

The Economic Crisis and Community Development Finance: An Industry Assessment

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The Community Affairs Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing a Working Papers Series. For submission guidelines and themes of upcoming papers, visit our website: www.frbsf.org/cdinvestments. You may also contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 215, San Francisco, California, 94105-1530. (415) 974-3467, David.Erickson@sf.frb.org.

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Foreword

The Federal Reserve Bank of San Francisco's Center for Community Development Investments recruited a team of experts to assess the state of affairs in community development finance during the current severe economic downturn. We engaged Mark Pinsky, president and CEO of the Opportunity Finance Network, a national network of Community Development Financial Institutions (CDFIs); Nancy Andrews, president and CEO of the Low Income Investment Fund, one of the country's largest and most respected CDFIs; and Paul Weech, a housing finance consultant with many years of experience at Fannie Mae, the U.S. Small Business Administration, and the Senate Committee on Banking, Housing, and Urban Affairs. We then asked Ellen Seidman, who is a senior fellow at the New America Foundation and executive vice president, National Program and Partnership Development, at ShoreBank Corporation, to provide a short summary of these authors' findings. The authors have done an impressive job of tapping all the available data, interviewing a range of key industry leaders, and sharing their observations and judgments based on decades of experience in the field to produce this report.

Ellen Seidman starts this report with a short but thoughtful and provocative summary of the authors' main points and their opinions about possible solutions. The main body of the working paper has three major sections. First, Mark Pinsky provides an overview and prompts us to think more systematically about the nature of the problem the community development finance industry faces and what the possible short- and long-term solutions might be. Second, Nancy Andrews focuses on the coping strategies of CDFIs trying to survive the current environment. She focuses on the need for both tight controls over operations and nuanced, forward thinking about where trouble may be lurking. Finally, Paul Weech tackles the very complex assignment of explaining current conditions in the debt and equity markets for CDFIs and other community development finance institutions. He examines where capital is drying up and where new sources are springing up; he also discusses the changing relationships between CDFIs and their partner financial institutions. We have also included an appendix with a quick summary of Rick Cohen's analysis of how foundations nationwide are affected during the economic downturn.

At times it was difficult to be consistent with terminology given that the paper describes a problem and an industry in broad terms while also offering specific recommendations on policies and programs. We use the term "Community Development Financial Institution" (CDFI) to refer to entities that are certified as such by the CDFI Fund in addition to other mission-oriented institutions dedicated to financing that benefits low-income and low-wealth people and communities. We also use the term "Community Development Institutions" (CDI) to refer to a larger constellation of institutions (which includes CDFIs) that comprise the community development finance network. Organizations in this category include community development organizations, those motivated by Community Reinvestment Act (CRA) requirements (banks and thrifts), state housing finance agencies, and other socially motivated sources of financing from philanthropies, insurance companies, pension funds, and other corporations. Also in this group are the on-the-ground organizations that build the housing, schools, clinics, and promote all types of community-building activities (an example would be community development corporations). Although we have focused more on CDFIs, we think the paper's insights are relevant to the entire community development finance industry.

I would like to extend a special thanks to our authors. We asked for the impossible: to give us a snapshot of what's happening in only a matter of weeks. They spent long days and nights researching, interviewing, writing, and collaborating to create this high-quality report. It is perhaps an additional sign of sophistication for the community development finance industry that we could field such a capable group of writers who had the background, contacts, and understanding to pull together this report so quickly.

This report will serve as a basis for our convening with practitioners and policymakers at the Federal Reserve Board of Governors. We hope the paper and convening will seed an ongoing discussion on how we can confront immediate challenges and lay the foundation for more long-lasting structural improvements in the community development finance industry.

David Erickson
Director, Center for Community Development Investments
Federal Reserve Bank of San Francisco
May 18, 2009

Community Development Financial Institutions: Challenges and Opportunities

Chairman Ben S. Bernanke

*Speech delivered at the Global Financial Literacy Summit, Washington, D.C.
June 17, 2009*

I am pleased to be back at the Town Hall Education, Arts, and Recreation Campus for the Global Financial Literacy Summit. I commend the organizers and participants for their commitment to financial literacy. As Americans struggle with very difficult economic and financial circumstances, the importance of financial literacy and financial education has never been more evident. Organizations such as our host today, Operation HOPE, with its local Hope Centers, provide a vital service by helping adults and young people gain the financial knowledge they need to achieve their economic goals.

