
**TAKING STOCK:
CDFIs LOOK AHEAD AFTER 25 YEARS OF COMMUNITY DEVELOPMENT FINANCE**

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I. INTRODUCTION

Community development financial institutions (CDFIs) as we know them took root approximately 25 years ago in the fertile soil of bank redlining, the Community Reinvestment Act (CRA), and the federal government's shift away from its short-lived Great Society strategy. Although no one thought much about it at the time, CDFIs were an experimental approach to community building and anti-poverty efforts organized primarily around two questions: Could communities without access to conventional finance organize their own financial resources? And, if they did, what difference would it make?

In the time since, CDFIs have succeeded by all obvious measures. A recent sampling of CDFI performance² found that 81 CDFIs managing \$1.8 billion in assets had provided more than \$2.9 billion in financing. They did this with a 1.8 percent cumulative loss rate, consistently low delinquencies, and no losses of investor principle. That financing created or retained more than 137,000 jobs and 121,000 affordable housing units. Though still small by capital market scale, more than 550 CDFIs manage more than \$6.5 billion in assets today—a lot of money in the nation's economically disadvantaged markets. The success of the U.S. CDFI industry is impressive, and it is encouraging similar efforts in the U.K., India, Eastern Europe, and elsewhere—efforts that will benefit from the lessons we have learned.

More important, CDFIs have demonstrated that financing non-conforming customers works if it is done in a way that recognizes the market's and the customers' idiosyncrasies. CDFIs have helped prove several things, many of which now constitute mainstream market thinking:

- that financing women and minority homeowners and business owners is not only possible but profitable, and that race and gender are not reliable indicators of financial performance,
- that conventional ideas about managing financial risk have changed and therefore will change in response to evidence that the un-conventional is possible,
- that managing risk in non-financial and non-traditional ways (such as intensive technical assistance) can work,

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² Data from National Community Capital's Annual Survey of its Members for fiscal 2000.

- that unconventional financial customers are important to conventional financial service companies because they are future customers and solid assets, and
- that community-centered groups can organize capital, manage it responsibly, pair it with organized people, and create measurable changes in communities.

Working just outside the margins of conventional finance and in thousands of economically disadvantaged communities, CDFIs have changed the relationships between financial services and economically disadvantaged people and communities.

CDFIs are the most recent—and in the current environment, perhaps the most promising—iteration of a series of intervention strategies aimed at revitalizing distressed local and regional economies, countering structural and systemic causes of poverty, and creating wealth and opportunities for economically disadvantaged people and communities.³ Because CDFIs are private-sector institutions that leverage mainstream resources, they are well positioned to succeed at the intersection of social policy and financial systems over the next five to ten years.

But while CDFIs have succeeded unmistakably in the obvious ways, some of the people most invested in that success want to know if CDFIs have succeeded in less evident but more lasting ways. This year, *Capital Xchange* has published a series of four papers⁴ by industry leaders that together comprise an important look back and a challenging look ahead at the community development finance industry.

This paper summarizes and reviews the *Capital Xchange* discussion on CDFIs. It provides an assessment of where we've been, what we've learned, and what we need to do in the years to come in order to best meet the needs of underserved people and markets in the changing world of capital and finance.

II. THE CDFI INDUSTRY TODAY

CDFIs are private financial institutions that operate just outside the margins of conventional financial services, linking unconventional customers and markets to the economic mainstream, and vice-versa. The CDFI industry today comprises community development banks and community development credit unions (the depository CDFIs), and community development loan funds and community development venture capital funds (the non-depository CDFIs). These CDFIs finance business start-ups and expansions, housing, and social and cultural institutions, ranging from childcare to community arts facilities. Business finance ranges from microenterprises to mid-sized

³ See Appendix for a short and simple history of the evolution of these efforts.

⁴ Andrews, Nancy, "Equity with a Twist: The Changing Capital Needs of the Community Development Field," April 2001; Moy, Kirsten and Alan Okagaki, "Changing Capital Markets and Their Implications for Community Development Finance," July 2001; Nowak, Jeremy, "Civic Lesson: How CDFIs Can Apply Market Realities to Poverty Alleviation," March 2001; Tansey, Charles, "Community Development Credit Unions: An Emerging Player in Low Income Communities," September 2001.

enterprises. Housing finance includes single and multi-family rental as well as homeownership. Some CDFIs also provide consumer finance.

CDFIs raise capital from institutions (banks, non-bank financial institutions (i.e., insurance companies), government, religious institutions, foundations, non-financial corporations), and from individuals. Approximately 8,000-10,000 institutions invest in community development finance in one way or another⁵. Most are small investors (less than \$100,000 per year). A much smaller number—perhaps on the order of 100—invest more than \$1,000,000. In addition, some 25,000 individuals invest, most through deposits in insured depository institutions (banks and credit unions).

These sources are motivated by regulatory, mission (or social), and/or yield concerns. Regulatory capital is the single largest group, social is second, and yield-driven capital is the smallest. Virtually all community development financing is below-market (risk-adjusted), with the implicit or explicit subsidy helping to cover high-transaction costs, supplemental activities (such as borrower training and market development), and/or work in non-revenue areas such as public policy and advocacy.

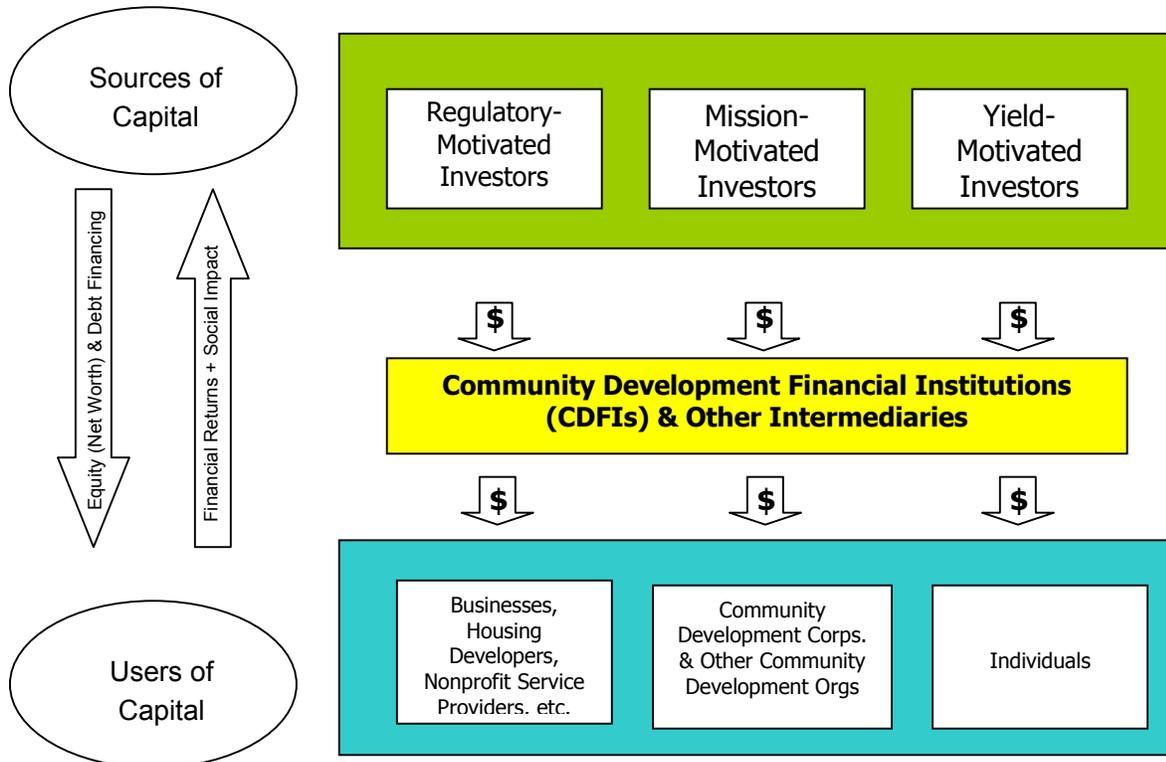
- ✓ Capital motivated by *regulatory* concerns includes banks and other insured depositories subject to the Community Reinvestment Act (CRA); non-insured financial institutions seeking to demonstrate their commitments to community development proactively to discourage imposition of CRA-like coverage on their sectors; and other corporations subject to regulations which directly or indirectly lead to involvement in community development.⁶
- ✓ *Mission, or socially, motivated* capital includes religious investments, government loans and grants, individual investments, foundation program related investments (PRIs) and grants, and socially responsible investments. The Social Investment Forum, a membership association of social investment professionals, recently launched a “1% in Communities” campaign to encourage socially motivated investors to put 1 percent of their investment portfolios in below-market community investments.
- ✓ *Yield-motivated* capital includes capital markets and capital-market type activity. Some community development banks and community development credit unions offer Certificates of Deposit at or very near to market rates. Otherwise, there is little market rate capital in community development.

