is a fourteen-year old community development financial institution with a strong track record in affordable housing lending. It recently launched a new public-private partnership, the San Francisco Childcare Facilities Fund (CCFF), in order to increase the

quantity and improve the quality of childcare in San Francisco. Initial capital for the CCFF was provided by the Miriam and Peter Haas Fund ($300,000), The Mayor's Office of Children, Youth and Their Families ($200,000), and Providian Financial Corporation ($400,000). Additional support has been received by public, foundation, and corporate resources. A linkage fee (or special tax) tied to office space development in San Francisco is another key source of funding for the initiative.

To date, the CCFF consists of three core programs:

1) *The Family Childcare Assistance Program (FCCAP)* provides grants of $1,000 to $5,000 to meet one-time capital expenses of family (in-home) childcare providers. Applications for the first round of funding, in which $100,000 was available, were received in May 1998. Twenty-three grants, serving 234 low-income children and supplementing the creation of 66 new childcare slots were awarded. Among the projects supported are facility renovations to provide improved access for disabled children, the purchase of equipment to expand infant care, and improvements to outdoor play space. Funds were entirely disbursed by the end of June. A second round of funding is anticipated in early 1999.
2) *The Childcare Center Assistance Program (CCCAP)* provides facilities finance for nonprofit childcare centers in San Francisco. Financial tools available include a limited number of capital grants, zero interest, mini-loans to support project planning, short-term direct loans, and access to conventional loans on favorable terms through CCFF guarantees or interest-rate write downs. Eleven preliminary applications for competitive capital grants have been received and seven awards, supporting the creation of 329 new childcare slots have been made. Five loan requests totaling more than $2 million and representing 260 childcare slots are under consideration.

3) *Technical Assistance* is also provided in order to boost the facilities expertise and business management skills of childcare providers. Seminars on debt, facilities development, and business management are provided to both nonprofit and family-based childcare providers.

The Rural Perspective: RCAC Offers Financing Options

From a rural development viewpoint, the economic realities of financing rural childcare are often more brutal than financing urban facilities. There are two reasons for this:

1) Large childcare programs have greater opportunity to service debt, but the smaller population of rural communities doesn't support larger programs;
2) Capital infrastructure is generally more developed in large cities than in rural towns, enabling the city provider greater access to resources such as grants, corporate donations, soft seconds, or dollar-per-year property leases.

The amount of equity a rural childcare provider will need to raise depends on an often precarious balance between:

a) the number of children served and availability of government subsidies, and;
b) the price of real estate/new construction or the costs of remodeling an existing building. Limited experience in this type of lending means most providers currently have to raise as much as 50 percent of the cost to remodel and existing building and up to 75 percent of the cost to develop a new facility!

Rural Community Assistance Corporation (RCAC), designated by the U.S. Treasury as a Community Development Financial Institution, makes affordable, interim and long-term loans to create or enhance community

facilities in rural communities in 12 states. These facilities can include childcare, adult day-health care, domestic violence protection and medical care. An interim loan offers childcare or other providers up to three years to meet long-term loan conditions typically required by traditional lenders. *RCAC Interim Loans* span a crucial gap in time, between initial concept to actual operation of a needed facility. The loan can be used for:

- Building a new facility;
- Buying and/or rehabilitating an existing building; or,
- Remodeling to improve the quality of an existing facility for increased capacity or scope of service.

The interim loan allows a provider to complete predevelopment and construction activity, move its program to a new location, stabilize its revenue and expenses and become a more attractive borrower in the eyes of a long-term lender.

RCAC's Loan Guarantee Program provided through the United States Department of Agriculture--Rural Development (USDA-RD), enhances long-term facility financing. Having recently received eligible lender status to participate in this program, RCAC now has the ability to make long-term loans that are 80 percent guaranteed by USDA-RD. Borrower qualification under this program is the same as RCAC's program:

- The facility must be located in a rural area with a population of less than 50,000 people;
- The borrowing entity must be a nonprofit organization or legally organized for the benefit of the general public, e.g., a cooperative, municipality or association; and
- Fifty-one percent of the families benefiting from the proposed facility must earn at or below the area median income.

Given the amount of equity that childcare facilities require, ownership may seem nearly impossible, but there have been a few exceptions. One provider was able to obtain a $300,000 community development block grant and raise $50,000 from fundraising activities, individual cash contributions and in-kind donations from local merchants. This equity of $350,000 plus a 25-year USDA-RD guaranteed loan for $100,000 enabled the provider to build a facility for 60 children which employs 10 people. This is an increase from its former capacity of 32 children and five employees.

There are numerous examples of creative financing for facility ownership, but it's never as simple as finding "free money" or a lender with a mission. Facility ownership comes about as a result of finding the right technical assistance to mold cash from all sources into a structure that is economically viable for those dedicated to providing decent care in an enabling environment.