Community-based organizations such as Operation HOPE offer training and counseling to people in traditionally underserved markets, helping them to manage credit, buy homes, and start small businesses. As we reaffirm our commitment to increasing financial literacy as a means of improving economic opportunity, we should recognize that the contributions of community development organizations go well beyond providing information and guidance to individuals and families. These organizations also facilitate economic growth and development by offering a broad range of services and financing in low- and moderate-income communities. In this regard, a uniquely important role has been played by a group of specialized lenders known as Community Development Financial Institutions, or CDFIs. This morning I would like to offer a few thoughts about this important set of institutions and the challenges they face in the current economic and financial environment.

We don't have to look too far to see the contributions of CDFIs. In this portion of Washington, D.C., east of the Anacostia River, CDFIs and other community-based organizations are working with private partners and with government in multifaceted efforts to spur development, add quality affordable housing, increase commercial activity, and better connect these neighborhoods to the broader regional economy. Community-based organizations such as CDFIs can play critical roles in these important undertakings because of their detailed knowledge of neighborhoods' economic needs and strengths and because of their commitment to their mission of community development.

CDFIs and Their Role in Community Development

CDFIs come in various forms. They may be banks, credit unions, nondepository loan funds, or venture funds. Generally, CDFIs strive to provide affordable and appropriate financial services to people and communities who traditionally lack access to such services. Depending on the institution and local needs, they may offer financing for homeownership, rental housing, commercial real estate, health care, small businesses, microenterprises, charter schools, and child care facilities, among other purposes.¹ CDFIs often also work with traditional lenders to attract private capital for community development. A nearby example of such cooperation is the redevelopment of the long-vacant former Camp Simms National Guard site in Southeast D.C. That project, which included a local CDFI in partnership with the D.C. government, a private developer, and a local community development corporation (CDC), led to the creation of a shopping area that included a much-needed grocery store and other commercial services.

In many ways, the formation of CDFIs represented an important milestone in the ongoing evolution of policy strategies for community development and revitalization. During much of the past century, federal community development efforts were large-scale, top-down affairs. As we have seen in the sphere of international development assistance, centralized, large-scale development efforts—though not without their successes—often imposed a one-size-fits-all approach that failed to take sufficient account of the particular needs and characteristics of local communities. In many cases, the results were disappointing or worse; for example, the so-called urban renewal programs of the 1950s and 1960s had what ultimately

¹ Paul Weech (2009), "Observations on the Effects of the Financial Crisis and Economic Downturn on the Community Development Finance Sector (802 KB PDF)," Working Paper Series 2009-5 (San Francisco: Federal Reserve Bank of San Francisco, May).

proved to be devastating effects on some areas. In response, the policy focus has shifted over time toward using tools that allow more-customized approaches to local needs, such as block grants and housing vouchers. The growth of local CDCs and the passage of the Community Reinvestment Act in 1977, which required most deposit-taking institutions to lend and invest throughout their business areas, exemplified the trend toward a more bottom-up approach to development.

By the late 1980s, new alliances formed among the public, private, and nonprofit sectors, creating a network of institutions that understood and were committed to serving local communities.² In 1994, the Congress created the CDFI Fund, housed within the Treasury Department.³ The Treasury recently estimated that the fund attracts \$15 in nonfederal investments for every dollar it invests in a CDFI.⁴

In addition, the government provided new market-based incentives to attract private capital to community development. For example, the Low-Income Housing Tax Credit program, created in 1986, offers credits to investors in affordable rental housing. The affordable housing developments, in turn, often rely on community-based organizations to help with development, financing, and property management. More than 2 million units of affordable rental housing have been built as a result of investors using the incentives offered by the program since its inception.⁵

Today, nationwide, there are more than 1,000 certified CDFIs with a collective \$25 billion in assets.⁶ These organizations have loaned and invested billions of dollars in our nation's most distressed communities and have attracted many conventional investors into underserved areas. For small businesses in particular, CDFIs provide critical funding because many traditional creditors view such loans as too risky or, sometimes, too small to be profitable. As a complement to lending, CDFIs offer training and technical assistance to their customers, directly or through partnerships, thus increasing borrower capacity and mitigating loan risk. Successful CDFI borrowers often graduate to conventional financing as their needs grow, thereby attracting the participation of mainstream lenders while freeing up CDFI resources to plant new seeds in the community.⁷

