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Shifting Ground: Can Community Development Loan Funds Continue to Serve the Neediest Borrowers?

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Introduction

Community development financial institutions (CDFIs) are designed to improve economic conditions for low-income individuals and communities by providing a range of financial products and services that often are not available from mainstream lenders and financiers. There are four primary types of CDFIs -- community development loan funds, banks, credit unions and venture capital funds – each of which offers a range of financial products and services to individuals and organizations (Benjamin, Rubin and Zielenbach 2004).

Community development loan funds (CDLFs) provide financing and technical assistance for businesses, for-profit and nonprofit real estate and housing developers, nonprofit organizations looking for facility or operating capital, and, increasingly, low-income individuals looking for financing to purchase or rehabilitate their homes. CDLF financings are intended to further various social goals, such as increasing economic growth and job creation in low-income areas; creating low-income housing; stabilizing population decline in distressed communities; improving the availability and quality of community facilities in underserved markets; increasing the number of businesses owned by women and ethnic minorities and promoting the growth of businesses that do not harm the environment (Caskey and Hollister 2001). Most of the organizations and people financed by CDLFs are not able to obtain capital from more traditional sources, or they cannot obtain it on terms they can afford.

CDLFs are unregulated financial institutions, and the majority of them have a nonprofit legal structure. Historically, they have relied on a combination of below-market-rate loans and grants to capitalize their activities. CDLFs re-lend this capital at market or near-market rates, using the spread – or difference – to help finance their operations.

The late 1990s was a hospitable economic and political environment for community development financial institutions (Benjamin, Rubin, and Zielenbach 2004). Like all CDFIs, CDLFs grew both in absolute numbers and in capitalization levels. However, the environment has changed dramatically since 2000, leaving many CDLFs struggling to stay alive as the subsidized capital necessary to fund their operations has largely evaporated.

This environmental change has sparked a conversation within the industry regarding what the future business and industry models should be for CDLFs and how best to transition them to that vision. Some consensus appears to have developed that, because CDLFs cannot count on either public or private sources of subsidized capital, they must become sustainable and find ways to operate using primarily market-rate capital, with little or no subsidy.

Whether the majority of community development loan funds have the human or financial capital necessary to weather such a transition is not clear. Those CDLFs that do not survive could leave their communities without access to necessary financial products and services. Even the CDLFs that are able to adjust to a low-subsidy environment by focusing primarily on the more profitable aspects of their operations risk behaving increasingly like conventional financial institutions, ultimately moving away from their community development objectives and the low-income communities they serve.

Part I of this paper reviews CDLF origins, structures, and current activities. Part II discusses the field's historic sources of subsidized capital and why they have shrunk. Part III reviews potential new sources of capital and the organizational ways that CDLFs are responding to their changed environment. The paper concludes with recommendations for CDLFs, funders, and policy makers.

The paper is based on organizational-level data from annual surveys of CDLFs conducted by the CDFI Data Project (CDP) and the Opportunity Finance Network; on two dozen interviews with CDLF, foundation and bank officers and staff and with policy makers involved with the field; on individual CDLF documents; and on contemporary press accounts. To protect their confidentiality, most of the individuals interviewed as part of this research are not identified.

Part I: Community Development Loan Funds

As of 2005, there were approximately 500 community development loan funds in the United States, with more than $3.5 billion in assets.[1] CDLFs financed more than $2.6 billion of activities that year, with more than $2.3 billion in additional financings outstanding. These figures are somewhat misleading, however, because CDLF activities were heavily concentrated in a few large organizations. The five largest CDLFs, for example, accounted for 52 percent of total loan-fund capital and 58 percent of all direct financing outstanding.

Table 1 provides additional data regarding the field's concentration. In 2005, the largest community development loan fund, Self-Help Ventures, accounted for almost 32 percent of all capital and 36 percent of all direct financing. The top twenty CDLFs held 77 percent of all capital and were responsible for 79 percent of all financing outstanding. Most CDLFs are relatively small, with median capital of $8.9 million (CDFI Data Project 2007).

Table 1 – *Community Development Loan Funds by Quintiles**

	Total Capitalization	Capitalization as % of Total	Median Fund Capitalization	Mean Fund Capitalization	Direct Financing Outstanding as % of Total
Fund 1	$ 921,007,142	31.6%			35.8%
Funds 2 to 20	$ 1,320,581,099	45.3%	$ 45,424,482	$ 69,504,268	43.0%
Funds 21 to 40	$ 354,313,809	12.2%	$ 15,912,444	$ 17,715,690	11.3%
Funds 41 to 60	$ 184,735,068	6.3%	$ 8,823,379	$ 9,236,753	5.8%
Funds 61 to 80	$ 101,828,833	3.5%	$ 4,872,143	$ 5,091,442	3.1%
Funds 81 to 98	$ 30,795,731	1.1%	$ 1,449,062	$ 1,710,874	1.0%