In Conclusion

The childcare industry cannot expand its capacity to serve more families and offer better quality of care unless it leverages its current capital base and strategically uses loans as a tool to do so. Financial institutions and community-based organizations must confront financing and development challenges head-on, and must act as partners to provide the necessary flexibility and support to create quality childcare facilities. After all, if the adage is true that "children hold the key to the future," isn't the extra effort now worth the social benefit later?

Technical information may be available to childcare providers through local Childcare Resource and Referral Centers. The National Economic Development and Law Center can also provide technical assistance to providers in California and referrals for other states. For more information, contact Julie Sinai (510) 251-2600.

For more information about the San Francisco Childcare Facilities Fund, please contact September Jarrett or Jonathan Klein at (415) 777-9804. For information about loan programs offered by RCAC, you are encouraged to call Rod Marshall at (916) 447-9832, (ext. 142) or Sondra Hartwell (ext.145).

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[1]The Economics of Child Care: A Report by the Council of Economic Advisors (December 1997).
[2]Ibid.
[3]San Francisco Department of Human Services, Capacity Projections (September 11, 1998).
[4]Los Angeles Times (April 23, 1998).
[5] Survey of Nonprofit Childcare Centers completed by the Childcare Facilities Fund of the Low Income Housing Fund (April 1997).
[6]Regional Market Rate Ceilings for California Childcare Providers, California Childcare Resource and Referral Network (July 1997).

About the Authors

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Roderick Marshall is director of financial services at the Rural Community Assistance Corporation (RCAC). In this role, Mr. Marshall manages lending activities, staff development, loan program and product development. The Financial Services Division provides both short-term and long-term financing for a variety of projects, including affordable housing, community facilities and small water and waste-water systems. Before joining RCAC in 1995, Mr. Marshall was a mortgage and commercial banker for 25 years specializing in real estate loans. His education includes a B.S. Degree from Washington State University and post-graduate work in mortgage banking at the University of Chicago.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 10, Issue 4 Mergers and Acquisitions in the Nonprofit World

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One can't pick up a newspaper these days without reading about the latest bank mega-merger or acquisition. Fierce with competition for bank customers, financial institutions constantly seek ways to expand product lines while creating efficiencies that result in cost-savings to the institution. Recent years demonstrate that merger deals can be smart and strategic moves in the game of market share and long-term corporate survival.

Executive directors of community-based nonprofits understand better than anybody the challenge of "doing more with less." For years, local grass-roots organizations have been at the core of successful community development initiatives, and this will likely continue into the future. However, as we will learn from the following article, mergers in the nonprofit world are beginning to occur with greater frequency. While a merger deal may not be on the immediate horizon, its benefits in the longer term may make it a business strategy worthy of consideration.

Banking, commercial real estate, the insurance industry. . .you name it. Mergers and acquisitions (M&As) have become the hottest business trend of the 90's. The persistent bull market and steady rise in stock prices has fueled much of the merger-mania experienced during the last several years.

In fact, M&As are one of the key growth strategies for companies in the private sector seeking to expand their markets and influence.

One of the obvious advantages of a private-sector merger is increased shareholder return. Less obvious, however, are other significant benefits that contribute to a company's bottom line; we'll discuss some of them later in this article. And, while M&As may seem applicable only to the private sector, many of the same advantages exist for their counterparts in the nonprofit world.

In the private sector, merging with or acquiring another company can make dollars and sense for a number of reasons:

1) Most M&A deals are paid for with shares of stock from the acquiring or "surviving" company; the higher its stock price, the more capital the company has to fund the purchase of other companies.
2) Company products and/or markets may be complementary or supplementary, thereby suggesting that the combined companies could fit well together. In such cases, the new "whole" might be viewed as greater than the sum of the original parts. If this is the marketplace perception, then the share price of the new company would likely increase, creating additional capital for future expansion.
3) The new company might also be better positioned to serve an expanded market, which is particularly important in highly competitive and fast-growing industries.
4) Significant cost savings might be created through the elimination of duplicative overhead and support services (accounting and back-room operations, for example), overlapping store, branch or service-delivery locations, and the reduction of personnel at various levels of the corporate structure.
5) All of the aforementioned activities could result in increased efficiencies and an enhanced ability to market the company's products.

Combined as elements of a long-term business strategy, these considerations are solid reasons for a private enterprise to consider a merger proposal. They are also critical factors in the financial and organizational survival of nonprofit entities as well.

