Community, Capital and Markets: A New Paradigm for Community Reinvestment

by James H. Carr

When one thinks about sources of capital for community development, the types of financing mechanisms that come to mind are Community Development Block Grants, Low Income Housing Tax Credits, tax increment financing and a variety of other targeted, specialized and limited support. By themselves, these sources have been, and will be, increasingly inadequate to meet the needs of distressed communities. The reason for the inadequacy is simple: Government programs cannot substitute for the scale and liquidity of the private capital market. Moreover, government funding for housing and community development is increasingly hard to find. While public resources and specialized funding will continue to play an important, albeit limited, role in urban revitalization efforts, private sources of funding must and can be greatly increased.

Interestingly, many lower-income and minority communities that face a severe shortage of capital are, nevertheless, rich with undervalued assets. But because these assets are often surrounded by blight, they are overlooked and undervalued by developers, investors and financial institutions. These assets include historic sites, vintage housing stock, convenience to mass transit systems, well-established religious institutions, traditional commercial thoroughfares, and the distressed area's proximity to major employers, cultural or recreation facilities, restaurants, boutiques, colleges and universities, parks and other city landmarks. These assets, if packaged and developed properly, can create enormous value for residents and extraordinary opportunities for investors.

Wall Street has a variety of innovative investment vehicles that can be tailored to rebuild distressed communities. Complex financial modeling combined with sophisticated technology provide the structures and mechanisms that allow wide flexibility in the design of financial products to meet a range of investment needs. Derivative securities are an example of investment products that could offer investors various rates-of-return options, but they are rarely used for community reinvestment initiatives. Real estate investment trusts (REITs) are another vehicle whose use as a community investment tool could be greatly expanded.

In addition, each year entrepreneurs with highly speculative investment schemes attract billions of dollars through the junk bond market and Internet initial public offerings. Internet IPOs are highly risky investments, viewed by some major investment fund mangers as about as secure an investment as a blackjack table. Yet those IPOs have attracted billions of dollars in investments. According to Judd Levy, president of the Community Development Trust, a small nonprofit that recently helped to create the first REIT specializing in affordable lending, "There is no such thing as a lack of capital for community development lending … If we can securitize defaulted car loans, then we can't say the problem with community development lending is credit risk."

Well-developed and carefully managed housing and economic revitalization efforts can be structured to attract a full range of investors, including those who are attracted to junk bonds, securitized defaulted loans, and other highly speculative investments. In addition, they can be packaged to attract conservative investors who are willing to accept narrow spreads in return for reliable income streams.

Most importantly, capital market tools can be combined with innovative "value-recapture" mechanisms, such as strategically designed land trusts, to generate funding for housing rehabilitation and home ownership for a neighborhood's lower-income residents. This internal wealth-generating mechanism can help ensure that lower-income residents benefit from redevelopment efforts in their communities. Internally generated financing mechanisms would also allow for greater leveraging of public and philanthropic support.

Achieving this type of robust investment for a distressed community can be described as a "market-based approach" to community revitalization. Succeeding requires the organizers of community revitalization efforts to:

- Package their community's undervalued assets into a financing plan that creates investment-grade assets.
- Create the financial tools to fund the development of these new assets.
- Design value-recapture mechanisms that produce internally generated financial pools to fund housing rehabilitation, home ownership and related initiatives for lower-income residents.
- Determine the most effective manner for government to encourage private investment so lower-income community residents will share in the benefits.
- Develop a method to evaluate, in the early years, the long-term value of various community reinvestment processes. Many key indicators of the long-term success of an investment strategy are intangible, such as the existence of a high level of social capital. Measures are needed to capture the financial value of processes that directly contribute to the financial viability of a community investment program.

Each of these challenges is complex but achievable.

Packaging Community Assets

The transformation of a community's undervalued assets into investment-grade resources begins with a strategy to ensure that neighborhood revitalization efforts are politically, economically and financially beneficial. Housing development must embrace the goals of true-market regeneration, housing preservation and neighborhood stabilization. In addition, comprehensive community development initiatives must maximize economic opportunity, ensure public safety, provide public health and other family-support services and encourage community building.

While today, most community development efforts are geared toward satisfying existing demand, this new proactive market-based paradigm realizes that supply can create demand. The concept of supply creating demand has been one of the most distinguishing success features of the rapid growth of the technology industry. From the Internet to desk-top computers, many of the most well-capitalized businesses have been launched prior to consumers having expressed any specific desire for the product or service.