**As of 2005*

Most community development loan funds began as either businesses– or housing-focused lenders (CDFI Data Project 2006). Business-focused community development loan funds originated in the late 1960s and early 1970s, with efforts by a few Community Development Corporations (CDCs) and a group of revolving loan funds to make loans to businesses in order to promote economic development (Grossman, Levere, and Marcoux 1998; Rubin 1998). Housing– focused community development loan funds began in the late 1970s with a loan fund set up by the Institute for Community Economics (ICE), an organization whose mission was to create cooperative land trusts designed to build communities and make home ownership affordable for low-income individuals (Matthei 1998; White 1998). ICE ultimately was involved in the creation of approximately twenty-five community development loan funds around the country, as well as the creation of the National Association of Community Development Loan Funds, the industry's trade association (Matthei 1998).[2]

[1] *The total number of community development loan funds is an estimate provided by the Opportunity Finance Network in the 2004 CDP report. This paper focuses on a subset of those CDLFs for whom larger loans (more than $35,000) constituted more than 50 percent of their financing activities. There were 98 such organizations in the 2005 CDP sample. Unless specified otherwise, the CDLF data presented in this chapter are based on this subset of 98.*

[2] *In 1997, the National Association of Community Development Loan Funds was renamed National Community Capital. In 2005 its name was changed again to the Opportunity Finance Network.*

Housing and business loans still make up the bulk of CDLF financing activities, accounting for 66 percent and 17 percent of all CDLF dollars outstanding as of 2005. However, many CDLFs have diversified their offerings, moving into the provision of operating and facility construction loans to other nonprofits, such as charter schools, child-care centers, health-care facilities, social services agencies, and arts organizations. Such facility financings accounted for almost 14 percent of all CDLF dollars outstanding at the end of the 2005 fiscal year (CDFI Data Project 2007). As with their business and housing finance activities, CDLFs began providing capital to nonprofits because more traditional capital sources viewed the nonprofits' revenue streams as too unpredictable to make them good credit risks.

As Table 2 demonstrates, the volume of lending for facilities is concentrated in a few organizations that specialize in this type of financing, with the ten CDLFs that make the most facilities loans accounting for more than 76 percent of the total dollars outstanding. Table 2 also shows the overlap between the top lenders, regardless of area of specialization. In particular, there appears to be significant overlap between the top housing and community facility lenders, with six CDLFs being among the top ten in each category. This reflects the path of diversification, from housing to facility lending, that many of the funds have taken. The fact that the top-ten lenders in all three areas consist of only twenty-one organizations also speaks to the overall concentration of capital in the industry.

Table 2 – *CDLFs with Largest Amount of Direct Financing Outstanding in Housing, Community Facilities, and Business**

CDLFs	Direct Financing Outstanding for Housing	Direct Financing Outstanding for Community Facilities	Direct Financing Outstanding for Businesses	Total Capital
CDLF 1	$ 748,440,928	$ 19,724,905 (5)	$ 53,076,811 (1)	$ 921,007,142 (1)
CDLF 2	$ 104,870,327	$ 19,178,025 (7)		$ 209,904,788 (2)
CDLF 3	$ 89,329,254			$ 123,184,193 (4)
CDLF 4	$ 53,728,511	$ 17,482,030 (8)		$ 99,026,215 (5)
CDLF 5	$ 45,188,000	$ 20,250,500 (4)	$ 43,619,500 (2)	$ 161,155,000 (3)
CDLF 6	$ 43,588,400			$ 44,182,624 (14)
CDLF 7	$ 41,277,302			$ 44,223,428 (13)
CDLF 8	$ 33,185,614	$ 8,723,341 (11)		$ 53,662,058 (9)
CDLF 9	$ 27,925,053	$ 19,378,029 (6)	$ 10,172,569 (11)	$ 88,821,250 (6)
CDLF 10	$ 27,606,506	$ 12,923,888 (9)		$ 56,588,364 (8)
CDLF 11		$ 67,992,324 (1)		$ 76,838,763 (7)
CDLF 12		$ 32,998,433 (2)	$ 16,890,795 (5)	$ 49,267,350 (10)
CDLF 13		$ 24,529,839 (3)		$ 36,778,931 (19)
CDLF 14		$ 10,923,517 (10)		$ 31,678,996 (20)
CDLF 15			$ 30,091,795 (3)	$ 45,424,482 (11)
CDLF 16			$ 19,871,948 (4)	$ 30,380,785 (21)
CDLF 17			$ 15,370,549 (6)	$ 36,981,310 (18)
CDLF 18			$ 13,093,238 (7)	$ 42,222,598 (15)
CDLF 19			$ 11,700,000 (8)	$ 44,559,350 (12)
CDLF 20			$ 10,524,781 (9)	$ 37,660,017 (17)
CDLF 21			$ 10,194,010 (10)	$ 14,421,052 (36)
Top 10 CDLFs as Percent of Total				
	80.39%	76.64%	58.31%	63.14%
Total Number of CDLFs with Direct Financing Outstanding by Specialization				
	69	53	71	71
Median Direct Financing Outstanding for all CDLFs by Specialization				
	$4,433,448	$1,787,297	$2,381,350	$2,381,350