Current Challenges and Opportunities for CDFIs

CDFIs have certainly not been spared from the financial disruptions of the past two years. While many CDFI portfolios have continued to hold up relatively well despite the financial crisis, rates of delinquencies and defaults on CDFI loans have risen as economic conditions have worsened.⁸ In light of the mission of CDFIs, it is not surprising that their financial concerns often reflect economic distress in the broader community: the once-thriving local business that is shutting its doors, the affordable rental housing complex that is struggling to make payments as tenants lose jobs and fall behind, and the after-school youth center that cannot repay its loan because its donor base has shrunk. Even as the capacity of CDFIs has become more constrained, economic conditions and pullbacks by mainstream lenders have increased the demands being placed on these organizations to provide credit and services.⁹

Traditionally, CDFIs have been able to fund a majority of their operating activities through earnings.¹⁰ However, those earnings have come under pressure as loan losses have risen, deal volumes have declined, and sources of capital for new activities have become more expensive or unavailable altogether. Moreover, CDFIs' main sources of outside capital and operating support are facing significant pressures of their own. Funding from philanthropic sources has been reduced as

2 David Erickson (2006), "Community Capitalism: How Housing Advocates, the Private Sector and the Government Forged New Low-Income Housing Policy, 1968-1996," *Journal of Policy History*, vol. 18 (2), pp. 167-204.

3 The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 107 Stat. 2369.

4 U.S. Department of the Treasury, Office of Performance Budgeting and Strategic Planning (2009), *FY 2010 Budget in Brief* (395 KB PDF) (Washington: Department of the Treasury).

5 National Council of State Housing Agencies (2007), *State HFA Factbook: 2006 NCSHA Annual Survey Results* (Washington: NCSHA).

6 CDFI Data Project (forthcoming), "Providing Capital, Building Communities, Creating Impact--Fiscal Year 2007". Previous reports can be found at <http://cdfi.org/index.php?page=dataprocject-c>.

7 See "Observations on the Effects of the Financial Crisis," note 1.

8 The net charge-off rate in fiscal year 2007 was 0.55 percent (see "Providing Capital, Building Communities," note 6). From a survey of CDFIs in fiscal year 2008, a charge-off rate of 1.7 percent was reported. See Opportunity Finance Network (2009), *CDFI Market Conditions Report: Fourth Quarter 2008*, OFN, April.

9 In the fourth quarter of 2008, 63 percent of reporting CDFIs reported an increase in credit applications, while over the prior quarter, 52 percent saw an increase in delinquencies. See *CDFI Market Conditions Report*, note 8.

10 Earned revenues represent 53 percent of CDFI total operating revenues. See U.S. Department of the Treasury, Community Development Financial Institutions Fund (2007), *Three Year Trend Analysis of Community Investment Impact System Institutional Level Report Data FY 2003-2005* (6.6 MB PDF) (Washington: Department of the Treasury, CDFI Fund).

endowments have suffered capital losses and rates of giving have declined.¹¹ Indeed, two-thirds of foundations surveyed recently reported that they plan to reduce the number and size of their grants in 2009, and cuts are expected to continue in 2010 and beyond.¹² Funding from state and local governments that sometimes support CDFIs is also dwindling, reflecting increased fiscal pressures. And mainstream financial institutions have reduced their support of CDFIs, both by providing less direct funding and by extending less credit in support of projects done in partnership with them.

Just as banks are adapting to the changing financial landscape, the community development industry can adopt changes to help it emerge stronger from this crisis. CDFIs are taking steps to minimize losses, strengthen their portfolios and liquidity positions, and assess existing activities and planned investments in light of the worsened financial and economic environment.

As CDFIs move past the immediate hurdles, however, careful consideration will need to be given to more systemic changes to correct weaknesses that have emerged in the current CDFI model. Notably, the reduction of funding by key participants highlights the importance of broadening and diversifying the industry's funding base. For example, in the case of the Low-Income Housing Tax Credit markets, major investors, including several large banks and government-sponsored enterprises, sharply curtailed their investments in affordable housing as the value of the tax credits declined along with their profits.¹³ Continuing and expanding the current efforts to attract new investors to the Low-Income Housing Tax Credit market could mitigate the overreliance on a few market investors. The same could be said for investors in projects supported by the New Markets Tax Credit, a program of the CDFI Fund meant to attract investment to low- and moderate-income areas.