The on-line auction house eBay, which allows people to trade miscellaneous collectibles, became an almost overnight success, yet there had been no discernable demand for this service prior to the site's development. In fact, the utility of the personal computer for home use was not appreciated by some of the most influential technology industry leaders during the early stages of PC's development. Just as these products have created strong consumer demand, a carefully designed community revitalization plan, with homes that contain appropriate amenities, and with safe streets and strategically located open space, convenience shops and other attractions, can create strong demand in a geographic area where none currently exists.

The marketing of a proposed community reinvestment program is a critical aspect of its asset packaging. A key starting point for a marketing program is to reframe the manner in which community revitalization efforts are presented to potential investors. Community development initiatives are routinely marketed with a strong emphasis on community *needs* in a manner that encourages financial institutions to view their potential investments as *contributions*. Rather than focusing on needs in search of contributions, the new paradigm markets community assets in search of *investments*.

Master-planned community builders of suburban upscale and resort properties have developed a variety of marketing principles that greatly enhance the perceived value of their planned developments. Many of these practices can be used in distressed community reinvestment programs. These strategies include 1) naming developments to attract specific investors and residents; 2) phasing developments to ensure that each lot achieves its maximum return on investment; and 3) developing target marketing strategies that focus on potential customers rather than nebulous *consumers.*

Selecting a name for a development might, on its face, appear as a minor issue. In reality, however, a development's name greatly influences potential investors as well as prospective new homeowners and residents. Names such as "The Woodlands," "Celebration" and "Redwood Shores" evoke images of serenity, pleasure and beauty. The name of a development sometimes has little to do with the reality of the site. For example, Green Valley, a master-planned community in Henderson, Nevada, is neither green, nor in a valley, but its name suggests a verdant environment.

Creating attractive names for development sites within distressed communities can be a powerful tool for revitalization. For instance, many distressed communities are associated with high crime rates, poor schools and multiple socioeconomic problems, and many old factory and loft areas have little identity in the public mind. Some of these places could be treated as urban blank slates, where the development takes on an image the investors choose. A good example is the Pearl District of Portland that was renamed in the 1970s when the site had only defunct industrial buildings. The name was chosen to capture the romance of Portland's maritime heritage. Names can also be used to reimage a stigmatized section of a city. New names such as Capital View, University Square and Old Town can offset long-standing negative associations.

Phasing of development is also a key marketing component. For-profit developers are precise about which lots to develop first and last. Their approach to development is to build in a manner that ensures each successive phase of development is more valuable than the previous one. In urban community revitalization efforts, often there is so much excitement about any new investment that the best sites are developed quickly and in a haphazard manner so that one phase of development undermines the investment potential of the next.

Target marketing is an approach to selling that focuses in detail on the preferences and desires of specific potential customers. Using a variety of data and information, marketers identify specific customer types who might be attracted to their products. This approach to marketing inner-city developments can be highly effective. Unlimited information exists to identify potential residents within a metropolitan area for an inner-city community revitalization program. The Fannie Mae Foundation's Office of Housing Research has published research that uses the target market typologies of households based on detailed examinations of lifestyle preferences to show that many suburbanites could be lured to cities.

Many other marketing strategies can be highly effective in distressed communities, including "imaging" or packaging to illustrate the potential finished product. If packaged properly, the investment appeal of a distressed community is greatly enhanced. Proper packaging means focusing on what the community can be rather than on what currently exists. For-profit suburban developers don't shop for investors with illustrations of undeveloped land. In the same way, community developers should de-emphasize the blight or abandonment of a distressed inner-city neighborhood and focus instead on its potential.

Connecting Communities to Markets

Persistent gaps in financial intermediation adversely impact the supply of business and consumer credit to many communities in the United States. One of the most important challenges presented by this new paradigm is to create market-based solutions to problems in distressed communities by linking them to capital markets.

Many countries are actively pursuing the creation of specialized financial institutions including microfinance or community development financial institutions. They are also exploring strategies for conventional intermediaries to downscale their services. The Fannie Mae Foundation is studying best practices in the area of microlending, community development lending and downscaling efforts of banks and other financial intermediaries to learn how it might bridge gaps in the financial systems that are hindering the revitalization of communities.

Bridging the gap between capital markets and communities must be tackled at three levels. First, project financing techniques must be developed to link comprehensive community initiatives to broader and deeper sources of capital, including the global capital markets. Second, innovative products such as structured financing, exchanges and clearinghouses, and credit derivatives must be adapted to support community asset-based lending. Third, creative and innovative institutions, instruments and structures must be developed to serve a wide variety of consumer and business credit demand in various types of communities. A continuum of credit to all sectors and residents of a community under development could be created through microlending and the use of guarantees, public and philanthropic investments and partnerships.