Differences undoubtedly exist between the structure and operation of private-sector businesses and nonprofit organizations, particularly the manner in which each generates capital. Unlike corporate capital generated from stock proceeds, nonprofit capital is generated from philanthropic sources, public sector contributions, service delivery revenue and/or member contributions. However, this doesn't alter the fact that nonprofits are also businesses and, as such, can benefit greatly from astute business decisions which may include a potential M&A with another nonprofit organization.

If the missions and visions of two nonprofits are complementary, the combination of the two could create a new and improved organization that enjoys greater cost efficiencies and long-term potential. Furthermore, potential funders would likely be more inclined to participate in an organization that is perceived to be larger, more cost efficient, and ultimately, more effective.

A Case In Point

The following is the story of two Neighborhood Housing Service (NHS) programs that served two low-income neighborhoods in Orange County. In late 1997 and 1998, the authors (hereafter "we") helped facilitate the merger of these two NHS programs that will now serve all of Orange County. This case study illustrates many of the advantages of M&A activity outlined above.

Pre-Merger Status

For nearly 20 years, there have been two NHS programs in Orange County, home to more than 2 1/2 million people. The La Habra NHS and Santa Ana NHS were both formed in the late 1970’s. They share similar origins, including a common connection with the same national intermediary, Neighborhood Reinvestment (NR). Both served predominately low-income Latino neighborhoods within a large, affluent, and politically conservative county.

Even with such striking similarities, the two programs differed in fundamental ways. The La Habra program enjoyed continuous organizational and financial stability since its founding, including an executive director with a 17-year tenure. The Santa Ana program, while strongly supported by neighborhood residents, suffered organizational and financial setbacks, difficulty in delivering program services, and problems in retaining an executive director. Beginning in June 1996, the La Habra executive director and other staff were hired under contract by Santa Ana to provide temporary leadership until a permanent solution could be found. Organizational assessments conducted by Neighborhood Reinvestment ultimately determined that the Santa Ana program was not financially viable in the long term.

In December 1997, we were engaged by La Habra NHS to help determine the optimal relationship between the two NHS programs and to explore ideas for resolving the situation. After a series of meetings with representatives of both organizations, we found that Board members and staff alike were anxious for a solution. But they were also concerned that a merger of the two organizations would dilute the benefits of local programs, leavning partnerships between residents, government and businesses diminished. Furthermore, Board members from La Habra NHS had grave concerns about the financial liability of consolidating. Their counterparts in Santa Ana were apprehensive about becoming a “step child” of the stronger La Habra program.

Externally, there was strong support for a countywide organization that could help revitalize a variety of low-and moderate-income neighborhoods by working with local residents, businesses, and the public sector. In contrast to neighboring Los Angeles County, there were relatively few organizations addressing affordable housing and community development needs within Orange County. Funders were enthusiastic about the possibility of reaching the lower-income communities in the County, including Santa Ana and surrounding cities.

Based on this research, our recommendation to both Boards was to create a new, countywide NHS by merging the two organizations, and slowly expand its programs into new communities as funds became available. Like mergers and acquisitions in the private sector, this one made sense for several reasons:

- the mission, products and markets of the two NHS programs were complementary and similar;
- both Boards and their respective staffs shared similar values, orientation and experiences through their connection to Neighborhood Reinvestment;
- a countywide NHS would be positioned to serve the unmet community revitalization and affordable housing needs of a larger market;
- significant cost savings would be created through the elimination of duplicative overhead and support services (administration, fundraising, accounting, program staff); and
- resources to support such an effort seemed available.

The key challenge was how to create a new, countywide program while preserving the existing programs and local presence of the two original organizations.

Planning Support
Neighborhood Reinvestment recognized the potential for M&A replication elsewhere in its network of more than 170 affiliates, and was strongly supportive of the planning effort. In addition to providing financial assistance for our study, NR staff participated in key meetings and retreats throughout the process.

The Fannie Mae Foundation funded a large portion of the planning effort. Other corporate sponsors such as the Enterprise Foundation, Wells Fargo, and Bank of America supported the merger effort based on NHS' excellent track record and reputation in the community.

The Planning Process
The next step involved the creation of a countywide Task Force to plan for the expanded organization. With the help of NHS staff, a 21-member Task Force was recruited that included members of both Boards, representatives of other Orange County housing programs, potential funders, and participating jurisdictions. Neighborhood Reinvestment staff attended all meetings and served in an ex-officio advisory capacity.

The purpose of the Task Force was to create a detailed plan for the expanded organization, including resolution of the issues identified by both organizations. After review, the plan would be submitted to both Boards and the members of each organization for approval. Some of the issues addressed were:

- the mission and vision for the expanded organization;
- the governance structure of the new organization, including composition of a new Board of Directors and Advisory Committee;
- necessary staffing and facilities;
- budgets for the initial year(s) of operation as a combined and expanded program;

- an identification of potential funding sources and a fundraising plan;
- a determination of the initial housing programs which would be offered;
- a marketing and outreach plan for the new organization; and,
- other details of the transition process, including a timetable for its implementation.