⁵ These statistics and others in this paper referred to as “approximately” or “about” are the author’s estimates. The information infrastructure for community development finance is limited. Where possible, I have identified sources for data.

⁶ In one instance, an electric utility agreed as part of a regulatory consent agreement to give a small share of earnings to a CDFI for community development projects with sustainable energy activities. The utility did so to help win approval of a merger application. The agreement could generate as much as US\$30 million in equity for the CDFI.

Users of CDFI financing include community development corporations (CDCs); other community-based organizations (e.g., nonprofit corporations, religious organizations and institutions); both for-profit and nonprofit small business owners or prospective owners; homeowners; renters; and real-estate developers.

Simple Illustration of the Relationships Between Sources & Users of Community Development Capital



Community development financial institutions (CDFIs) emerged to fill gaps in financing for economically disadvantaged people and communities. They intermediate between sources and users of capital where and when direct financing is difficult or unavailable. Most often, this occurs because the sources of capital have limited knowledge of the user market and/or the transaction costs are prohibitive. Non-conforming borrowers or investees usually require technical assistance that might range from credit counseling to business planning. These services are un-economical for banks. For many banks, then, managing transaction costs is key to their partnerships with CDFIs.

CDFIs are more than just convenient intermediaries, however. They are value-added partners to both their investors and borrowers. They build the capacity of borrowers and sometimes of whole communities. Their targeted development strategies help foster markets—some sources of capital now see CDFIs as market builders, developing a customer pipeline. In addition, CDFI financing often closes structural financing gaps in deals, allowing mainstream financial institutions to

participate in transactions that otherwise would not have happened. For example, CDFIs routinely finance pre-development and development stages of real estate construction to attract conventional institutions to provide permanent financing. In other cases, CDFIs subordinate their interests to make deals work for banks and other conventional investors. In these ways, CDFIs provide credit enhancements that link conventional sources of capital to unconventional users.

As public purpose organizations, CDFIs make explicit and implicit public promises to produce positive social and economic changes. CDFIs count beyond the bottom line to demonstrate the impact of their work, although there is no widely accepted or used methodology for this. Finally, CDFIs also advocate on behalf of their customers (borrowers and investees) as well as the communities they serve. This ranges from making investors more responsive, to speaking out on policies that affect their markets.

The CDFI industry we know today grew out of the convergence of several factors over the past 40 years:

- *Changes in the financial services industry* that diminished the role of banks, increased the role of non-bank financial institutions, decreased local financial intermediation strategies, increased international money flows, emphasized asset conformity, and left smaller, unconventional financial markets gasping for capital.
- *Ideologically and financially motivated efforts to reduce government's role in social services and social change*, weakening "safety net" services, and increasing demand for extra-governmental solutions. This led eventually to a new approach for government as a sort of angel venture capitalist for "third sector" market interventions, including CDFIs.
- *The emerging economic importance of diverse demographic customer bases*—generally, women and minority borrowers, investors, savers, and transactors. This is part of the broader and still incomplete trend of political and economic mainstreaming of racial and gender equality.

CDFIs have ridden a wave of circumstances, opportunity, and skill to a measurable degree of economic influence, particularly when viewed through local—rather than global—market lenses. Disintermediation of local financial markets through the 1980s and much of the 1990s opened market niches for CDFIs. At about the same time, policy changes helped meet CDFI demand for capital by encouraging banks working under the Community Reinvestment Act (CRA) to invest in and lend to CDFIs. An unfunded 1991 initiative championed by President George Bush was re-invented as a model President Bill Clinton initiative in 1993 that led to the CDFI Fund, a key federal force in CDFI growth. Just prior to creation of the Fund in 1994, there were half as many CDFIs as there are today managing one-third the assets.

Growth notwithstanding, the CDFI industry and the broader community development finance system remains “informal and unorganized”⁷ compared to capital markets. Unlike conventional markets, the community development finance system lacks such key components as:

- ✓ A well-developed investment banking function to structure financing,
- ✓ Financial products that offer investors a full range of products appropriate to risk,
- ✓ Investment vehicles to diversify risk,
- ✓ Widely available and easily accessible information about CDFI performance,
- ✓ Ratings systems to provide information to prospective investors, and
- ✓ A layer of brokers and salespeople.

The system today is almost entirely a primary market, with minimal secondary market activity and almost no sustained links to capital markets. The CDFI industry lacks the conformity of products⁸, scale of activity, and financial incentives needed⁹ to pursue securitization and secondary market activity more aggressively.

III. THE CAPITAL XCHANGE SERIES

The four *Capital Xchange* articles grapple with these issues, and offer suggestions on how the industry might respond. The series was not intended to capture everything that CDFI practitioners have learned over 25 years. It nonetheless does a good job of drawing out four of the more important issues that CDFIs must address to continue the momentum built over 25 years or more of experimentation:

- ✓ What role(s) should CDFIs play?
- ✓ How should CDFIs relate to larger, mainstream systems and structures?
- ✓ Is product innovation key to the industry’s future success?, and
- ✓ Does CDFI type, or structure, matter? Are certain CDFI types more important than others going forward?

The papers in the *Capital Xchange* series point forward in contrasting ways. The papers overlap little, save perhaps for their common assumption that the CDFI industry could achieve more than it currently does.

⁷ Davidson, Steve C., “Financial Markets and the CDFI Industry—An Oversimplification.” National Community Capital Association, Philadelphia, PA. 2000.

⁸ As a reflection of the customer-specific nature of community development finance, there is very little conformity from transaction to transaction, let alone across organizations.

⁹ In one subset of the community development finance system—National Community Capital’s membership—CDFIs have steadily grown assets by more than 40% per year for six years while deploying virtually all new inflows, lowering their cost of capital to 2%, and keeping defaults low at less than 1.5% on almost US\$2 billion in financing.

Two fundamental questions CDFIs have asked explicitly and implicitly over the past 25 years or so are (1) whether there is a market gap between conventional financial services and government and, if there is, (2) whether non-conventional financial institutions can fill the gap. The answers to those two questions appear to be “Yes, and it’s growing” and “No, certainly not alone.” The second answer raises other, equally important questions: If CDFIs cannot do this alone, with whom do they need to partner? And what must they do to change?

Jeremy Nowak¹⁰ makes the case for CDFIs as civic intermediaries in mainstream regional economies.¹¹ Drawing on the experience of the CDFI he runs, he suggests that CDFIs can play a much larger and more public role than most currently do. He envisions a role for CDFIs in bridging social, political, and infrastructure gaps that constrain regional economic growth. (“CDFIs have an opportunity to become an important part of the civic networks that mediate between low-income people and economic growth. They are, of course, only one source for these networks.”)¹² Nowak suggests that CDFIs can leverage much larger institutions, ranging from government to banks to private industry.

As financial intermediaries with community development missions, CDFIs tend to operate both in the worlds of wealth and poverty and the worlds of large organizations and small groups. Nowak believes that CDFIs that operate regionally, but probably not those that operate locally (i.e., in select neighborhoods), can be effective civic intermediaries. (“We need new kinds of civic institutions that can maximize the connections between regional economic growth and low-income households.”)¹³ Using as a model the CDFI that he leads, The Reinvestment Fund, he makes a compelling case that a CDFI can play this role as well as, if not better than, other institutions. He identifies three “focal points” for CDFI growth: financial product depth, information intermediation, and expanded mainstream relationships.

Nowak envisions CDFIs as levers of structural and systemic change organized around poverty alleviation *and* economic growth strategies. Implicit in this vision is Nowak’s “so what?”. What has the CDFI industry accomplished if there are only a handful of CDFIs positioned to take advantage of the convergence of social, economic, and political trends that he describes? Today, few other CDFIs have the civic, political, and financial assets that Nowak describes, and, of course,

¹⁰ In the sometimes-cozy confines of the community development finance field, people and organizations overlap and conflicts of interest abound. In fairness to the reader, I must disclose that Jeremy Nowak runs a CDFI that is a member of the organization I lead, National Community Capital; Nancy Andrews does the same, and she also is a member of NCCA’s Board of Directors; and Kirsten Moy and Alan Okagaki did much of the research for their paper through a project that used National Community Capital as its fiscal agent.