Other ongoing efforts to access institutional funding and the capital markets should continue so that CDFIs can tap more-reliable sources of funding at wholesale prices. For instance, the Federal Housing Finance Agency recently introduced its rules for public comment on how certified CDFIs can become members of the Federal Home Loan Bank System and access its lower-cost funds, as permitted under recent legislation. Such funding, with known pricing and terms, would be reliable and would help CDFIs manage their balance sheets more efficiently and inexpensively.

Prior to the financial crisis, some CDFIs had been making progress in gaining access to secondary financing markets. Although these markets remain disrupted, such efforts hold promise, especially to the extent that CDFIs are able to produce high-quality data and analysis of proposed investments. Good data, together with qualitative knowledge, is critical for identifying previously unrecognized market opportunities, assessing investment performance, and helping guide investors to make better decisions.

Finally, cultivation of nontraditional funding sources might prove fruitful. Increased interest by socially motivated individual investors has expanded the pool of investment capital for community development. One CDFI has created a product similar to a mutual fund where individuals purchase "community development notes" that are invested in community development organizations. The fund has raised capital from about 4,700 individuals and invested about \$160 million; further, it has performed well, with an average 3 percent rate of return to investors and very low loss rates.¹⁴ Even during the recession, new investors have been drawn by the appeal of supporting low- and moderate-income communities while earning relatively good rates of return. Other developments, such as emerging peer-to-peer lending platforms, also hold promise.

While community development finance is a small part of our overall capital and credit markets, the Federal Reserve recognizes that these financial flows are critically important for many low- and moderate-income communities. In fact, the Board of Governors has been working with several of the Federal Reserve Banks to promote research on how best to promote CDFIs' effectiveness and financial stability.¹⁵

11 At last report, philanthropic sources made up 12 percent of capital and 25 percent of operating funds for CDFIs. See Three Year Trend Analysis, note 10.

12 See Steven Lawrence (2009), "Foundations Address the Impact of the Economic Crisis (518 KB PDF)," Leaving the Board Foundation Center, Research Advisory, April.

13 Angelyque Campbell and Jennie Blizzard (2008), "Community Development Finance: Innovative Paths to Capital during the Credit Squeeze," Federal Reserve Bank of Richmond, MarketWise, Fall/Winter.

14 Data from audited financial statements on the Calvert Foundation Community Investment Notes, as of year-end 2008. Since the fund's inception in 1995, the portfolio reports an overall 0.20 percent loss rate, none of which has been realized by investors. See Calvert Social Investment Foundation (2009), "Community Investment Note: Due Diligence Brief," Calvert Foundation, April. Also see the Calvert Foundation's website at www.calvertfoundation.org.

15 For instance, in May 2009 the Board hosted a Community Development Finance Summit to discuss promising strategies for CDFIs facing challenges in the current crisis. The Federal Reserve Bank of San Francisco has conducted research on these topics through its Center for Community Development Investments, and the Federal Reserve Bank of Boston has worked with key partners to identify and promote best practices.

The current crisis points to the importance of a strong network of healthy community-based organizations and lenders. As many communities struggle with rising unemployment, high rates of foreclosures, and vacant homes and stores, these organizations lead efforts to stabilize their neighborhoods. Rather than pulling back, CDFIs are introducing new products and programs to help communities respond to the crisis. For instance, a number of groups are purchasing homes, which might otherwise sit vacant, from loan servicers who take possession of foreclosed properties. These homes are repaired and then sold or rented to families. Because foreclosures and resulting vacancies impose costs on neighborhoods and local governments, facilitating occupancy can help maintain neighborhood stability.¹⁶ These efforts are difficult, time consuming, and challenging to finance—exactly the kind of thing in which CDFIs specialize. CDFIs and other groups across the country are working hard to stabilize neighborhoods because they do not want to lose the progress attained by years, and sometimes decades, of investment in low- and moderate-income communities.