Legal counsel was provided by Orrick, Herrington & Sutcliffe, a San Francisco-based firm under contract with La Habra NHS. The attorneys worked closely with us throughout the merger process, providing legal guidance on organizational options and preparation of required legal documents.

The Results

The merger was completed in August 1998 following the presentation of Task Force recommendations to both Boards of Directors and members of La Habra and Santa Ana NHS organizations. In September 1998, "Neighborhood Housing Services of Orange County, Inc." (NHS OC) became a reality.

With its new mission and vision, the Board of Directors and staff are genuinely excited about the possibilities that lie ahead. There is a new 21-member Board of Directors comprised of representatives of the La Habra and Santa Ana programs and a number of new members. In addition, there are two Advisory Boards representing "chapters" and overseeing local programs in the two original communities. As new communities are added, Advisory Boards and chapters will be created to retain the neighborhood planning and oversight function that makes the NHS model so strong. Program expansion will begin with the creation of a "Homeownership Center" which will serve low-and moderate-income clients from all over Orange County. In addition to its existing facilities, NHS OC will locate its administrative and program staff, as well as the Homeownership Center in a

new facility that is centrally located in the County. A two-year budget has been prepared, along with a fundraising plan campaign which has already begun to raise money from lending institutions, foundations and other funders.

Through a careful examination of the issues, members of two local NHS programs were able to look beyond their immediate horizons and see the greater potential presented by a larger and more comprehensive program. NHS OC has been carefully structured to retain the present program strengths while expanding to serve more neighborhoods and people in need. Other non-profit organizations may learn from the NHS OC experience, and are welcome to consider it as a model for replication.

Considering a Merger Deal?
If so, ask yourself these key questions:

1) Are our missions similar, and do our activities significantly complement or supplement each other?
2) Can the market for our services be better served by a larger organization?
3) What cost savings can be anticipated from the potential combination of two organizations?
4) Can we make the case to both our respective Board members and our funders that this makes sense? Will they be supportive?
5) In the final analysis, do the potential advantages of a merger and acquisition significantly outweigh the disadvantages?

For additional information on the NHS OC merger or other community development initiatives, please contact Kathy Kenny at (415) 826-2547 or John Trauth at (415) 332-4346.

About the Authors

John R. Trauth has been working in the affordable housing field since 1972.

Kathy Kenny has over 15 years experience in community development, affordable housing and program design. For over 10 years, they were the team responsible for many of the nationally recognized programs of the Development Fund, a nonprofit organization dedicated to the development of innovative financing programs for community development. Working closely with the Federal Reserve Bank of San Francisco, they helped create financing programs for community reinvestment in seven states totaling $650 million, including the California Community Reinvestment Corporation (CCRC), the California Economic Development Lending Initiative (CEDLI), and California Resources and Training (CARAT). As consultants, they have developed affordable housing strategies for cities and have jointly conducted numerous strategic planning efforts and organizational start-ups. John Trauth was instrumental in the creation of BRIDGE Housing Corporation and Southern California Housing Development Corporation, two highly successful nonprofit housing development corporations. Kathy Kenny currently serves as a planning consultant to the Council on Foundations, several California foundations,

nonprofit community development organizations, and the Federal Reserve Bank of San Francisco.

Community Investments Vol. 10, Issue 4 Community Development Venture Capital: The Double Bottom Line

Author(s): Kerwin Tesdell, President, Community Development Venture Capital Alliance and Julia Rubin, Doctoral Candidate, Organizational Behavior Program, Harvard University
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Kentucky Highlands Investment Corporation has worked for thirty-two years to alleviate poverty in the heart of Appalachia. In Duluth, Minnesota, Northeast Ventures has spent a decade tackling the economic devastation brought on by dramatic reductions in the region's ore mining industry. In 1996, Boston Community Ventures was established in one of the poorest sections of Boston to foster the creation of quality jobs and the growth of socially responsible businesses. Meanwhile, similar efforts have sprung up in such diverse locations around the world as Nizhny Novgorod, Russia; Zagreb, Croatia; and Lima, Peru.

What do these organizations have in common? They are all community development venture capital (CDVC) funds, members of a new but rapidly growing field of organizations that use the tools of venture capital to create good jobs, productive wealth, and entrepreneurial capacity to benefit disadvantaged people and economically distressed communities. They seek to apply the powerful engine of growth that has driven the economic expansion in Silicon Valley, and other hotbeds of business development, to communities that the current prosperity has passed by.