**As of 2005*

CDLFs lend both independently and in conjunction with conventional lenders. When lending in partnership with more conventional institutions, CDLFs generally take a subordinate position, absorbing most or all of the risk. Such partnerships can consist of collaborations on one project or can last for many years and include multiple joint investments, as well as bank investments in CDLFs and bank staff holding positions on CDLF boards of directors.

Through such partnerships, in which CDLFs assume the higher-risk portions of joint deals, and through successful solo lending, CDLFs play an important role in demonstrating the financial viability of low-income communities to traditional financial institutions. In the area of small-business lending, for example, CDLFs have encouraged banks to lend to small-business customers located in low-income markets, a group banks previously had rejected (Rubin and Stankiewicz 2001).

In the area of multifamily housing, CDLFs have helped bring commercial banks into projects and have demonstrated how to underwrite such projects successfully and profitably. Banks now consider lending to multifamily development projects reasonably safe because of the underlying physical collateral; the presence of subordinate, risk-alleviating financing such as CDLF loans, low-income housing tax credit equity, and public loans; and the extensive organizational and project-based counseling and technical assistance that CDLFs provide to the borrowers. The same holds true for commercial real estate developments. As a result, conventional financial institutions have become much more involved in real estate projects that previously were financed primarily or exclusively by CDLFs. In certain markets, CDLFs and their bank supporters find themselves competing for the same multifamily loans. As banks have moved into markets that had been served entirely by CDLFs, the latter have had to take on increasingly risky investments (Rubin, Caskey, Dickstein, and Zielenbach 2008).

The newest area of CDLF activity is the provision of home loans to individuals. As of 2005, twenty-one CDLFs, representing approximately 20 percent of all CDLFs surveyed, reported providing housing loans directly to individuals. These organizations closed more than 1,858 mortgages (CDFI Data Project 2007). While this represents a tiny fraction of the mortgages made by conventional financial institutions, this type of financing has benefits beyond the individual homeowers served. Home loans from CDLFs are an important alternative to the expensive subprime home loans that have been the only route to home ownership for many low-income families.[3]

Another little-documented area of CDLF activity is the role they have played in shaping policy. CDLFs and other types of CDFIs have influenced government at both the national and state levels. The Clinton administration's creation of the CDFI Fund, the New Markets Tax Credit, and the New Markets Venture Capital programs were all strongly encouraged and shaped by CDFIs and their leaders (Dickstein 2006; Roberts 2005; Rubin and Stankiewicz 2003; Pinsky 2001). CDFI advocacy also played a role in the Clinton administration's 1995 strengthening of the Community Reinvestment Act (Pinsky 2001).

CDFIs also have advocated successfully at the state level for program funding as well as increased regulation and consumer protection. The latter has included efforts to enact and strengthen state-level Community Reinvestment Act legislation, enact laws to curtail predatory lending and fringe banking, and advocate on numerous local issues, ranging from workforce to environment policies. Some of the largest CDFIs, such as Self-Help, Enterprise Corporation of the Delta, The Reinvestment Fund, and Coastal Enterprises, have created specialized subsidiaries, or have dedicated personnel, to conduct research and influence policy. Self-Help's Center for Responsible Lending, for example, has contributed significantly to knowledge and regulation on the issue of predatory lending, including passage and evaluation of the first state-level anti-predatory lending legislation. The Center works with academics and advocates around the country to conduct research, build coalitions, advocate for anti-predatory lending policies, and support litigation (Center for Responsible Lending 2006).

[3] For an excellent summary of how CDFIs are addressing the subprime and foreclosure crises see Carla Dickstein, Laura Buxbaum, Hannah Thomas and Kimberly McLaughlin (2008), The Role of CDFIs in Addressing the Subprime Mortgage Market. Paper presented at the CDFI Fund Research Conference, Washington DC, June 24.

Part II: Sources of Capital

Community Development Loan funds are capitalizated mostly by debt, which accounted for 67 percent of all CDLF capital as of 2005. The remaining 33 percent of CDLF capital is equity. Since most CDLFs are nonprofit in legal form, the equity consists primarily of grants and accumulated earnings.