Project financing is a carefully engineered financing mix that has long been used to fund large-scale natural resource projects, from pipelines and refineries to electric-generating facilities. It is different from conventional direct funding in that, rather than require a firm's entire asset portfolio to generate cash flow, individual projects become distinct legal entities with financing tailored to the cash-flow characteristics of each individual asset. Such a structure can yield a more efficient allocation of risks and returns than conventional financing because each comprehensive community development initiative will ultimately have a unique project, partnership and asset structure. Although this approach requires careful financial engineering to make it successful, it is emerging as the preferred alternative to conventional methods of financing infrastructure and other large-scale projects.

Asset-based lending in the context of comprehensive community-building initiatives is rooted on the notion that a community's assets should be able to stand on their own, independent of a broader community development plan or institution promoting the redevelopment program. Asset-based lending has contributed significantly to the success of asset securitization and structured finance, which have made the U.S. mortgage finance and capital markets the most efficient, stable and sophisticated in the world.

Government Support

Government has and will continue to play a key role in the redevelopment of distressed communities in America. With resources in decline, it will be increasingly important to leverage every government dollar to the greatest extent possible. In addition, it will be important to better understand ways in which government can support community reinvestment other than by providing funding. Within the context of the market paradigm, government's role is to:

- assist private firms to extract value from community assets;
- take a lead role in certain strategic community investments; and
- aid in the development of value-recapture mechanisms.

All three roles share a common element — they place government in the role of facilitator and catalyst for market regeneration. In that capacity, government is responsible for several functions that are key to market regeneration that include, first and foremost, its traditional role of managing and maintaining public infrastructure such as schools, roads, mass transit facilities and related property. Failure to provide proper upkeep of these facilities will undermine even the best reinvestment plan.

Government also plays a powerful regulatory role. Included in the powerful sets of tools it has to rebuild communities is the manner in which it:

- supervises and enforces building codes and land use regulations;
- modifies existing codes and regulations to stimulate market development;
- designs creative mechanisms to make land accessible and affordable;
- transfers publicly held properties to communities for development; and
- develops and enforces tax policies to encourage investment.

Publicly provided funding should be targeted at creating an environment that is receptive to investment. That role includes supporting the nonprofit community development infrastructure and specialized community lending institutions that will be essential in organizing distressed community markets and laying the infrastructure for wider sources of private funding. In addition, rather than fund projects directly, public monies can be greatly leveraged by identifying and participating in strategic investment opportunities. This might include guaranteeing certain risk tranches on new or innovative investment vehicles until those instruments gain market acceptance.

Benefiting Residents

The idea of creating mechanisms to capture value for community residents is not novel. Examples of such mechanisms include various forms of trusts — land trusts, housing trusts, community trusts, investment trusts and equity trusts. Value-recapture mechanisms also can include shared-appreciation instruments, public-private partnerships and stock options. Other financial structures can also be engineered to support community development activities that benefit lower-income households, depending on the assets in question or legal interests involved.

Communities possess a variety of tangible assets including public buildings, land, parks and reservoirs, transportation infrastructure and the rights to potential revenues arising from businesses' use of those assets. Many of those assets or the rights to revenue accruing from the use of those assets can be channeled to a trust fund to benefit community revitalization efforts. Operating agreements can be established, cash flow can be allocated for designated purposes. This cash flow can be capitalized or securitzed, which means that financing can be available immediately from the capital market. The trust fund structure allows for protection of such cash flow strictly for the purposes for which they are intended.

Moreover, by strategically phasing the development of a site, for example, the property owned by the trust can be positioned to increase in value over the life of the redevelopment program. This process would then provide significantly more funding for the benefit of lower-income residents than simply using the value of the original asset.

A land trust, for example, is a private, nonprofit entity created to acquire and hold land for community benefit. Land trusts are used to develop affordable housing, commercial space and parks while promoting home ownership, historic preservation, local control and community revitalization. A land trust was originally conceived as a democratically controlled institution that would hold land for the common good and make it available to individuals through long-term land leases.

Urban community land trusts are often established to combat the negative effects of speculation and gentrification. Community land trusts are nonprofit corporations with open memberships and elected boards of trustees. While members have a say in policies and activities of the trust, there is no personal ownership of any assets, which the trust may own or control.

Community land trusts are well positioned to tackle complex projects in distressed neighborhoods. They have a unique combination of attributes that enable them to aid in neighborhood organizing and community development and can play an instrumental role in capturing value for lower-income community residents. Community land trusts are only one value-recapture mechanism that could be structured to ensure that lower-income residents benefit from the revitalization of their communities.

Measuring Investment Values

Understanding the long-term potential of a development's full-project horizon is critical to attracting and maintaining private capital. Yet, little is known about either the specific actions and processes that lead to successful long-term community development efforts, or the most effective manner to assess the cash-flow performance of such efforts.