Indeed, this community stabilization work is important for the overall economic recovery. Healthy and vibrant neighborhoods are a source of economic growth and social stability. CDFIs and other community groups are already responding to the evident needs, but they will require many willing partners to ensure success in the long run, including governments, mortgage servicers, and mainstream lenders. Strong community organizations can accomplish a great deal, but their capacity will be severely limited without the willing partnership of many other institutions.

Conclusion

As the effects of the financial crisis and the resulting economic downturn have spread, there has been increased focus on preserving the gains made in low- and moderate-income communities over recent decades. Accomplishing that objective requires preserving the institutions that helped build these communities. Without strong CDFIs, attracting investments and capital to rebuild and revitalize communities would be even more difficult. Economic recovery, like economic development, is a bottom-up as well as a top-down process. Through their work at the community level, CDFIs, together with other community development organizations, can help build a sustainable recovery for all of us.

16. In particular, recent research points to the adverse spillover effects of foreclosures on local property values. See, for example, Zhenguang Lin, Eric Rosenblatt, and Vincent W. Yao (2009), "Spillover Effects of Foreclosures on Neighborhood Property Values," *Leaving the Board Journal of Real Estate Finance and Economics*, vol. 38 (4), pp. 387–407.

Executive Summary

Ellen Seidman
New America Foundation and ShoreBank

For thirty years, the community development finance industry—banks, credit unions, loan funds, community development corporations, venture funds, microfinance institutions—has quietly provided responsible, well-designed and well-priced credit to lower-income people and communities. These entities have provided this credit with the support of the federal government, through the Community Development Financial Institutions Fund, the Low Income Housing and New Markets Tax Credits, the Small Business Association, the U.S. Department of Agriculture, and various housing and facilities development programs. The industry has also been supported in its efforts by mainstream institutions such as banks and insurance companies, most frequently motivated by the Community Reinvestment Act (CRA) or by concern that CRA-like obligations would be imposed. Philanthropic foundations and supporters and state and local governments have also played their parts. The result: a community development finance industry that has survived and even prospered during recessions and political downdrafts. But the field, and the communities, businesses, and individuals it serves, are hurting now, and fearing bigger hurt. This paper by Mark Pinsky, Nancy Andrews and Paul Weech examines this situation and focuses attention on what needs to be done.

A major theme of the paper is that time is of the essence. Even before the current meltdown, the industry was stressed by years of federal cutbacks and a changing dynamic that made bank funding more difficult to obtain and more expensive. The paper recommends longer-term steps, such as establishing a fiduciary duty for all financial institutions to invest in “opportunity finance.” However, the authors agree that capital, liquidity, well-priced debt, and financing partners are needed now. Delay may well mean the infrastructure of community finance, especially for housing and particularly in hard-hit and rural areas, will die before help arrives.

The paper makes three major recommendations, in a variety of contexts and forms.

Policy, particularly at the federal level, is critical on three dimensions: 1) making funds available (capital, liquidity, and project finance), 2) getting that money on the street fast, and 3) establishing and enforcing obligations on the part of all financial institutions to support community finance.

- The effectiveness and efficiency of the CDFI Fund in moving money from appropriation to the street is critical in both the grant programs and the New Markets Tax Credit. Innovative new programs, like the Capital Magnet Fund, should be implemented quickly to provide additional equity and liquidity to community developers and financiers. The Fund’s current and future investment in CDFIs can be enhanced, as to both effectiveness and efficiency, with programs that support liquidity and facilitate the workout of troubled institutions and assets. This might be accomplished by, for example, creating a “bad bank” and with technical assistance. The Fund also has a role in establishing an effective regulatory infrastructure that increases the transparency of financial condition and performance of all members of the industry while remaining sensitive to the size and business operations of the institutions involved.
- Increased funding is needed for other federal programs that support projects in lower-income communities, such as those in SBA, the Department of Housing and Urban Development, and USDA. To some extent, these programs might also consider moving to the CDFI model of equity and investment in institutions that are long-term participants in the communities they serve and that can leverage government funds effectively with capital from other sources.
- The housing programs, particularly the Low Income Housing Tax Credit, the Neighborhood Stabilization Program, and support from Fannie Mae and Freddie Mac, need special attention.
- The Community Reinvestment Act should be expanded, strengthened, and modernized. We now understand that the entire financial system operates in the context of federal support. Institutions that receive this support, whether directly or indirectly, must serve the entire nation; most will not do it directly, but can through support of community development finance intermediaries.