Table 3 shows the sources of debt capital for the industry as of 2005. Banks, thrifts, and credit unions were by far the largest source, providing almost 50 percent of all debt capital. Other sources included foundations, federal and state governments, nondepository financial institutions, corporations, religious institutions, national CDFI intermediaries, and socially motivated individuals.

Table 3 – *CDLF Debt Capital by Source**

Source of Funds	Twenty CDLFs with Greatest Capitalization	All Other CDLFs	All CDLFs
Banks, Thrifts & Credit Unions	57.7%	33.9%	49.6%
Foundations	16.9%	15.1%	16.3%
Federal Government	6.3%	15.8%	9.5%
Religious Institutions	3.0%	13.1%	6.4%
State & Local Governments	4.9%	4.0%	4.6%
Nondepository Financial Institutions	4.4%	3.1%	4.0%
Individuals	2.0%	4.7%	2.9%
Corporations	1.7%	4.2%	2.5%
National CDFI Intermediaries	2.0%	3.4%	2.5%
Other	1.2%	2.7%	1.7%

**As of 2005; Excludes Self Help, Local Initiatives Support Corporation, and six funds for which data are not available.*

As Table 3 documents, there is substantial variation in sources of capital between the larger and smaller CDLFs. This variation reflects the greater ability of larger institutions to attract debt capital from banks, thrifts, and credit unions, which have become an increasingly important source of capital for CDLFs. Capital loaned to CDLFs increased by 91 percent between 2000 and 2005. As Table 4 demonstrates, however, dollars loaned by depository financial institutions grew by 165 percent during this time period. The debt capital that came from foundations, the federal government, and religious institutions, the three next largest sources of capital, only grew by 47, 22, and 41 percent, respectively.

Table 4 – *Percentage Change in Debt Capital by Source: 2000 to 2005**

Source of Funds	Twenty CDLFs with Greatest Capitalization	All Other CDLFs	All CDLFs
Banks, Thrifts & Credit Unions	184%	103%	165%
Foundations	46%	51%	47%
Federal Government	-8%	79%	22%
Religious Institutions	31%	59%	41%
State & Local Governments	257%	148%	204%
Nondepository Financial Institutions	209%	107%	196%
Individuals	11%	56%	31%
Corporations	22%	680%	108%
National CDFI Intermediaries	57%	308%	110%
Other	104%	-24%	40%

** Based on 56 CDLFs for which data are available for both years.*

Although CDLFs grew their capital under management between 2000 and 2005, the growth rate was much slower than during the previous five years. As Table 5 documents, the twenty-eight loan funds for which data are available for all three years grew their debt and equity capital by more than 150 percent between 1995 and 2000. Between 2000 and 2005, however, these CDLFs grew their debt by 91 percent and their equity by only 36 percent.

Table 5 – *Change in CDLF Capital Under Management**

	Debt	Equity
1995 to 2000	156%	166%
2000 to 2005	91%	36%

** For 28 CDLFs for which data are available for all three years.*

More important, these overall growth rates can mask the underlying environmental trends that are making it increasingly difficult for CDLFs to raise the subsidized capital they need for the high-risk loans and investments, the provision of technical assistance, and the financial experimentation that is their mainstay. Loans from depository financial institutions to CDLFs, for example, increasingly are carrying market or near-market rates of interest, greatly limiting the subsidy that CDLFs rely on for many of their activities. The remainder of this section will detail the environmental trends affecting the industry, including the decline in federal government support for community development finance, the changing nature of funding from conventional financial institutions, and the decreased funding by foundations.

As noted earlier, the most dramatic increases in financial service provision in lower-income markets occurred during the mid-to-late 1990s, during the Clinton administration, which had made a strong commitment to this goal. Clinton's support of the Community Reinvestment Act and sponsorship of the CDFI Fund was critical to the growth of the CDFI industry and to the expanded efforts by conventional financial institutions to serve historically underserved communities. The George W. Bush administration has been much less welcoming to community development finance. Evidence of this is most notable in the administration's treatment of the Community Development Financial Institutions (CDFI) Fund and the Community Reinvestment Act (CRA). Early hopes that the New Markets Tax Credit program would provide capital for non-real estate business financings have also largely been unrealized.

The Community Development Financial Institutions (CDFI) Fund

The CDFI Fund is one of the few sources of grant and equity capital for community development finance. Under the Bush administration, the CDFI Fund saw a dramatic reduction in funding from $118 million in 2001, the last budget under President Clinton, to $55 million in 2007. Even this reduced level of support required a significant lobbying effort by the CDFI industry as the administration's proposed 2006 budget called for moving all funding to the Department of Commerce, except that which was necessary for oversight of existing commitments and for administration of the New Markets Tax Credit (NMTC) program. The administration's 2007 budget again called for similar consolidation provisions. Following the election of Democratic majorities to the House and Senate, the administration's 2008 budget abandoned consolidation and asked for a $29 million appropriation for the Fund. Congress successfully increased that to $94 million.