¹¹ As with all of my summary information about the four papers, I’m oversimplifying here. I’ve made every effort to accurately represent the author’s ideas, and I apologize for any misrepresentation that may result. Readers should refer to the original papers for complete accuracy.

¹² Nowak, p.9.

¹³ Nowak, p.2.

the Reinvestment Fund's strategy is still a work in progress. Is civic intermediation an effective strategy for many CDFIs? Or is it an idiosyncratic solution that works for The Reinvestment Fund?

Kirsten Moy's and Alan Okagaki's article more directly questions what 25 years of CDFI industry growth has amounted to. Moy and Okagaki find the CDFI industry in a "precarious position."¹⁴ They believe that seismic shifts in CDFI operating environments mandate that the CDFI industry "re-engineer, reposition, and re-tool"¹⁵ itself in order to be viable in the 21st century. In brief, Moy and Okagaki argue that CDFIs must conform to existing, conventional capital market systems to ensure an adequate supply of capital to economically disadvantaged people and communities. Like Nowak, they urge action and encourage expanded mainstream relationships. Unlike Nowak, Moy and Okagaki seem to suggest that CDFIs should play more compliant roles: It's time to get serious about fitting our systems into more conventional systems.

Moy and Okagaki focus on the operational and financial changes CDFIs must make to channel the vast resources of the capital markets and mainstream institutions into community development. They explain how the macroeconomic and microeconomic changes over the past 20 to 30 years have fundamentally altered the operating environment for community development. ("While the CDFIs of the 1970s were well adapted to their time, subsequent policy shifts and financial industry restructuring have undermined their early conceptual foundations.")¹⁶ In short, they argue that CDFIs must align themselves more closely with capital market institutions (i.e., technical sophistication and scale efficiencies) and with capital market needs (i.e., volume and standardization). "Thus we believe the fundamental issue for CDFIs is not just growth ... but also enhancing core capabilities, niches, and positioning vis-à-vis conventional capital markets," they suggest.¹⁷

They are right in theory. Financial services and social policy have gone through a series of quantum changes over the past 25 years. And CDFIs are in a "precarious position." Most practitioners would argue that they ought to be, although perhaps not in the way that Moy and Okagaki describe. CDFIs live life on the edge—they strive to always be on the leading edge, but Moy and Okagaki characterize them on the lagging edge. Some—perhaps too many—CDFIs are in precarious positions because of stagnation, over-caution, weak market analysis, poor strategic thinking, and economic models that are difficult to sustain. The industry is still maturing—50 percent or more of CDFIs working today have been around for less than a decade. In general, though, the CDFI industry has never been stronger in capitalization, portfolio performance, public perception, government relations, and positioning vis-à-vis conventional finance. For many in the private and government sectors, CDFIs represent the leading edge in financing for economically disadvantaged people and communities.

¹⁴ Moy, p.11.

¹⁵ Moy, p.2.

¹⁶ Moy, p.6.

¹⁷ Moy, p.11.

The issues Moy and Okagaki raise are important; the CDFI industry has been debating and wrestling with them for at least the last decade. Their fundamental thesis resonates with everyone trying to build an infrastructure capable of supporting an expanded CDFI industry, as my organization does. (A key point Moy and Okagaki make is that the presence of an infrastructure is evidence of widespread use and acceptance of a system, and that the CDFI industry lacks key infrastructure components.) Their assumption that the way this must happen is for CDFIs to internalize and adapt to the needs of the capital markets does not sit well with many CDFI practitioners, however.

There is structural and permanent tension between the non-conforming, idiosyncratic, labor-intensive character of community development financing—on the one hand—and the efficiencies and scale of capital market operations—on the other. I wish I had a nickel for each time someone from Wall Street told me that they could bring billions of dollars to the CDFI industry if only we would offer a liquid, market-rate product and someone from the CDFI industry told me that Wall Street investors would invest in an illiquid, below-market instrument if we only marketed our social impact better.

It may seem remarkable that CDFIs have been as successful as they have at attracting substantial amounts of new, inexpensive financing to community development. The National Community Capital CDFI sample, for example, grew by about \$600 million in assets in FY2000 while keeping the cost of capital low—just 2.1 percent (that was still very low in 2000, although it doesn't seem so low today).

For most CDFIs, changing the behavior of wealth holders is central to their purpose. They are advocates for their borrowers and investees. If CDFIs saw themselves simply as delivering conventional financial products to economically disadvantaged people and new markets—in other words, if they saw only an “access to capital” problem—they would embrace Moy and Okagaki's premise. Because their experience tells them that the problem is more complex—involving capacity constraints, rate and term limitations, and sometimes bias and misunderstanding—they see themselves as activists as well as financial pipelines.

Moy and Okagaki are grappling with the interlocking problems of scale vs. individual customer needs, commoditization vs. customization, and supply vs. demand. It is the challenge of intermediation, and CDFIs are without doubt constrained by their resistance to capital market compliance. Just the same, CDFI leverage derives from CDFI alignment with community needs instead of capital market demands.

Nancy Andrews' article focuses on how product innovation to meet a unique market need is a key to increasing CDFI market leverage and impact. Nowak and Moy-Okagaki raise the issue; Andrews tackles it. Her detailed example of “equity with a twist” spotlights several issues central to the future of the CDFI industry.

Andrews offers insight into how a CDFI adapts its financing products to meet community needs and, in the process, conveys why the CDFI outlook is in conflict with Moy's recommendations. She describes how her CDFI, the Low Income Housing Fund (LIHF), solved a borrower's needs for equity-like capital (risk-tolerant and patient). The borrower, Rubicon, is a Richmond, CA, nonprofit business providing high-end baked goods nationwide while employing and training primarily homeless people. Rubicon builds its employees' skills and assets. Its high operating costs erode profit margins, however, leaving it constantly short of cash.

LIHF ultimately provided what Andrews calls "equity with a twist" by providing a three-year, unsecured working capital loan at a reasonable rate with minimal oversight. While *this* product met *this* borrower's needs, Andrews points out that, "The community development finance field has not yet crafted all the needed financial instruments to support the many capital gaps in the field."¹⁸ Her paper is a good example of and a call for product innovation.

Andrews calls attention to several key issues:

- *First*, while three years is good, longer-term is better. Andrews notes that LIHF has done 10-year working capital loans. The tension, of course, is that most investors (certainly conventional investors) want liquid investments with risk-adjusted yields—higher returns for higher perceived risks. CDFIs tend to offer illiquid investment opportunities with below-market yields.
- *Second*, CDFI transactions require innovation. Not all deals are idiosyncratic, but most are. Standardization and conformance are elusive.
- *Third*, Andrews suggests, in the spirit of CDFI finance, that LIHF could make the loan affordable because its mission allows it to take some return in social impact rather than financial yield. Yet, she acknowledges, there is no generally accepted method for assessing or describing impact.

The most recent article, by Charles Tansey, makes a compelling case for expanding community development credit union (CDCU) capacity to fill market gaps on both the asset and liability side of the balance sheet. Tansey provides an insightful look at the promise and problems of CDCUs. He describes a series of steps that could help CDCUs expand.

Tansey sees enormous potential in community development credit unions (CDCUs), but his paper conveys equal shares of disappointment ("So what?") and promise ("What's next?"). To many CDFI aficionados, CDCUs seem to be a conceptually pure form of community development financial institution. They provide financing, savings, and checking services to people who might not be able to obtain it elsewhere, as well as lifeline financial services (such as deposit taking, bill payment,

¹⁸ Andrews, p.10.

etc.). CDCUs also are member-owned cooperatives and so represent a structural commitment to social capital.

With more than 500 “low income credit unions” and thousands of conventional credit unions in business, CDCUs also would seem to provide a promising mechanism for the kind of volume and scale of conforming products that could link to capital markets, as Moy and Okagaki encourage.

So why, Tansey asks, don’t CDCUs leave a bigger footprint on the community development financial service landscape? And why isn’t the CDFI industry doing more to build the capacity of existing CDCUs and increase the number of new ones? (CDCUs “may be the best replicable model for providing affordable capital and financial services in low-income and very low-income areas. Why can’t there be more of them?”)¹⁹ He offers a multitude of reasons—too many, in fact, to draw a conclusion, although he hints most strongly at the economics of CDCUs (particularly, the difficulty many CDCUs have paying wages that make employment sustainable).