Individual institutions must strengthen their ability to survive and prosper by rigorous self-examination, risk management, and planning ahead. Institutions should focus on the critical elements of a financial intermediary: net worth, liquidity, and net operating income. They should plan for worst-case scenarios, understand where the stresses lie, and plan to meet and overcome them. Restructurings and extensions are to be expected, but institutions should rigorously examine these options and move to workouts and liquidations where recovery cannot be expected within a reasonable period of time. Now is the time for intelligent but hard-headed borrower support, not sentiment. Some institutions are likely to fail, and the industry may be stronger for this “creative destruction,” but an orderly process of merger and transfer is needed to avoid leaving communities high and dry when institutions fail.

The industry must come together, strengthen its network, and learn from one another.

- The needed policy changes will only be realized through strong, united action. The industry needs a shared vision of its special role. This shared vision must cross both policy and financing silos. It must unite business, housing, schools, health care, and household asset-building by coordinating funds from government at all levels, the private sector, and philanthropy to strengthen communities the “market” once ignored and then destroyed. If all community finance entities can work together—banks and loan funds, credit unions and community development corporations, venture funds and microfinance—then, as Arlo Guthrie memorably observed, “friends, they may think it’s a movement.”
- Working together also increases the opportunity to share knowledge, understanding, best practices, skill and resources. For example, few community development institutions are large enough to hire workout specialists; working together, they can share and cross-train. Can healthy institutions help others and themselves by taking in and working out troubled assets, particularly where there is a geographic match or a match with the type of asset financed? And by working together, can the industry develop new and more efficient ways to access and deploy capital?
- Finally, by working together, the community finance industry can help rebuild the capacity of institutions not devoted to community finance to be constructive participants in community development. It can help to rebuild the human and financial capital and interest of the large banks, insurance companies, and other corporations who supported communities through the 1990s but whose interest waned during the past decade as pressures built up for short-term profits through financial engineering.

Community finance is at a crossroads. For the first time in almost a decade, financial institutions devoted to serving lower-income communities and those who live and work there have a champion in the White House. Congress, which supported the industry during the lean years, has upped the ante. But time is short. With borrowers and funders in pain, liquidity is tight and capital is scarce. Community development finance needs action now—from the government, from our partners, from ourselves—to do what we’ve done before: come through the hard times stronger as an industry and for those we serve.

Ellen Seidman is a senior fellow at the New America Foundation and executive vice president, National Program and Partnership Development, at ShoreBank Corporation. From 1997 to 2001 she was Director of the Office of Thrift Supervision.

Part I: Overview

The New Normal: The Extraordinary Future of Opportunity Markets

Mark Pinsky

Opportunity Finance Network

In Jewish folklore, the mythical village of Chelm is a town of fools, where each person is more foolish than the next. When Chelm's only butcher was convicted of murder and sentenced to die for his crime, the town elders decided to execute one of the town's two bakers instead because Chelm could not survive without a butcher.

Many people who work in community development feel like that baker. They are facing early death or at least a lifetime of operational confinement and reparations for crimes they did not commit. Many people and institutions are responsible for the current economic and financial crisis and none are community development practitioners.

"Since you are being sentenced to death for a crime you did not commit," the town elders asked the baker, "how would you prefer to die?"

The baker thought only briefly before he answered, "If I have a choice, of old age."

The Context

(Mark Pinsky and Nancy Andrews co-wrote this section)

We are wading through the collapse of what economist Nouriel Roubini calls "the biggest asset and credit bubble in human history." The financial market implosion is global in reach, pervasive across economic sectors in scope, but deeply personal and painful for individuals, families, and communities.

In April 2009, the International Monetary Fund estimated that global losses would reach \$4.1 trillion, with \$2.7 trillion occurring in the United States, enough to threaten to exhaust the capital base of the entire U.S. financial system. Although the losses will be spread broadly, it is important to remember that every other estimate of damage so far has turned out to be low. Remember when the idea that the global damage might reach \$1 trillion seemed almost ridiculous? That was less than one year ago.