New Markets Tax Credit Program

The New Markets Tax Credit (NMTC) program was designed to combine public- and private-sector resources in order to bring $15 billion in new investments to impoverished rural and urban communities. The program was enacted as part of the Community Renewal Tax Relief Act of 2000. The last round of the NMTC originally was to take place in 2007. However, the program was twice extended for an additional year and $3.5 billion more in funding; once in December 2006 and again in October 2008 .

The CDFI Fund, which administers the NMTC program, allocates a set pool of tax credits to financial intermediaries, called community development entities (CDEs), based on a competitive application process. The CDEs, which must be private and for-profit (though their parent entities can be public or nonprofit), then offer the credits to investors in exchange for equity capital investments. The credit is equal to a 39 percent cumulative tax reduction for the investors and must be used over seven years – allowing for a 5 percent reduction in taxes in each of the first three years, and a 6 percent reduction in each of the remaining four years (CDFI Fund 2005).

The program came into existence with strong encouragement and support from the CDFI industry. When the program was being designed, there was great hope that it would be a significant new source of equity capital to fund business lending and investments. Due to several statutory and regulatory provisions, however, the program has so far been used almost exclusively to finance real estate–related transactions (Rubin and Stankiewicz 2003; Seidman 2007; Lambie-Hanson 2008). Even more critically, the highly competitive nature of the program and the expense and expertise required to meet its legal and compliance requirements also have precluded all but the largest and most sophisticated CDLFs from being able to take advantage of a NMTC allocation. Despite these limitations, the NMTC is an important resource for CDLFs, providing a source of fee-based revenue and an opportunity to expand the size and nature of financing activities.

The Community Reinvestment Act

Banks and financial institutions provide capital for community development loan funds primarily to comply with the Community Reinvestment Act (CRA), which was enacted by Congress in 1977 to encourage regulated financial institutions to fulfill their "continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered" (NCRC 2005). The CRA is crucial for CDLFs because any weakening of its provisions translates into fewer resources to fund CDLF activities.

The CRA was revised in 2004 and 2005 with new amendments that supporters felt were part of an ongoing effort by the law's opponents to "dismantle the act, piece by piece" (Rubin and Rubinger 2004). More recently, opponents of the Act have tried to blame it for the subprime debacle and the current economic meltdown (Krauthammer 2008; Seidman 2008).

Changes to the financial services industry over the last thirty years have prompted observers to call for the Community Reinvestment Act to be expanded to mortgage and investment banks and insurance companies

(Seidman 2007b), as well as to financial institutions with a stronger rural presence, such as the farm credit bank system and federal home loan banks (Rubin 2008b). In March 2007, Representatives Eddie Bernice Johnson (D-TX) and Luis Gutierrez (D-IL) unsuccessfully introduced The CRA Modernization Act of 2007, (H.R. 1289), which would expand the Act's reach and repeal the most recent regulatory changes. In February 2008, House Financial Services Committee Chair Barney Frank held a hearing to examine ways to enhance the CRA, a likely first step to the introduction of similar modernization legislation during the 111th Congress.

The U.S. financial services sector has experienced other environmental changes over the last few decades, caused by globalization, domestic deregulation, and technological advances (Avery et al. 1999), which have affected their relationships with community development financial institutions. The most dramatic recent change to the U.S. financial services sector is the consolidation of the banking industry through mergers of increasingly large organizations.

Consolidation of Conventional Financial Institutions

As of 2006, the ten largest U.S. commercial banks controlled 49 percent of all domestic banking assets, a substantial increase from the 29 percent they controlled a decade ago (Economist 2006). This consolidation has had both positive and negative effects on the CDLF industry. On the positive side, banks planning to acquire or to be acquired have been more likely to be concerned about their CRA rating, and thus to make community-development related investments, even unprofitable ones (Bostic et al. 2002; Avery et al. 2000). This benefit has been watered down somewhat by the recent decrease in large-bank mergers and the perceived reduction in CRA enforcement.

The negative consequences of consolidation have included a post-consolidation reduction in both home-purchase and small-business lending by the merged organization. This is particularly true for larger banks that acquire other larger banks and for markets that experience increased concentration of banking services (Samolyk and Richardson 2003; Avery et al. 1999). An additional consolidation-related concern is the reduction in absolute sources of capital for community development that occurs when large institutions merge. This leaves fewer sources of capital for CDLFs to approach, diminishing the overall odds of a CDLF being able to obtain a capital commitment.