Many CDCUs play essential roles in their local markets, roles that no other institutions are trying to fill. Yet the cost of success is often hardship. The structure, culture, and economics of these cooperatives make them self-reliant but also make them difficult to sustain and grow. Like most other CDFIs, CDCUs seem to suffer the problem of “widget economics”—they lose only a penny per widget but make it up in volume. Because of their legal structure, they have a difficult time raising funds from foundations, a strategy that sustains the growth and expansion of many other types of CDFIs. Finally, CDCUs depend heavily on sweat equity from the membership, and that is hard to sustain in the very difficult job of running a credit union.

CDCUs, and Tansey, suggest answers to several questions the “Capital Xchange” series raises. Clearly, CDCUs demonstrate that communities without access to conventional financing can organize their own financial resources. CDCUs also provide evidence that there are significant market gaps between economically disadvantaged communities and the conventional financial services industry. One visit to CDCUs in the rural southeast or southwest proves the point.

In addition, CDCUs suggest that the differences CDFIs alone can make sometimes amount only to preventing further decline. In areas where CDCUs operate in isolation, without mainstream financial partners or competitors, they often can do nothing more than provide the first step on a ladder of economic growth and opportunity that is missing the rest of its rungs. Whether the CDCUs can be faulted for that is an open question. CDCUs often exist because there is no other financial infrastructure; yet some CDCUs and other CDFIs have succeeded in stimulating and generating growth that attracted partners and competitors.

CDCUs provide several products and services that are irreplaceable. To respond to many community development finance challenges, though, CDCUs are neither well positioned nor equipped. Most CDCUs have a hard time providing equity financing, for example, and large-scale

¹⁹ Tansey, p.2.

project financing. And CDCUs historically have not partnered with banks and other mainstream financial institutions, in part because many bankers see credit unions as competition. There are admirable exceptions to all these reasons, however, such as Alternatives Federal Credit Union in Ithaca, NY, Self-Help Credit Union in Durham, NC, and Santa Cruz Community Credit Union in California.

These four articles have taken stock of the CDFI industry and offer insight into how it might find its niche in a changing market. So what have we learned from our past that can help us to shape a successful future?

IV. LESSONS FROM 25 YEARS OF CDFI EXPERIENCE

Few, if any, CDFI practitioners ever considered their work an experiment. They may have thought they were taking on a new sort of community organizing, they may have set out to prove banks wrong, or they may simply have accepted at face value that economically disadvantaged people and communities needed something they could not get anywhere else. Nonetheless, taken together, CDFIs have constituted an experiment, and by the late 1990s, a growing number of CDFI industry leaders began to recognize that we had, in fact, learned some important lessons.

The overarching lesson is that an effective community development finance system must work just outside the margins of the conventional financial system, while constantly striving to generate change in mainstream ideas and practices. This speaks both to role and positioning.

From just outside the margins, development finance links economically disadvantaged people and communities to the economic mainstream, and vice-versa. To succeed from the margins, community development finance must hold substantial resources and power yet remain nimble, as the margins shift constantly. Community development finance aims to change conventional ideas about risk, requires innovative partnerships with mainstream institutions, and seeks to influence the behavior of institutional and individual wealth holders. To do these things, the community development finance system must be equally facile in both the mainstream marketplace of wealth and the more populous world of economically disadvantaged people and communities.

In the late 1990s, banks moved downstream in the credit markets as the sustained U.S. economic boom resulted in high levels of prime credit market saturation. Eventually, the banks found themselves competing for deals with CDFIs that they had helped to finance (capitalize) or fund (provide grants to). This set off a push-and-shove match between banks and CDFIs, with each insisting that the other get out of their respective markets.

CDFIs had little choice but to declare victory and move on. The victory was that CDFI financing in unconventional markets had helped persuade the banks and other conventional lenders that their perception of risk was wrong, and that community development financing could be profitable and prudent. Moving on meant identifying new target markets just outside the margins of

the banks. This adjustment took less than a year and pushed CDFIs to find and develop new markets, such as child care facilities, charter schools, and emerging business sectors.

CDFIs need to understand that they cannot and will not replace or compete with conventional financial institutions, which will always have more resources. Nor can they replace government financing. Government will always have “better” resources (i.e., grants), and more of them.

CDFIs can leverage systemic change by influencing the behaviors of larger, more mainstream, institutions. This is the idea behind Nowak’s civic intermediation, and it is related to Moy and Okagaki’s effort to make better use of capital markets. CDFIs leverage change in three ways:

- By demonstrating through their financing that conventional wisdom is wrong (i.e., that financing women and minority homeowners and business owners is not only possible but profitable, and that race and gender are not reliable indicators of financial performance).
- By advocating on policy issues—particularly those involving financial services—at the local, regional, state and national levels. In some circumstances, particularly those involving financial services, CDFIs are effective advocates because they are accomplished practitioners. For example, Self-Help, a CDFI with a credit union and a loan fund, has led national advocacy leadership against predatory lending.
- By organizing civic coalitions around poverty alleviation strategies, as The Reinvestment Fund is doing.

The second lesson is that community development finance has focused not so much on innovating *new* products and strategies as on *adapting* conventional products and strategies to unconventional—or, non-conforming—markets. Almost all of the major innovations in community development finance in the U.S. were, in fact, ripples resulting from earlier changes in more conventional systems. Community development finance is primarily a delivery strategy.

Community development lending grew from the realization that the credit boom of the 1960s was not reaching many communities because of a bank practice known as “redlining.” Banks literally drew red lines on maps around neighborhoods they thought presented unacceptable risks. The Community Reinvestment Act of 1977 (CRA)²⁰ was the federal government’s response to this practice. Absent the widespread availability of credit, the discrimination would have been much harder to identify and correct. Similarly, housing finance as a community development strategy began in the late 1960s, echoing the homeownership boom for mainstream families through the 50s and 60s. Business finance as a community development strategy blossomed in the early- to mid-1990s, more than a decade after the explosion of consumer paper issues, junk bonds, and other

²⁰ 12 United States Code 2901.

creative business financing techniques hit the mainstream economy. Even community development venture capital financing, which blossomed in the late 1990s, is largely an echo of the aggressive growth of conventional venture capital financing in the high-tech and other sectors.

Andrews' paper demonstrates that effective innovation can come from adaptation. Indeed, LIHF's "equity with a twist" leverages a conventional product (a long-term working capital loan) that CDFIs had previously used to finance for-profit businesses.

The third lesson is that CDFIs are not and must not be prefabricated institutions; they are customized responses to distinct and unique market conditions. When President Clinton's staff set out in 1993 to design a federal program to support CDFIs, their first lesson was that diverse CDFI types exist to meet local market conditions. The traditional government approach of creating a model and replicating it would not work.

The success of The CDFI Fund is directly tied to this understanding. The challenge this presents is to identify common traits and practices without squashing distinctive qualities and activities.²¹

CDFIs should once again look to and borrow from conventional financial services to anticipate how their institutional structures can best serve their missions going forward. There is a reason the banking industry does not look and function like it did 25 years ago. The macroeconomic changes that Moy and Okagaki identify have driven banks away from "banking" as it once was. Twenty-five years ago, deposits and portfolio lending were the organizing activities for most banks. Today, fee-based services are. Banks and non-bank financial service companies (ranging from investment managers to insurance companies to pension funds) are rapidly converging. The 1999 financial modernization law was a reaction to changes that had already occurred. The revolution it promised had already happened.

This suggests that insured depository CDFIs might not be as appealing as they seem. Much as check cashers have superseded banks and credit unions in many economically disadvantaged communities, "community development financial service centers" may soon provide neighborhood portals to financial services. These centers could offer products from multiple suppliers (i.e., CDCUs, community development banks, and conventional banks on the savings side, and all of the above plus community development loan funds and community development venture funds on the financing side). Imagine quicken.com in a storefront. (Indeed, community development financial services may be possible via the Internet, if Internet access is widely available through community institutions such as libraries.)

²¹ In "Best Practices for CDFIs: Key Principles for Performance" (1998), National Community Capital tried to reconcile this tension by identifying 15 "performance principles" that are common to all CDFIs (i.e., "The CDFI has a clear, realistic, and compelling mission to guide its activities."), while recognizing that the best practices for individual CDFIs may vary within each principle.

Depository institutions have a significant advantage when it comes to borrowing capital, of course. In the capital markets, however, banks have lost market share to mutual funds, pension plans, and other investment vehicles. Non-depository CDFIs are already raising substantial sums without deposits, but to continue their aggressive asset growth they will have to tap new investor markets using innovative new investment vehicles. The challenge is reaching capital market-oriented investors with capital-market like instruments that lack capital-market liquidity and yield. It won't be easy, but it can be done.