CDVC funds make equity and equity-like investments in highly competitive small businesses that hold the promise of rapid growth. These fast growing companies produce a “double bottom line” of not only financial returns, but also social benefits in the form of good jobs and healthier communities. The investments typically range from $100,000 to $1 million, much smaller than most traditional venture capital investments.

The companies in which CDVC funds invest generally employ between ten and one hundred people. Investors in CDVC funds include foundations, banks, insurance companies and other corporations, government, and private individuals. They invest because of an interest in the social and financial returns of the funds; they too are interested in the double bottom line.

The CDVC Industry

There are currently more than forty CDVC funds operating across the United States and Canada. In the U.S. alone, such funds have more than $330 million under management. CDVC funds have also become a powerful economic development tool in economies in transition in Eastern Europe and in developing economies in Latin America.

CDVC funds come in many different forms, including not-for-profit, for-profit, and quasi-public organizations. Their structures encompass for-profit “C” corporations, limited partnerships, limited liability companies, community development corporations (CDCs), and Small Business Investment Companies (SBICs). Despite this structural diversity, CDVC funds all share a commitment to the creation of good jobs through business investment.

CDVC funds use a multitude of investment techniques to accomplish their missions. These range from the purchase of preferred and common stock to the provision of subordinated debt with equity “kickers” such as warrants or

royalties. CDVC funds, as compared with lenders, thus structure their financing so that they enjoy the "upside" when a company does well, but also the "downside" when a company does poorly. For this reason, CDVC funds take a much more active role than a lender ever would in advising, and sometimes even helping manage, an investee's business, in order to help it succeed and grow rapidly. This often-intensive entrepreneurial and managerial assistance is the heart of the economic development impact of CDVC.

Why Community Development Venture Capital?

There are a number of reasons that community development venture capital is a powerful tool for economic development.

- Equity capital is vital to the success and growth of small businesses, particularly during their expansion stage when large numbers of jobs and productive wealth are being created. Because equity capital is high risk, it is very difficult to access.
- Equity capital is in particularly short supply in low-income areas and among minority entrepreneurs. The primary source of risk capital for most small businesses is personal savings and loans from friends and family. In low-income areas, these tend to be lacking. Traditional venture capital firms provide financing for only a tiny portion of businesses nationally, and venture capital is almost completely absent from low-income urban and rural areas.
- Equity capital leverages other financing. Banks and other lenders will not make loans to businesses unless they maintain a prudent ratio of equity to debt capital. An infusion of equity capital is often the linch pin for assembling other financing for new or expanding businesses.
- CDVC funds target companies that are highly competitive and thus likely to expand rapidly. These companies not only provide substantial financial returns, they also create large numbers of good jobs and have the financial resources to offer decent wages, employee benefits,

worker training, and opportunities for career advancement. This sector of small, competitive businesses can form the backbone of a successful local economy.

- CDVC funds provide significant entrepreneurial and managerial assistance to businesses. Unlike lenders, equity investors become partners with their investee companies, sitting on their boards of directors and providing other substantial assistance by identifying additional financing, making contacts with customers and suppliers, and helping with executive recruitment. For businesses in low-income areas, this assistance is often as crucial as the financing itself.
- Some CDVC funds operate, or have relationships with, workforce development programs that help place unemployed people in jobs that are created by their financing activities.
- Some CDVC funds go beyond providing financing and technical assistance to existing businesses. They start and nurture businesses, and then recruit local business people to own and operate them. In this way, CDVC funds are able to jump-start business develpment in even the most economically distressed areas.

The Difficulties of the Double Bottom Line

A focus on social returns differentiates CDVC funds from traditional venture capital funds. Like traditional venture funds, however, CDVC funds must also deliver financially to remain in operation. This double bottom line of social and financial objectives presents many challenges that are different from those that traditional venture capital funds encounter. Among the challenges that the CDVC industry faces are problems in raising capital and reaching scale, difficulties in attracting experienced talent, and high costs of operation.

Problems In Raising Capital and Reaching Scale

The pool of potential investors that share an interest in the social component of the double bottom line is limited, and CDVC funds generally do not offer

traditional venture capital returns. For this reason, CDVC funds find it difficult to raise large amounts of capital, and the average size of a mature CDVC fund in 1996 was only $5.8 million. This is significantly smaller than most traditional venture funds, and also less than the approximately $10 million minimum generally thought necessary to help cover operating expenses, attract experienced fund managers and allow for investment diversification. Substantial new sources of risk capital must be found for funds in the CDVC industry to reach an economic scale where the full power of the model may be demonstrated.