Bank consolidation also has resulted in an increased emphasis on profitability by the larger banks, which have felt pressure to justify the mergers to their shareholders. This has led them to cut costs by consolidating facilities and activities (Tully 2006), leaving some communities with few or no local banks and bankers. Such communities lose the leadership that bankers, "with their financial clout and community development obligations," can provide, including the ability to have bankers serve on CDLF lending committees and boards of directors (Seidman 2007). The increased emphasis on profitability also has encouraged banks to focus on their most lucrative activities, such as advising on mergers and acquisitions, at the cost of riskier and less profitable ones, such as commercial lending (Hovanesian 2005).

The diversification and mergers within the financial services industry also mean that more and more commercial banks are part of larger financial services organizations. Such entities can minimize CRA scrutiny by moving assets to those operations not covered by the CRA – as has been the case with commercial banks that own subprime lending subsidiaries that do not have to meet the same CRA standards as the parent entities.

Foundations

Foundations have been a small but important source of capital for CDLFs. Foundations are particularly important as a source of the difficult–to-obtain grant dollars. Grants act as equity on a CDLF's balance sheet, enabling it to create loan-loss reserves to secure its investments and to attract debt capital from banks. Operating grants also enable CDLFs to subsidize their most costly, and often most developmental, operations.

In addition to grants, foundations provide CDLFs with program-related investments (PRIs), which primarily are loans with lower interest rates and longer durations (generally ten years) that are used to fund CDLFs' lending activities. PRIs accounted for more than 16 percent of all CDLF debt capital in 2005 (CDFI Data Project 2007).

In the last few years, foundation support for CDLFs' lending activities has dropped, due in part to the 2000-2001 stock market decline, which shrank foundation assets and led to an overall reduction in foundation giving. More significant, however, have been decisions by the most active foundation investors to change the nature of their support for the sector or to withdraw support entirely. Foundations generally view their dollars as seed money, intended to catalyze other sources of capital and ultimately lead to organizational or project sustainability. For CDLFs, this has meant that the subsidized foundation dollars that helped capitalize many organizations in the industry's early years have become rare or unavailable.

Some foundations have pulled back entirely, no longer funding CDLFs or other types of CDFIs except when the work of individual organizations overlaps with their other programmatic interests, such as workforce development; health-care, education, or child-care initiatives; or efforts to stop predatory lending. Others are focusing their resources on those few organizations or programs perceived to be the most innovative and likely to bring about the next wave of significant development within the industry – those experimenting with securitization or other ways to use market-rate capital, or policy initiatives that could increase the impact of CDFI activities.

Even those foundations that have continued to fund individual CDFIs evaluate these investments relative to the range of other community development options available. As one foundation official stated, "There has been a lot of activity in the last five years and its reshaped the landscape a lot and signaled to foundations and banks that they can have the same impact with a better return."

This quote indicates an additional challenge for CDLFs, and for all CDFIs -- the difficulty of verifying that the social impact of their investments is greater than that created by alternative community development investments. CDLFs have not been able to quantify the outcomes they produce beyond the widely used measures of jobs created and retained. Even the job-related figures are challenging to aggregate, as individual organizations use different methodologies to track this information, reflecting varying levels of organizational capacity, and the lack of money and authority to impose a unifying, industry-wide standard.

Part III: Alternative Sources of Capital

In response to the increasingly challenging environment that they are facing in raising subsidized capital, CDLFs have turned their energies toward finding ways to reduce their ongoing reliance on such capital by becoming more sustainable. For many organizations, sustainability is associated with increasing their capital under management. While some small CDLFs can survive due to ongoing local subsidies or unique environments that create barriers to new competitors, overall it is very difficult to cover operating expenses with a small capital base.

Intermixed with the push for sustainability is an emphasis on reaching scale to be able to maximize impact (Dunlap, Okagaki, and Seidman 2006; National Community Capital Association 2004; Moy and Okagaki 2001). The goal of getting to scale is not "growing BIG institutions," but rather increasing the volume of financings by five to ten times (Pinsky 2006, 8). In its 2004–2010 strategic plan, Opportunity Finance Network, the CDLF trade association, listed increasing volume of financings as its most important strategic goal. This reflected frustration that, despite impressive growth, the CDFI industry had failed to reverse growing economic inequality or the ravages of predatory financial institutions.

To grow their volume, CDLFs have been targeting new or previously limited sources of capital, such as state and local governments, individual investors, pension funds, and the capital markets. CDLFs also are rethinking the way they do business and repositioning themselves, in order to cut costs and find new ways to use market-rate capital to fund their operations.

State and Local Governments

Although most state governments are facing a budget shortfall for the 2009 fiscal year, until recently the states offered healthier economic environments and more receptive policy environments than those at the federal level. Community organizations also have a track record of successfully lobbying for state-level CDFI funds, Community Reinvestment Acts, and tax credits designed to encourage community economic development.