The fourth lesson is that the supply of community development capital often generates its own demand and so CDFIs must supply substantial and ambitious flows of capital to economically disadvantaged markets. The historical lack of capital in these neighborhoods may reflect the depressed nature of most economically disadvantaged economies or the lowered expectations of people and communities that have been systematically excluded from the financial mainstream, or both.

Community development that is capital-driven seems to have several unique characteristics. It is disciplined, sustainable, agile, and focused. This is not always true, of course, as some CDFIs are not well managed. But capital-driven organizations must balance investor and community accountability, operate at arm's length from both, and steward scarce resources responsibly.

The nature of the capital matters, as well. Community development requires the longest possible term and lowest possible cost capital. Based on National Community Capital's network of CDFIs, the term of borrowed capital grew longer and the cost went down steadily over the past decade. At fiscal year-end 2000, for example, the average term of borrowed capital was 115 months (more than 9-1/2 years) and the weighted average cost of capital was 2.1 percent.²² This is where CDFIs and Wall Street stumble and fall when they try to dance together.

The fifth lesson is that financial capital drives community development finance in the U.S. only when it is coupled with human and intellectual capital. No amount of capital flows alone can make sustained positive differences in distressed markets and local economies. In fact, substantial flows without commensurate, targeted development services to build the capacity of borrowers and strategic management to keep CDFIs on track have consistently produced negative results in these markets. Oddly, perhaps, money alone will not alleviate poverty; money plus expertise might. Fortunately, capital attracts talent.

Development services are expensive. CDFI's "efficiency ratios" (the cost to provide \$1 of financing) cannot compete with that of conventional lenders and equity investors, in part because

²² For a more detailed analysis, see "Inside National Community Capital's Membership: 1999 Statistics and Information." Available from National Community Capital at www.communitycapital.org or by writing NCCA, The Public Ledger Building, Suite 572, Philadelphia, PA 19106, U.S.A. Also of interest may be a report on the U.S. community development venture capital field, "No Exit: The Challenge of Realizing Return on Community Development Venture Capital Investments," prepared by Boston Community Capital. Available from BCC, 56 Warren Street, Palladio Hall, Boston, MA 02119, U.S.A.

their transaction costs are so high. This fact drives the need for subsidy (both as below-market capital and as grants). It is a barrier to closer CDFI alignment with conventional markets.

The sixth lesson is that community development finance in the U.S. is fundamentally a poverty alleviation intervention, with goals ranging from wealth creation to civic revitalization to social stability. Whether the goal is to increase access to credit, encourage savings, create jobs, foster healthy communities, or something else, community development finance seeks to counter social, economic, and political patterns and behaviors that make and keep people poor.

The CDFI industry is increasingly sophisticated, but the basic idea remains the same—to make capital available to people systemically excluded from mainstream financing so that they can improve their economic standing and, perhaps also, strengthen their communities. People are excluded for a range of reasons—most often race or gender; sometimes language or lack of formal education; at times because conventional institutions overlook them.

As Andrews points out, however, there is no effective or accepted methodology of assessing whether CDFIs are having their intended impact. Within the industry, there is growing recognition that future financial support for CDFIs will hinge on the industry's ability to articulate precisely what impact CDFIs strive for and the extent to which they are achieving their goals. With prodding and support from major industry investors, several CDFIs such as Coastal Enterprises in Maine and Enterprise Corporation of the Delta in Jackson, MS, have done longitudinal impact analyses that suggest positive impact. Everyone involved agrees, however, that large, longitudinal studies are too cumbersome to meet the need.

National Community Capital is adapting a model used by microenterprise lenders in developing nations to track and improve impact. Called "Practitioner-based Impact Assessment" (PIA), this methodology attempts to quantify qualitative information provided by CDFI borrowers and investees to measure impact trends. For example, a CDFI financing businesses to create living wage jobs might ask the businesses monthly whether its employee compensation is higher, lower, or the same as it was the month before. This approach is intended to improve impact, not prove it. Others are also working on impact assessment models.

The seventh lesson is that community development finance requires an advocacy voice that speaks of and from the experience gained working effectively in unconventional markets. Ultimately, community development finance is just a means toward an end, and it does not operate in isolation from larger systems. As Bruce Katz of The Brookings Institution has pointed out, federal spending on transportation has a more profound influence on patterns of poverty than all of the community development financing ever carried out in the U.S. The community development finance field cannot afford to ignore this fact. In addition, the predatory lending practices of some financial institutions can do more harm to economically disadvantaged people and communities than community development finance can do good. Because community development finance practitioners work in many of the same markets as predatory lenders, they are particularly effective advocates for responsible lending.

The community development finance field cannot afford to limit its policy focus just on creating and accessing government sources of capital. It must find ways to leverage its experience and credibility to change the policies that keep rich people rich and poor people poor. This ranges from financial service policies such as CRA to tax policies to education reform.

In addition, community development financial institutions and other players in the field must recognize the political potential of their work. A CDFI can speak for and organize not just its borrowers, but also its investors, local elected officials involved in community development, the workers who benefit from their financing, and the people in communities that benefit from the CDFI's work. It is a wide and powerful circle of influence that the field underutilizes today.

Nowak's concept of civic intermediation is one way of approaching advocacy, but it does not replace it. Civic strategies may have advocacy, or political, components, but CDFI advocacy needs to extend beyond proximate interests to broader policies that shape markets in profound ways.²³

Finally, ***the eighth lesson*** is that performance matters. Resources for community development are scarce and miniscule in comparison to the size of the problem. Everyone involved in community development finance should understand that performing poorly is never an option. At the same time, because the field must work with both conventional institutions (financial services and government) and economically disadvantaged people and communities, it must be credible in both. Effective CDFIs and other community development organizations have no choice but to meet high expectations in these widely differing operating environments.

A demonstrated track record of performance opens doors. The unknown CDFI field was able to shape the federal CDFI Fund to its liking because it was a credible advocate that could point to real successes and speak honestly about its limitations and shortcomings. CDFIs rely on their performance records to help prospective non-governmental investors make the decision to invest. It matters to all investors that we can speak about low default and delinquency rates coupled with high capital deployment rates.

²³ The most important question about CDFIs that I have heard in a long time grew out of a discussion on the roles CDFIs might play in combating predatory lending: Is the role of CDFIs to change markets or to change policies? While CDFIs clearly can and do change markets at some levels, their greater clout is in leveraging policy changes. Within the context of capital markets, CDFIs are tiny. Capital markets are not inherently democratic. But within the equally expansive world of politics and policy, CDFIs have several distinct advantages. Because they are financial institutions, they are more credible in certain debates than other community-based organizations; but because they are community-based and public-purpose institutions, they are less suspect than conventional, profit-oriented institutions. Because they operate in between the partisan fissures of local, regional, state, and national politics, they come to the debate without ideological constraints. For many years, CDFIs said they achieved Democratic goals using Republican means. But the extra-partisanship goes further. In the network of financial, civic, and social relationships that CDFIs must maintain, there is an eclectic mix of ideological and partisan interests and relationships. Politicians recognize this immediately, even though CDFIs tend to overlook the potential leverage this gives them.

Most of all, good performance matters to customers. Economically disadvantaged people and communities have a right to expect the highest quality service and products from all the organizations that want to serve them, including community development finance organizations.

V. THE NEXT FIVE TO TEN YEARS

The CDFI industry is poised for significant growth and impact. That growth will require new strategic relationships (CDFI roles and market positioning), product innovation and sophistication, institutional growth, and infrastructure.

The next five or ten years will be more difficult, more complex, and—likely—more painful than the past decade, if not the past 25 years. CDFIs face some tough challenges:

- Managing through economic turbulence after almost a decade of smooth sailing;
- Adapting products to rapidly evolving markets and market conditions;
- Re-thinking its capital and development services delivery systems in response to the kinds of seismic shifts that Moy and Okagaki describe;
- Defining productive relationships with mainstream institutions, notably banks, other financial service companies, and government (federal, state, and municipal); and
- Justifying their continued existence by documenting, articulating, and communicating the impact they are having.

As recently as five years ago, many—if not most—of the people working at CDFIs assumed that their institutions would eventually work themselves out of business, to be replaced by something better. No one knew what would follow. That assumption has dropped away, however, as industry leaders have demonstrated the potential for CDFIs to play lasting roles in poverty alleviation and social justice efforts. Today, CDFIs assume ongoing, indefinite roles for themselves.