Attracting Experienced Talent

Only a small number of individuals have the skills necessary to operate a successful equity investment program. Most of them work for traditional venture funds and are highly compensated for their work. Those with the necessary skills and experience to produce the double bottom line of making successful financial investments while also creating social benefits are even more scarce. The relatively small number of CDVC funds currently operating has thus far been fortunate in attracting extraordinarily talented and dedicated people. Creating opportunities for training and apprenticeship learning will be necessary to allow the CDVC industry to continue its rapid expansion and retain its high quality.

Costs of Operation

The economics of CDVC funds are fundamentally different from those of traditional venture capital funds: CDVC funds are generally more expensive to operate, as a percentage of funds under management. Increased scale would help this problem, but, for at least two reasons, costs will always remain an issue. First, the size of the average CDVC investment is significantly smaller than that of the average traditional venture investment, although the cost of making a smaller investment is often as great as making a larger one. Also, CDVC funds often become even more involved in providing entrepreneurial and managerial assistance to their investee

businesses than do traditional venture capitalists, and this too is expensive. The smaller investment size and greater business assistance are both integral to achieving the social benefits of CDVC funds. For investment returns not to be unduly reduced, a model must be developed that will help pay for the social benefits produced by CDVC funds from a source other than investment earnings alone.

Future of the Industry

Economic development professionals, as well as leaders in finance and business, are increasingly turning to CDVC as an effective way to help build healthy communities and make durable improvements in the lives of disadvantaged people. While CDVC shows great promise, the jury is still out regarding the full measure of its effectiveness. As existing funds mature and newer ones are formed, they are sharing knowledge and best practices with each other, and efforts are under way to measure the full social benefit and financial returns of the industry. Together, these funds are experimenting with and building a model that is different from traditional community economic development, but is not quite venture capital either. It is a new hybrid that borrows sophisticated tools of finance and business development and applies them in promising new ways to some of the most serious and intractable problems of our time.

The Community Development Venture Capital Alliance (CDVCA) promotes use of the tools of venture capital to create good jobs, productive wealth, and entrepreneurial capacity that benefit low-income people and distressed communities. CDVCA's members operate funds in low-income urban and rural areas throughout the United States and around the world. It seeks to build the field of community development venture capital by providing training, offering opportunities for peer exchange and learning, increasing members' access to capital and other resources, providing individualized consulting services, developing standards and best practices, and advocating

for the field. It also encourages and facilitates involvement of the traditional venture capital communities in community development finance.

For general information about CDVCA, contact Judy Burton, CDVCA Administrator, 700 Lonsdale Building, Duluth, Minnesota 55802, (218) 722-0861/jburton@cdvca.org. For more specific information, contact Kerwin Tesdell, President, CDVCA, 915 Broadway, Suite 1703, New York, New York 10010,(212) 475-8104, web address ktesdell@cdvca.org.

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FEDERAL RESERVE BANK
OF SAN FRANCISCO

Community Investments Vol. 10, Issue 4
Consortia and the CRA

Author(s): Fred Mendez, Community Affairs Advisor, Federal Reserve Bank of San Francisco
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Multi-bank community development organizations ("consortia") represent the industry's best effort to formalize community development lending as an equal partner in the world of traditional banking. By assuming the role of sub-contractor to their bank investors, consortia can provide the community development expertise and capacity that small- and mid-sized financial institutions cannot often afford. At the same time, these intermediaries can provide large financial institutions with an effective way to reach underserved populations through products and services that may initially be unprofitable if performed internally.

The role of consortia within the financial industry is still a topic for discussion in many banking circles, and regulatory agencies have no role in determining the mechanisms in which banks meet the credit needs of their communities. However, one role that the regulatory agencies do play is in setting the foundation for bank participation in newly formed consortia by providing regulatory guidance. The Federal Reserve Bank of San Francisco is currently providing such guidance to two-dozen financial institutions in the State of Utah that are undertaking the task of creating a statewide consortium. The grid presented on the following page is derived from a presentation delivered to these financial institutions in an effort to explain the CRA implications of consortia lending.

Setting the foundation for this grid are two over-arching issues concerning assessment area and the innovation/complexity of consortia products. The regulation clearly states that community development loans, services, and qualified investments are considered under CRA if they support a community development organization or activity that services an area which includes a financial institution's assessment area. The assessment area need not receive an immediate or direct benefit as long as the purpose, mandate, or function of the activity serves the geographies and/or individuals inside the assessment area or an area that is larger, but includes the assessment area. Keep in mind, however, that an examiner will consider community development activities that have a direct benefit to an institution's assessment area as being more responsive to the credit needs of that area than those activities whose benefit is uncertain or diffused throughout a larger area.