The potential of state-level initiatives is best illustrated by California, where public-sector activity over the last decade has encouraged the creation of numerous innovative sources of capital to fund community development finance. In 1996, The Community Organized Investment Network (COIN) was established in the state at the request of the insurance industry as an alternative to state legislation that would have required insurance companies to invest in underserved communities. To date, the program has facilitated $14 billion in insurer investments in affordable housing and economic development projects (California Department of Insurance 2008). The COIN program also certifies California CDFIs, which then become eligible for investments from COIN's managed pool of capital. Most recently, COIN member insurance companies were responsible for the creation and capitalization of Impact Capital, which has been an innovator in securitizing multifamily mortgages in low- and moderate-income communities.

In 1997, California adopted a 20 percent tax credit for qualified deposits of $50,000 or more in CDFIs in the state. In 2001, the program was extended for five more years. Furthermore, in May 2000, then state treasurer Phillip Angelides launched The Double Bottom Line: Investing in California's Emerging Markets initiative, "to direct investment capital – through state programs and the State's pension and investment funds – to spur economic growth in those California communities left behind during the economic expansion of the past decade" (Angelides 2001, 1). As part of this initiative, Angelides successfully encouraged the boards of California's two largest public pension funds, on which he serves, to invest in real estate and businesses in the state's poorest communities. As of 2006, the two pension funds, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), had made more than $4.34 billion in real estate and $1.09 billion in business investments in such communities (Angelides 2006).

Individual Investors

Individuals have been a source of capital for community development loan funds from the field's beginnings, when they helped capitalize the first community development loan funds via below-market-rate loans. At present, however, such socially responsible investors make up a fairly small percentage of all capital sources. In 2005, community development loan funds received less than 3 percent of their debt capital from individuals.

Community development loan funds face a number of challenges in attracting individual investors. First, investors perceive community investments as higher risk. Additionally, unlike community development banks and credit unions, CDLFs cannot offer insured deposits, and their products are more diverse and difficult to explain to investors, making them more challenging to sell than conventional bank or credit union offerings. A final challenge is the fact that CDFIs offer lower broker commissions than other investment options, which can translate into reduced incentives for brokers to offer community investment products (Kanders 2002).

As the field of social investing continues to evolve, however, CDLFs and other types of CDFIs increasingly are looking at individuals as a potentially important source of future capital. CDLFs, which are mostly nonprofit in legal form and thus unable to accept equity investments except as grants, generally structure their investments from individuals as low-interest loans. Individuals also can invest in CDLFs via intermediaries, which aggregate the capital and provide due diligence on different CDFIs. CDLFs also are borrowing from the higher-education and foundation models and encouraging investors to dedicate the proceeds of a trust to them or to include them in their estate planning.

Pension Funds

U.S. pension funds control over $7 trillion in assets (Anand 1998). Historically, most pension fund assets have been very conservatively invested, due in large part to the prevailing interpretation of ERISA (the Employee Retirement Income Security Act of 1974), which Congress enacted in response to numerous private-sector pension scandals. Prior to 1994, ERISA was interpreted to mean that investments could only be selected for their economic return and safety. In 1994, the Department of Labor issued an interpretive bulletin on the subject, stating that economically targeted investments (ETIs) were allowable as long as they met the benchmark financial return rate of comparable investments with comparable risks (Logue and Clem 2006).

A number of pension funds have incorporated economically targeted investments (ETIs) into their portfolios. To date, most of the pension fund ETIs have been in fixed income and real estate. The real estate focus has created an opportunity for CDLFs to access this capital, if they can provide the scale and rate of return that pension funds require.

Capital Markets

Given the decreasing availability of subsidized capital, significant energy has been focused on finding ways to fund CDLF activities via market-rate capital and the traditional capital markets. It is unclear how the current financial meltdown will affect such efforts.

Selling loans to free up capital is not a new concept for CDLFs, many of which have sold their loans to commercial banks and to the Community Reinvestment Fund (CRF), a national nonprofit headquartered in Minneapolis, which since 1989 has operated a secondary market for CED loans. Historically, however, these loan purchases were made by a socially motivated, and thus limited, pool of investors. Furthermore, despite their historically low loss rates, CDLFs generally have had to discount their loans in order to make them attractive to banks and to the Community Reinvestment Fund, reducing the amount of capital produced by such transactions.

Even before the current credit crunch and loss of faith in securitization, there were significant obstacles to making the traditional capital markets an ongoing source of capital for more CDLFs. Two primary ones are a lack of standardization in loan performance data, documentation, and underwriting procedures among CDLFs and the lack of infrastructure to support these types of transactions (GAO 2003). A number of initiatives were under way to overcome such barriers and make securitization a viable, ongoing way for CDLFs to access capital. It remains to be seen whether such efforts will flourish in the face of current economic constraints.