Not all CDFIs can, or should, live indefinitely, however. The financial and human resources that CDFIs consume are limited. Most significantly, community development finance requires subsidy, and while there is plenty of philanthropic intent among institutions and individuals, the cost of finding, mining, and extracting that scarce commodity will eventually reach a point of diminishing returns. Before it does, CDFI investors and funders will make choices about how to allocate their subsidy. Indeed, they already are doing that. Strategy is the art of saying, “No.” In a time when expectations are growing faster than subsidy, CDFIs are coming face-to-face with the four strategic questions raised by the Capital Xchange series:

- ✓ What role(s) should CDFIs play?

- ✓ How should CDFIs relate to larger, mainstream systems and structures?
- ✓ Is product innovation key to the industry's future success?, and
- ✓ Does CDFI type, or structure, matter? Are certain CDFI types more important than others going forward?

Individual CDFIs are crafting their own strategies. As in the past, many of these strategies will gain recognition and replication by other CDFIs. Across the CDFI industry, eight strategic themes will guide the progress CDFIs make individually and collectively:

1. Strengthening structural ties to mainstream financial systems by vertically integrating itself into the financial services industry while maintaining its focus on poverty alleviation and community development. This will require CDFIs to:

- ✓ Extend and expand strategic partnerships with mainstream financial institutions that align their interests with ours. The New Market Tax Credit may be effective at bringing new investors into the CDFI market and redefining the ties between investors and CDFIs.
- ✓ Invest in new systems development, particularly things that make it easier (i.e., more transparent and less expensive) for prospective new investors to enter the CDFI market. National Community Capital has developed a CDFI Assessment and Ratings System (CARS) that may prove useful. In addition, an international collaboration that grew out of the World Economic Forum is attempting to create a Global Social Investment Market that organizers expect to involve CDFIs. Finally, the CDFI Data Project (a collaboration of 13 organizations) is beginning to help gather, analyze, and disseminate information about CDFIs.²⁴
- ✓ Provide investors with products that include incentives to increase their engagement with CDFIs. The Equity Equivalent (EQ2), a product National Community Capital developed in partnership with Citigroup in 1996, gives banks leveraged CRA credit in exchange for taking more risk and providing long-term financing.²⁵ We count more than \$90 million in bank EQ2 investments in CDFIs today. We have also been developing products targeted at socially motivated investors that offer near-market yields but provide CDFIs with affordable, patient capital.

²⁴ The CDFI Data Project participants are Aspen Institute, Association for Enterprise Opportunity, The CDFI Coalition, The CDFI Fund, Community Development Venture Capital Alliance, Corporation for Enterprise Development, The Ford Foundation, The John D. and Catherine T. MacArthur Foundation, National Congress for Community Economic Development, National Federation of Community Development Credit Unions, National Community Investment Fund, and Neighborhood Reinvestment Corporation.

²⁵ For more information, please see our web site at www.communitycapital.org/TKTK.

- ✓ Work with investors and prospective investors to provide expertise that helps them integrate CDFI financing into their investment strategies.

2. Making CDFI poverty alleviation strategies integral to federal, state, and local policy as well as to private sector reforms of the financial services industry. This will require CDFIs to:

- ✓ Preserve and improve the CDFI Fund. Congressional appropriations dropped from \$118 million in fiscal 2001 to \$80 million in fiscal 2002. While this represents a gain over President Bush's \$68 million FY2002 request, it is inadequate. Demand for these funds is more than triple the supply. In addition, CDFIs are likely to play expanded roles as a result of the 2001 recession.²⁶
- ✓ Help implement the New Markets Tax Credit so that it is an effective tool for CDFIs and others to channel new sources of capital into poverty alleviation strategies.
- ✓ Help keep the Community Reinvestment Act strong as it goes through a scheduled review, which started in mid-2001. The 1995 CRA revisions significantly increased opportunities for CDFIs.²⁷

²⁶ Since 1980, government's role in poverty alleviation and community development has been uncertain and unreliable. What played out through the 1980's largely as a partisan battle between "more" and "less" funding for anti-poverty, housing, and social programs, emerged in the early 1990s as a different approach.

The CDFI Fund became a model for something different. The CDFI Fund model puts government in the role of seed venture capitalist in ventures that balance public purpose and private discipline—CDFIs. In the process, it suggested that government can invest in business strategies rather than projects, and local market expertise rather than government cookie-cutter approaches. The CDFI Fund became a model for a unique kind of public-private partnership in poverty alleviation and community development that wedded the local with the national and public with private.

²⁷ Until 1995, CDFIs were not mentioned in CRA regulations. Today, CDFIs are often favored partners in CRA partnerships. As the bank regulatory agencies begin a 2002 review of CRA, opening this particular Pandora's box of issues, there may be as much risk in doing nothing with CRA as in making significant changes.

The fundamental problem dogging CRA is that it has failed to keep pace with the times. In the 25 years since CRA became law, the financial services industry has gone through several revolutions. CRA, however, still rests on the same foundation: deposits. When the law was enacted, deposit taking was a core business (arguably the main business) of banking. Because banks enjoyed the advantage over non-bank financial institutions of deposit insurance, the banks had an edge in borrowing money.

Of course, that was before inflation and regulations on what banks could pay for deposits drove savers into money market funds, cash management accounts, and other investment vehicles. It also preceded the shift in banking from "spread"-based products to fee-based products. In short, deposits no longer drive banking.

The first step to modernizing CRA would be to shift the emphasis away from deposits. The second step would be to transpose the notion that CRA is tied to the implicit government subsidy of deposit insurance to the notion that it should be tied to any government subsidy—implicit or explicit—that banks and other financial institutions receive.

A modern CRA, then, might allow all financial institutions to choose their markets without geographic restrictions (much as a credit card bank can mail its card offerings anywhere). Its assessment area—that is, the area in which it is required to meet CRA responsibilities—would be its market area. All financial service companies that operate with the assistance or benefit of government subsidy—implicit or explicit—would have to meet CRA responsibilities.

- ✓ Increase state-level support for CDFI-related financing, including direct CDFI support, and ensure that state financing for community development (including housing) increases. Six states currently have state CDFI initiatives. We—and others—are working to increase the number of states supporting CDFIs.
- ✓ Make CDFIs effective advocates in response to predatory lending and, where possible, encourage CDFIs to provide access to financing to counter predatory lending.

3. Increasing the number of strong CDFIs at or approaching a scale that enables them to play significant financial and civic roles in the market they serve. This will require:

- ✓ Investors and funders to understand that needs vary among small and emerging CDFIs; up-and-coming CDFIs; and industry leaders:
 - Small and emerging CDFIs need a blend of financing and human capital development services (training, consulting, informal technical assistance) to build strong core competencies and the potential for successful growth.
 - Up-and-coming CDFIs need “hard-to-get” capital (long-term, affordable debt, subordinated debt, EQ2, and equity capital) linked to strategic capacity building services (i.e., strategic planning, capitalization strategies, market research).
 - Industry leaders need large amounts of financing and support for new products and services.
- ✓ The CDFI industry to increase the supply of CDFI capital and grant financing by developing new capitalization products and demonstrating their impact to justify increased support.
- ✓ The industry to significantly expand training and consulting products and services to help ensure a steady supply of skilled individuals and strong organizations.

4. Researching and developing new products, services, systems, and alliances that anchor community development finance to mainstream interests, needs, and objectives. Products such as the Equity Equivalent (EQ2) Investment and the New Markets Tax Credit will play key roles in advancing the field by, for example, creating new incentives for new investors to participate. Overall, this theme will require:

- ✓ CDFIs to focus first on adapting existing products and systems to fit their goals. There is no need to reach for the brass ring when there is low-hanging fruit to harvest.

- ✓ CDFIs to develop new products that attract socially motivated investors to community development finance. Socially motivated investors are the most likely source of the long-term debt and venture capital financing that CDFIs need most.
- ✓ CDFI collaboration with universities and corporations to train young and mid-career professionals in community development finance skills.
- ✓ CDFIs and mainstream financial institutions to recognize and leverage common advocacy interests and goals. Support for the CDFI Fund is an obvious first choice.

5. Enhancing individual CDFIs' ability to respond to economic changes by regularly monitoring the industry and disseminating the findings. CDFIs are learning from the current economic turbulence just how closely their fortunes are linked to those of the mainstream economy. This will require that:

- ✓ CDFIs understand not only macroeconomic trends but economic and political trends within the industry. National Community Capital recently launched a "CDFI Market Trends Report," to help CDFIs, CDFI investors, CDFI funders, and policy makers track changes in CDFI markets. This "Report" is based on a monthly survey of CDFIs.
- ✓ CDFIs respond to turbulent or changing market conditions by refining and/or developing new products and services. After a decade of relative stability, CDFIs must become more agile in response to their markets.
- ✓ CDFI investors, funders, and trade associations adapt to changing CDFI needs by providing new or refined technical assistance, publications, consulting, training, and other resources.