Another factor to take into consideration is the level of innovation and complexity. This is determined by a financial institution's efforts to meet community development needs not being met in the normal course of business by the local private market. Financing an organization such as a consortium that provides innovative and complex products and services is all well and good, and will likely result in the typical "garden variety" CRA consideration. But, active partnership with a consortium in the development, management, and distribution of such products and services will result in innovative and complex consideration under the CRA . . .the stuff of which Outstanding ratings are made.

Understanding the role of consortia, what they can and cannot do, and how to use multi-bank initiatives to provide the greatest impact to those most in need requires a partnership of resources and expertise. While the financial industry continues to evolve, the role of consortia must change with the industry in order to continue the mission of meeting the changing needs and expectations of bank investors. The four federal banking regulatory agencies

are committed to assisting the industry in the development and evolution of multi-bank community development initiatives. And, while the CRA is challenging at times, it provides plenty of flexibility to try new things through intermediaries like consortia.

	Large Financial Institutions	Small Financial Institutions	Wholesale or Limited Financial Institutions
Lending	Lending Test: Loans made to a consortium are considered community development loans. Loans made through a consortium either through participation or purchase are also considered community development loans. The loans made by a consortium as a result of a financial institution's loans or investments will allow that	The focus of the streamlined CRA examination procedures for small financial institutions is on lending and lending-related activities. Loans made to a consortium are considered community development loans, as are loans made through a consortium either through participation or purchase. The loans made by a consortium as a	Community Development Lending: Similar to large financial institutions, loans made by wholesale and limited purpose financial institutions to a community development consortium are considered community development loans, as are loans through a consortium either through participation or purchase. The loans made by a

	financial institution to receive continuing consideration for community development lending activity as long as documentation supports this continued activity. For CRA reporting purposes, multi-family affordable housing loans are considered both a home mortgage and a community development loan.	result of a small financial institution's loans or investments will allow that financial institution to receive continuing consideration for community development lending activity as long as documentation supports this continued activity. Participation in a consortium can also be an adjustment factor for a low loan-to-deposit ratio and allows for a bigger "bang for the buck" by providing access to innovative financing that would not be available if the	consortium as a result of a financial institution's loans or investments will allow that financial institution to receive continuing consideration for community development lending activity as long as documentation supports this continued activity. For CRA reporting purposes, multi-family affordable housing loans are considered both a home mortgage and a community development loan.

		institution did not participate in the organization.	
Investments	Investment Test: Any lawful investment in a consortium, be it for creation, capitalization, or the purchase of securitized loans, is considered a qualified investment. In the cases where the consortium generates both community development loans and community development investments, the split credit rule may apply, allowing both lending and investment test consideration for the same tranaction. (See Community	The most recent Interagency Questions & Answers document on CRA clarifies that lending-related investments, such as an investment to capitalize or create a consortium, will be evaluated by examiners when evaluating small financial institutions for a satisfactory CRA rating under the streamlined examination procedure.	Community Development Investment: Any lawful investment in a consortium, be it for creation, capitalization, or the purchase of securitized loans, is considered a qualified investment. In the cases where the consortium generates both community development loans and community development investments, the split credit rule may apply, allowing both lending and investment test consideration for the same transaction. (See

	Investments, Winter and Spring 1997)		Community Investments, Spring 1996, and Spring 1997)
Services	Service Test: Participation by financial institution representatives in the provision of financial services-related activities to consortia is considered a community development service. This includes, but is not limited to: participation on the task force to create a consortium, participation on the organization's board of directors, and participation on the organization's loan committee.	The provision of community development services to the consortium will help a small financial institution if they choose to be evaluated for an Outstanding CRA rating.	Community Development Service: Formal participation by financial institution representatives in the provision of financial services-related activities to consortia is considered a community development service. This includes, but is not limited to: participation on the task force to create a consortium, participation on the organization's board of directors, and participation on the organization's loan committee.

About the Author

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FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 10, Issue 4 CDFIs Unmasked

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All too often, it's the people and businesses that need credit the most that can't get it. As a result, already distressed communities decline further, increasing the need for money in the community but, at the same time, making it harder to come by. Community development financial institutions (CDFIs) help reverse this downward spiral, acting as financial intermediaries that find ways to make loans and investments which traditional financial institutions would consider "risky" or unbankable. In spite of this "riskiness," CDFIs do quite well overall: members of the CDFI Coalition, which represents more than 350 established CDFIs in 50 states, have loaned and invested some $3.5 billion in our nation's most distressed communities with a collective loan-loss rate comparable to the best banks.

CDFIs differ in structure, size and development-lending goals:

Community Development Banks (CDBs) are insured depository institutions. Many CDBs go beyond merely lending money and include such components as real estate development and skills development programs like job training, business technical assistance and non-bank financing.