Repositioning and Rethinking

In addition to identifying innovative ways to attract capital to make growth possible, CDLFs are rethinking their business models in order to become more sustainable and less reliant on subsidized capital, and to increase the scale of their impact. Toward that end, many of them have undertaken strategic planning processes to determine how to achieve these objectives. The resulting innovations have included:

- Forming partnerships, networks, and mergers to increase impact and cut costs.
- Identifying and focusing on the most lucrative and socially meaningful activities, while outsourcing others, such as loan processing and back-office operations, to cut expenses.
- Finding ways to use market-rate capital by drawing on their in-depth knowledge of local markets to create products that conventional financial institutions consider too high risk.

- Increasing their levels of off-balance-sheet transactions, in which CDLFs invest funds from other organizations in exchange for origination and servicing fees.
- Diversifying their base of borrowers and mix of products.

Conclusions

Community development loan funds are at a critical junction. The economic environment of the late 1990s, which facilitated their most dramatic growth, is unlikely to return soon. The last few years also have brought increased competition for capital in the form of new financial products that promise both community impact and market-rate returns. Even some CDLF successes, such as demonstrating the financial viability of low-income communities, have created new pressures for CDLFs. As conventional financial institutions have become more willing to take on CDLF's more profitable transactions, CDLFs are forced to find new and sustainable ways of serving low-income communities at a time when the subsidies necessary for such innovation have become rare and the problems of poverty that CDLFs are trying to address have worsened.[4] Additionally, many predatory financial service providers have come to view low-income communities as market opportunities, reversing the wealth-building efforts of community development financial institutions.

To address this problem, CDLFs must increase the scale of their activities by finding ways to operate with significantly less subsidy than the industry has used to date or develop new sources of subsidized capital. Some of the largest and most sophisticated CDLFs have led the way in rethinking and restructuring the way they do business in order to identify "a sustainable business model that meets the mission" (Dunlap, Okagaki, and Seidman 2006, 12).

However, the industry, and most critically, its government and foundation funders, must not lose sight of the ongoing importance of subsidy. Subsidy is necessary for the continual innovation and risk-taking that have enabled CDLFs to demonstrate repeatedly the financial viability of new products and markets. Subsidy also is necessary to enable CDLFs to maintain an in-depth knowledge of the low- and moderate-income communities they serve, a critical component of the CDFI model. The low- and moderate-income communities that CDLFs were designed to assist are facing an increasingly difficult environment. The U.S. poverty rate has grown since 2000, while funding of services for the country's neediest has shrunk. The current economic situation is likely to exacerbate both of these trends. Furthermore, many CDLF activities – such as the provision of micro-loans, nonprofit operating loans, extensive technical assistance, and pre-development financing – are not cost efficient. Without ongoing subsidies, CDLFs will be forced to abandon such activities, diminishing their ability to serve low-income communities.

In a no-subsidy or low-subsidy environment, it is likely that only the largest and best capitalized CDLFs will survive. More critically, as these leading CDLFs increasingly move toward market models and methods, they will be under growing pressure to modify their missions and the nature of their activities.

To access subsidized capital in the current environment, CDLFs need to better understand and document the social outcomes of their work. This includes their role as policy advocates on behalf of low-income communities; as innovators that demonstrate to conventional financial institutions the viability of new markets; as intermediaries that bring together other sources of capital to make projects and programs possible; and as direct providers of financial products, services, and education. Foundations, governments, and universities should help provide the financial and academic resources necessary to make these evaluations both rigorous and effective.

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[4] *The official U.S. poverty rate for individuals has increased from 11.3 percent of the population in 2000 to 12.7 percent in 2007 (U.S. Census Bureau 2008).*

Government has a critical role to play in serving the financial needs of low-income communities. CDLFs recognize the importance of public policy for the industry's future as well as its past. Both individually and through their trade association, they are continuing to advocate for critical regulatory changes and additional funding at the federal and state levels.

The most important of these regulatory changes are those related to the federal Community Reinvestment Act. These include the need to reverse the 2004–2005 regulatory changes and expand the act to include multiple types of financial institutions, such as mortgage and investment banks and insurance companies, to more accurately reflect the current financial landscape.

Regulatory changes to ERISA also are needed to make pension funds more accessible sources of capital for CDLFs and other types of CDFIs. As an industry, CDLFs have more than twenty years of extremely low loss rates to offset their relatively modest financial returns. In light of the recent appetite among pension fund and other institutional investors for pools of subprime mortgage loans, and the current default rates within that class of investments, encouraging pension funds to invest in CDLFs can be seen as a relatively conservative option.

The low- and moderate-income communities that CDLFs were designed to assist are facing an increasingly difficult environment. The U.S. poverty rate has grown since 2000, while funding of services for the country's neediest has shrunk. The products, services, and knowledge that CDLFs provide are needed more than ever, and they must not be allowed to fail.

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