For example, a housing development initiative in which a community development corporation first organizes the community to support a proposed rebuilding effort might be more successful in the long term than an initiative led by a CDC that just constructs units because community organizing might help to eliminate a serious crime problem prior to construction.

The Fannie Mae Foundation has already started work on an aggressive program to better understand how to evaluate various processes for community development so that this information can be formally included in potential-investor prospectus materials. It is studying the utility of several creative methodologies to analyze and model the cash flow characteristics of comprehensive community development initiatives.

A New Approach?

Several features of this approach are new and unique. They include:

- viewing an entire community as a single market with undervalued assets that can be used to attract private capital;
- borrowing successful development practices from suburban and resort community builders for use in distressed communities;
- using proposed value-recapture mechanisms to benefit existing lower-income residents;
- introducing a variety of financial instruments for community development that will appeal to investors throughout the investment-risk spectrum;
- fostering sustainability; and
- developing measures that will enable critical intangible aspects of distressed community revitalization to be built into project financial proformas.

This concept builds on the previous work of experts who view inner-city neighborhoods as rich in assets and capable of attracting new investments. One of the earliest and most significant contributors to the discussion of cities as sources of undervalued assets is Harvard University Professor Michael Porter. Porter's theory, articulated in works on the competitiveness of cities, is that cities possess a variety of assets that if properly utilized can provide a platform for a variety of important business activities.

Undervalued assets, according to Porter, include vacant, abandoned or otherwise underutilized sites in strategic proximity to central business districts, untapped markets with substantial purchasing power, growth opportunities via integration with regional business clusters, and stable and underutilized workforces. Porter has institutionalized his efforts to promote inner-city business growth through the creation of the organization Initiative for a Competitive Inner City (ICIC) and its spin-off, the Boston Advisors Group. These efforts provide important opportunities for industry leaders and business schools to consider, debate and test alternative approaches to capitalize on Porter's concepts of undervalued inner-city assets.

Robert Weissbourg and Christopher Berry, both of Shorebank Corporation, also call for shifting focus from a community's deficiencies to its market opportunities. They cite the need for corporate engagement to be presented as investments rather than subsidies. In a recent paper prepared for the Brookings Institution, Weissbourg and Barry argue that lower-income inner-city communities are often underserved because they have enormous market potential that is frequently undervalued.

The principal impediment to robust economic activity in low-income urban neighborhoods is, in their view, a lack of reliable market information that would enable businesses to better estimate the real buying power in these communities. Shorebank is working on an exciting series of projects to help close this information gap.

A third recent initiative focused on improving inner-city markets is the "Emerging Markets Neighborhood Initiative" being coordinated by The Social Compact and sponsored by the State Farm Insurance Companies, the Ford Foundation, The John D. and Catherine T. MacArthur Foundation and the Fannie Mae Foundation. That initiative seeks to create new sources of business-oriented data and a market-analysis model that will define communities by the their strengths and opportunities rather than their deficiencies and needs. It also seeks to stimulate new business alliances and highlight the effective role of local governments and community organizations in strengthening the market fundamentals that foster sustainable business investment.

Most recently, the White House is developing a New Markets Initiative that is aimed at encouraging increased private investment in distressed communities. Among the Administration's proposals is an America's Private Investment Companies (APICs) effort that is modeled after the Overseas Private Investment Corporation that helps promote growth in emerging markets abroad. APICs would provide equity capital for large-scale businesses in inner-city and rural areas. Other pending activities include expanding the Small Business Administration's New Markets Venture Capital Initiative, by matching private investments with government debt guarantees, and increasing funding for the Community Development Financial Institutions Fund.

These initiatives should be supported and encouraged, as they represent the types of capital that can be leveraged for market regeneration in inner-city and distressed community markets.

Why Now?

This market paradigm seeks to identify and develop the levers that attract investment, so that communities will no longer need to rely on pressuring financial institutions via the Community Reinvestment Act and other regulations to make investments. Enormous potential exists in linking capital markets with lower-income and minority inner-city communities.

Successful strategies could result in the creation of huge new investment opportunities, where the primary and secondary markets, mortgage insurers, institutional and individual investors and others come to benefit from programs traditionally considered the obligation and responsibility of government. While all the details have yet to be worked out, this proposed paradigm shift will hopefully prompt more aggressive thinking about ways to better connect distressed communities to the only true sources of sustainable funding, i.e., the capital markets.

Success at this market-based paradigm could lead to overcoming one of the most intractable problems of this century and set the stage for vibrant and reinvigorated communities in the next millennium. ■

James H. Carr is Senior Vice President, Innovation, Research and Technology, at the Fannie Mae Foundation.