6. Standardizing data, information, and information-sharing protocols to facilitate a more efficient flow of value-added information across informal and formal networks, reduce transaction costs, and simplify access to information about CDFIs and their performance. This will require:

- ✓ Refinement of the CDFI Data Project to standardize CDFI data collection and dissemination methodologies. Still in its first year of development, The Data Project is a collaboration among 13 organizations. It is looking at CDFI operations and outputs.
- ✓ Development of asset-level data to enable and ease securitization, improve policy advocacy, enhance market analysis, and open new doors to CDFI performance analysis.
- ✓ Implementation of a set of protocols for monitoring and measuring CDFI impact.
- ✓ Standardized financial statement presentations. National Community Capital has developed a model for standardizing the format of nonprofit CDFI financial statements, which tend to

vary widely. The model significantly reduces input time, reduces the risk of calculation errors, and increases our ability to analyze across CDFIs using an “apple-to-apple” format.

7. Formalizing learning systems through peer-to-peer (horizontal integration) and expert-to-student (vertical integration) approaches. Peer-to-peer systems serve best where expertise is unique to or involves distinct CDFI competencies, while expert-to-student systems are best suited to fundamental building block topics taught routinely in universities, business schools, and elsewhere. This will require:

- ✓ Multiple, tightly targeted classroom training offerings. All of the CDFI industry trade organizations provide this form of training, and all will need to increase their supply to meet growing demand. This training ranges from core skills such as market analysis to highly specialized skills such as equity financing for businesses and management of community development credit unions.
- ✓ Partnerships with universities and corporations specializing in core skills training. A growing number of people joining CDFIs are developing interest in CDFI careers as undergraduates or in graduate business or planning programs. University certificate or degree programs specializing in the hard financial skills as well as community development planning would significantly boost the supply of skilled professionals and raise the level of the field. Financial service companies that operate credit training programs, for example, could open their programs to CDFIs.
- ✓ Online and digital learning systems that reduce the cost of training by two-thirds while increasing the supply of training options. These systems enable interaction among CDFI professionals across geographic and sector lines.
- ✓ Technology that increases the flow of informal knowledge sharing among CDFI practitioners.
- ✓ Expanded consulting services to apply specialized knowledge to organizations dealing with developmental or strategic challenges.

8. Streamlining CDFI systems and operations to make better use of scarce operating resources.

- ✓ The Ford Foundation, JP Morgan Chase, and others are aggressively seeking system-wide solutions that reduce CDFI inefficiencies. National Community Capital did a study funded by JP Morgan Chase that explored potential savings CDFIs could achieve by outsourcing loan servicing. While the savings would be significant, most CDFIs resist ceding control over what they consider a central risk management and market intervention activity.

- ✓ Internet-based corporate solutions enable far-flung professionals to share ideas and information easily. In a field like community development finance, where every transaction requires specialized knowledge, knowledge acquisition is one of the most costly inefficiencies. Adapting one or more of these solutions to serve the CDFI industry could save millions of dollars annually and improve CDFI performance.

VI. CONCLUSION

The discussion that Capital Xchange has facilitated this year did not actually start this year. It began 16 years ago on a fall afternoon in Massachusetts. Nancy Andrews, Kirsten Moy, and Jeremy Nowak were among 81 participants at the first conference of the National Association of Community Development Loan Funds (NACDLF)—now National Community Capital—debating, among other things, where this nascent field might go, and how it might get there. The mood was upbeat, the prospects seemed good, and the tone of the discussion was positive.

Andrews and Moy participated as funders of the emerging community development loan fund (CDLF) movement representing The Ford Foundation and The Equitable, respectively. At the time, Nowak was a newcomer to the CDLF field as the new Executive Director of the Delaware Valley Community Reinvestment Fund (now The Reinvestment Fund).

Everyone in the room marveled at the scale and potential of the movement. With more than 40 institutions managing more than \$27 million in assets for financing, the loan fund sector seemed poised for greatness.

Some things never change.

APPENDIX

A SIMPLE HISTORY OF COMMUNITY DEVELOPMENT FINANCE IN THE U.S. SINCE 1960

U.S. history is full of examples of self-help finance and the creation of related systems to foster economic development, civic institutions, social and cultural networks, and political rights. Economic development benefits economic interests—including tax bases, capital investment, and the labor force—while “community economic development” or “community development” defines and targets its benefits differently.²⁸ Community development includes both tangible and intangible benefits. Tangible benefits include, for example, not just any jobs for community residents but jobs that provide compensation that allows individuals and families to move up the ladder of economic prosperity. Intangible benefits might include things such as community stability, civic revitalization, and more democratic access to and/or control of capital.²⁹

The history of the modern U.S. community development finance system involves public policy, social policy, economic trends, politics, and the American spirit. In 1962, author Michael Harrington laid the groundwork for our current community development finance system with his book, “The Other America.”³⁰ Arguing that a significant share of U.S. citizens was structurally excluded from the economic mainstream—and so from real opportunities to create wealth and opportunities—Harrington challenged the comfortable assumption that the post-World War II prosperity boom was inclusive.

The coincident rise of the U.S. civil rights movement from the regional stage to the national one, driven by the visionary leadership of Dr. Martin Luther King, Jr., grounded the community development finance system in strategies to counter racial discrimination. Racial justice became and remains the primary—though sometimes unacknowledged—force behind most community development finance today.

President John Kennedy embraced Harrington’s argument and joined it to the goals of the civil rights movement. Kennedy’s strategy was an unprecedented effort to use federal dollars to combat social, political, and economic discrimination.

Launched after his death, Kennedy’s approach first sought to put federal dollars to work through municipal and regional government structures. It had two goals: First, to use the leverage of the federal purse to change discriminatory practices by governments at the state and local levels. Second, the federal government wanted to put economic resources into or within reach of the people

²⁸ For the sake of discussion, community economic development is assumed to include a full range of intervention strategies including housing, community facilities and services, as well as business development.

²⁹ My organization, in our vision statement, talks about the need to give all people “the opportunity and ability to act in the best interests of their communities, themselves, and future generations. In this world, all people are able to participate fully and equally in social, economic, and political life.”

³⁰ “The Other America: Poverty in the United States.” 1962. New York, NY. MacMillan.

suffering discrimination, first, and economic deprivation, second. In the South, where this effort was concentrated, his target was helping black Americans.

This effort stumbled because funds flowed—or sometimes failed to flow—through state and local elected officials, and often did not reach their intended beneficiaries, demonstrating the constraints of responses to poverty organized within political systems. In response, the Johnson Administration tweaked the strategy to provide funding to community organizations that were not government controlled. This angered local officials, who did not want to lose control of the financial resources or the power that went with them. Sadly, much of this effort ended in a financial and legal morass. Because local and state officials retained a hand in the distribution and management of the funds, they tied up the strategy. In addition, many organizations and people suddenly charged with managing federal funding for community economic development projects lacked the expertise and skills to succeed.³¹

The most significant product of Johnson's agenda was the launch of the community development corporation (CDC) as a community-based vehicle for intervention in urban and rural communities. Through creation of the Office of Economic Opportunity, Johnson seed-financed a small number of CDCs to lead highly targeted, geographically centered community revitalization strategies. This effort did what earlier efforts had not been able to do—it established an essential place for community-led (rather than municipal-led) organizations in federal strategies.

As with the earlier effort, some of these experiments in democratic community development struggled, and some failed. Yet the long-term impact and survival of a few early CDCs such as Kentucky Highland Investment Corporation, Coastal Enterprises, Inc., in Maine, and New Communities Corporation in New Jersey are the foundation for the community development finance system today. From a handful of organizations like these has grown a community development finance system comprising more than 4,000 community-based organizations; a string of federal, state, and local financing programs; and the increasing involvement of conventional financial and non-financial corporations.

The CDC experience also proved fruitful, revealing the limitations of neighborhood-based strategies³² and the challenges of managing persistent tensions in the community development finance business—scale and efficiency versus community decision-making processes; responsible stewardship of scarce resources versus compassion for people in need; and investor accountability versus community accountability.

Some CDCs soon realized that their efforts suffered due to lack of access to private sources of capital. By the early 1970s, a small number of what we now call CDFIs had surfaced to organize

³¹ Nicholas Lemann provides an insightful analysis of the War on Poverty and the Great Society in *The Promised Land: The Great Black Migration and How it Changed America*, 1991. Alfred A. Knopf, New York.