Capital sources for CDBs include conventional banks, insurance companies, foundations, government agencies and wealthy individuals. Challenges facing CDBs range from recruiting and retaining personnel, who need a certain amount of expertise in the field to be useful, to creating a sense of mission. Providing leadership in the community can be as important as providing money. In many ways, CDBs are seen as the local handyman--often intimately familiar with local problems, they can link area residents, financial resources, and government programs in a coherent renewal effort.

South Shore Bank, for example, realized that reviving Chicago's South Shore neighborhood meant renovating its many deteriorated multi-unit buildings. So the bank's holding company established a real estate company, City Lands Corp. (now Shorebank Development Corp.) to develop residential and commercial property to benefit low- and moderate-income residents. Today, Shorebank trains residents to become property managers and provides assistance in solving practical problems ranging from screening tenants to reducing energy costs.

Community Development Credit Unions (CDCUs) are member-owned and controlled financial cooperatives that bring credit and financial services to people and communities with limited access to mainstream financial institutions. CDCUs are organized around a common bond such as church membership, employment, or geographic proximity.

In contrast to "mainstream" credit unions, CDCUs target low-income people and communities. They can expand their capital base by accepting deposits from non-member institutions and can receive low-interest loans, deposits and technical assistance from the National Credit Union Administration and the National Federation of Community Development Credit Unions. Finally, they have greater flexibility in determining membership.

CDCUs require broad community buy-in to get rolling, which can take eighteen months to three years. Other challenges facing CDCUs include competing with other credit unions, who sometimes find distressed communities profitable, and providing technical assistance to borrowers, such as credit counseling and business planning. A labor-intensive endeavor, CDCUs serve large numbers of people with very small borrowing and savings plans.

About 100 community development credit unions have lent more than $2 billion over the past 65 years, with a loss rate of less than 2 percent.

Community Development Loan Funds (CDLFs) are financial intermediaries that borrow capital from socially conscious investors and lend it, primarily in lower-income communities, to support nonprofit affordable housing efforts, worker-owned and community-based businesses, and other projects. Funders include individuals, foundations, banks and religious institutions.

In the world of CDLFs, technical assistance is crucial. Borrowers often need help to plan and implement successful projects and develop capacity to undertake more ambitious projects; banks need their loans repaid.

CDLFs traditionally have dealt with higher-risk borrowers, but the market is changing quickly. In the past, CDLFs have faced challenges obtaining investments from banks and other financial institutions, who, if they lend at all, lend at much higher rates since they anticipate low returns.

Community Development Venture Capital Funds (CDVCs) provide equity, similar to purchasing stock in a company, for community real estate and small-and medium-sized business projects that provide good jobs in low-income communities. Capital sources for CDVC funds are foundations, corporations, individuals and government.

Financial institutions usually require borrowers to have a certain amount of equity, so if their business goes under, the lender can recover at least part of the loan. CDVCs can provide this equity. In this way--unlike lenders--CDVCs become partners with businesses. CDVC funds help advance the social good through more than just financing by, for example, joining the boards of companies in which they invest and advocating good hiring, labor and environmental practices.

To start a CDVC, one needs approximately $5 million to $10 million and a fair amount of expertise. CDVCs have trouble attracting skilled people, since anyone with enough expertise can earn a lot more money in the private sector.

Microenterprise Development Loan Funds (MDLFs) foster social and business development through loans and technical assistance to low-income people, who run very small businesses or are self-employed, and who are unable to get conventional credit. Like CDLFs, they offer training and technical assistance to the borrower.

MDLFs work either by getting direct loans from the organization administering the fund or through peer groups. In the latter scenario, small loans are made to groups of eight to 10 people who loan the money to one or more members with the best business plan. The rest of the group acts as guarantors of the loan, ensuring that funds will be available to other members once the first person has repaid the loan. These programs have had mixed results when not tailored to an individual community.

MDLFs are fairly expensive to operate, since they require a lot of time recruiting and training people, and providing technical assistance. On the whole, though, they have helped many who otherwise would not have had access to capital. About 50 microenterprise development loan funds have lent more than $25 million, averaging $2,500 per loan.

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For more information, you may contact the CDFI Coalition, 924 Cherry St., 2nd Floor, Philadelphia, PA 19107, (215) 923-4754, www.cdfi.org; The Woodstock Institute, 407 S. Dearborn St. #550, Chicago, IL 60605, (312) 427-8070; CDCVA, 700 Lonsdale Building, Duluth, MN 55802, (218) 722-0861; Chicago Community Loan Fund, 343 S. Dearborn St., Suite 1001, Chicago, IL 60604, (312) 922-1350; Shorebank Corp., 1950 E. 71st St., Chicago, IL 60649, (773) 753-5697; National Federation of CDCUs, 120 Wall St., 10th Floor, New York, NY, 10005, (212) 809-1850, x 220.