³² Nowak, Jeremy. "Neighborhood Initiative and the Regional Economy," *Economic Development Quarterly*, Vol.11, No.1, February 1997.

financial capital from diverse private sources.³³ The leading sources of financing for these CDFIs were religious institutions and, to a much smaller extent, religious individuals.³⁴ In the late 1960s and early 1970s, several denominations recognized that the substantial financial resources they held could be aligned with their missions of faith to extend the work they had long devoted themselves to, including active involvement in the civil rights movement. A few—notably the national Episcopal, Roman Catholic, and Presbyterian churches—had earlier put substantial amounts of capital at risk in direct financing of community development, with disappointing financial and social results. To their credit, rather than backing away they sought out more skilled community development lenders, CDFIs.

In the 1970s, two other movements piggybacked on the civil rights movement to shape the community development finance system. The Equal Rights movement that began in the late-1960s and peaked in the 1970s broadened community development's counter-discrimination focus to include gender bias. At about the same time, the rise of the environmental movement introduced the concept of environmental justice as a community development priority.

Through the 1960s, 1970s, and 1980s the campaign for divestment of investments in companies doing business in South Africa—in protest of the harsh racist policies and practices of the ruling government there—added still more impetus to the community development movement. The divestment movement spotlighted the power of capital aligned with values, and so helped foster the social investment movement in the U.S. and abroad. Through the 1950s, 60s, and 70s, U.S. citizens had accrued remarkable amounts of wealth. The power of the divestment movement was proportional to the amount of capital that individual U.S. citizens had invested in the very companies whose practices they opposed.

This wealth also reshaped the financial services industry worldwide in ways we are still sorting out today.³⁵ In 1976, Merrill Lynch introduced a new kind of account that, for the first time, gave individuals access to credit, savings and investments, and liquidity (checking) without doing business with a bank. It is called the Cash Management Account, or CMA.

CMAs were exempt from the Federal Reserve rule that limited what banks could pay in interest. As inflation rose in the late 1970s and early 1980s, U.S. savers watched their savings accounts lose ground against inflation. They moved their savings into CMAs and, later, similar

³³ Some CDFIs pre-dated this time.

³⁴ The CDFI industry might not be around today were it not for Orders of Women Religious, who in the 1970s and 1980s loaned their modest retirement savings at very low rates to CDFIs with little or no capital to protect their investors. They were among the first lenders to CDFIs at a time when CDFIs were just beginning to develop basic financing skills. This little known act of faith is one of the most inspiring stories in the history of community development finance.

³⁵ A fascinating and important history of this change appears in "A Piece of the Action: How the Middle Class Joined the Moneyed Class," Joseph Nocera. 1995. New York, NY. Simon & Schuster.

products. Savers became investors, leaving banks for CMAs, mutual funds, and other investment vehicles.

To this day, the banking industry is scrambling to catch up. The Citibank-Travelers merger in 1999; the string of mergers and acquisitions among banks, insurance companies, and Wall Street firms; and even the 1999 Gramm-Leach-Bliley Financial Modernization Act all are evidence of this development.

The community development system also felt the impact of the CMA. In 1977, Congress passed and President Carter signed into law the Community Reinvestment Act (CRA). CRA “recognizes a continuing obligation on the part of federally insured depository institutions³⁶ to help meet the credit needs of their entire communities, including [low- and moderate-income] areas and individuals, consistent with safe and sound banking practices.”³⁷ CRA was the third leg of the financial services anti-discrimination stool, joining the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act.

In 1977, approximately two-thirds of Americans’ long-term savings (including investments) were in banks and other insured-institutions in accounts that were subject to CRA. Today, approximately one-quarter or less are in comparable accounts. As a result, the overall share of American wealth that is subject to CRA has declined precipitously. At the same time, of course, the asset size of insured institutions and the financial services industry overall has skyrocketed.

The performance of CRA has not always matched its potential, largely due to uneven implementation. Over the past 23 years, banks under CRA have entered into more than 370 agreements with community organizations (such as CDCs and CDFIs), committing more than \$1 trillion to minority and lower-income communities. But less than 2% of those agreements occurred from 1977-1991, and more than 98% since 1992.³⁸ What changed, in 1992, was the election of President Clinton, who made CRA enforcement and CDFI expansion the basis for his community development strategy. The two came together in 1995 when new CRA regulations recognized CDFIs, for the first time, as qualifying investments and borrowers, making it easier for banks to finance CDFIs and, in turn, for CDFIs to finance community development projects.

³⁶ Federal deposit insurance covers individual accounts up to \$100,000 per account. CRA presumed that since deposit insurance uses taxpayer financing to help banks raise funds, the banks have a quid pro quo responsibility to taxpayers.

³⁷ “The Community Reinvestment Act After Financial Modernization: A Baseline Report,” Prepared for the US Department of the Treasury, April 2000. Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky, and Susan White Haag. Available online at www.ustreas.gov/press/releases/docs/crareport.pdf. This report provides an excellent, succinct history of CRA as well as a current report on the state of CRA-related financing. See also Susan White Haag, “Community Reinvestment and Cities: A Literature Review of CRA’s Impact and Future.” March 2000, The Brookings Institution, Washington, DC.

³⁸ National Community Reinvestment Coalition, Washington, DC.

CDFIs grew incrementally through the 1970s and 1980s, but expanded dramatically and aggressively in the 1990s. In 1993, approximately 300 CDFIs managed slightly more than \$2 billion. In 2000, more than 550 CDFIs managed \$6 billion. Stepped-up CRA enforcement is one major reason why.

The other major reason is The CDFI Fund, a program within the federal Department of the Treasury that finances CDFIs and banks that invest in CDFIs and that increase their community development financing. To date, the Fund has committed more than \$350 million to CDFIs, most of it as equity or capital grants,³⁹ and has provided more than \$130 million in incentives to banks.

The Fund is important for at least six reasons. First, it is the largest single source of financing for CDFIs. Second, it places a priority on equity or net worth financing to strengthen CDFIs. Third, it emphasizes the use of government financing to leverage private financing. Fourth, it has raised the visibility of CDFIs enormously. Fifth, it has brought credibility to a field that was all but invisible up until 1992. Sixth, it has reinforced the benefits of private, targeted financial intermediation strategies as policy tools, opening other federal and state doors to CDFIs.

The Fund also has brought with it some risks. First, and most important, it has shifted the focus of many CDFIs from private sources of capital to government sources. This is a risky approach because of the potential volatility of government funding and because some government funding sources may lack the fiscal discipline that private lenders to CDFIs usually require. Second, the Fund is under constant pressure to introduce political considerations into what would ideally be a merit-based awards process. (This is not a criticism of the Fund but recognition of politics in the U.S. system.) Ultimately, there is danger that a program like the Fund might see Congress, rather than CDFIs, as its customers.

The bottom line, though, is that the Fund has catapulted the CDFI field forward. As much as any other accomplishment of the Clinton Administration, it represents a new approach for government and a promising model for the future of community development finance.

The next major step for community development finance may be the New Markets Tax Credit (NMTC), enacted in December 2000. The NMTC will create a new incentive that CDFIs, CDCs, and other organizations that finance businesses in distressed markets can use to raise capital. The credit will be worth 30% of the net present value of an investment in a community development enterprise (CDE). It would roll in over 7 years.

The Treasury Department currently is preparing regulations to govern the NMTC. Several key issues that could significantly affect the NMTC's usefulness remain up in the air. The Administration is wrestling with the question of selecting qualifying businesses based on census tracts (or geography) or beneficiary. A geographic definition works better for government because

³⁹ Capital grants are awards to nonprofit CDFIs that function much like equity, serving as net worth on the balance sheet and, in some instances, as working capital.

compliance is more readily monitored. A beneficiary definition works better for CDFIs, which are organized around markets rather than census tracts. In addition, the Treasury Department is trying to reconcile a requirement that "substantially all" the proceeds raised using the tax credit be deployed to create public benefit with the sometimes uneven deployment of capital under market conditions. If, for example, a successful business repays a CDFI investment early, should that force the CDFI out of compliance with the "substantially all" rules? Finally, the law takes a draconian approach to non-compliance, allowing no real "cure" period. The risk of non-compliance triggering the loss of the value of the tax credit is enough to scare prospective investors away.

The Bush Administration has stated strong support for the NMTC and has committed to implementing it in 2002. Because of the scale and because it would enhance community development finance returns to investors, it could fundamentally reshape the ways in which the community development finance industry relates to capital and increase dramatically the amount of capital the industry could use to help economically disadvantaged people and communities.

It may be the next big thing.