The U.S. and global economies are in a state of turbulence that will not settle for years. Global asset values have plunged by one-half in a matter of months. The United States has lost more than 5.1 million jobs since the recession started. Global job losses could exceed 50 million, by some estimates. Unemployment in the United States may rise above 10 percent in the next year. In some locations, such as Los Angeles, unemployment nearly doubled in 12 months. Credit markets remain sluggish, at best, and frozen for most would-be consumers.

The U.S. financial system is barely withstanding the unprecedented stress. The collapse of the mortgage market has toppled the financial house of cards built on faulty assumptions, unrealistic economic theories, and unreliable private and government controls. Anchor institutions—including Bear Stearns, Lehman Brothers, Merrill Lynch, Washington Mutual, Wachovia, AIG, Citigroup, Morgan Stanley, Fannie Mae, Freddie Mac—have failed or likely would have failed but for the infusion of an estimated \$14 trillion in U.S. government aid. The federal government now owns most of the housing finance system and holds material stakes in much of the banking system.

Many state and local governments are cutting essential safety net services, exposing children, poor families, and other already vulnerable populations to even greater risk and uncertainty. Institutional and individual philanthropists are stepping in, but at best they can only plug holes while their net assets and giving power decline. Public purpose institutions—non-profit service providers, educational institutions, Community Development Financial Institutions¹ (CDFIs), community development corporations, and other community-based organizations—are straining to meet steep increases in need and

¹ CDFIs are private-sector financial institutions dedicated to community development in ways that create benefits for low-income and low-wealth people and places. They have a range of community development missions—that is, some concentrate on quality affordable housing, others on small businesses and jobs, and still others on community facilities, such as charter schools. Throughout this working paper, "CDFIs" include all entities that meet this definition and is not limited to those that are certified by the CDFI Fund in the U.S. Department of the Treasury. Financing entities that are affiliated with or part of larger organizations—such as bank CDCs—are not CDFIs because their parent organizations do not meet the community development standard.

demand with declining supplies of money and resources. Their strategic management is being put to the test, and choices they made in the past are coming back either to haunt or help them.

Like the baker in Chelm, low-income and low-wealth people and places, and the institutions that serve them, are hoping to outlast the moment even as they struggle to understand it. Unemployment is well into double digits in many of these communities, and housing prices have fallen as much as 40 percent in some. Homelessness is rampant, foreclosures have riddled communities, and safety net services are stretched to the breaking point. Places like Elkhart, Indiana, and Fresno, California, where expansive shantytowns have grown under freeways and across abandoned land, present shocking new images of the human cost of economic and financial systems failures.

The New Normal

“The new normal” reflects the seismic shift underway that will result in fundamentally and permanently different market practices, rules, and realities than those anyone working in financial services and community development has ever known. The systemic and structural changes of the past two years, and those likely over the next one to two years, create a financial marketplace that is distinctly different from the market of the past thirty years. This new normal also frames a new set of core questions. What will happen to opportunity markets—growth markets of the future that today are populated by people, businesses, and places outside the economic mainstream? How will they survive? Who will serve them?

This paper² focuses on the ramifications of “the new normal” for opportunity markets and the financial and community development institutions (CDIs)³ and systems that serve them. In addition, it suggests for discussion key elements of a strategy to ensure both that effective CDIs emerge stronger from the current crisis than they entered it, and that federal policy and private financial markets work with them, not against them. This presumes that many, but not all, CDIs are effective; that many, but not all, will survive; and that alignment of federal policy, private markets, and CDIs will involve challenging—probably painful—compromises and fundamental changes for all parties.

The Strategic Framework

The financial market collapse and economic recession is a systemic failure precipitated by structural and systemic financial system flaws and faulty basic economic assumptions. It requires structural and systemic responses and sounder assumptions. Until those responses are in place, however, it also requires urgent, mid-term, and long-term steps. All efforts today in the United States and around the world are focused on containing the problem and mitigating its human toll. They will soon, however, turn to structural and systemic fixes intended to restore economic vitality and foster prosperity—hopefully, this time, for all.

The current crisis is a product of a revolution in the financial marketplace that began quietly decades ago when asset quality was separated from pricing (a structural mistake guaranteed to crash any market eventually).⁴ Market fundamentalists—who believe that any transaction that clears is *de facto* a good transaction—convinced investors that it was not important

2 This paper incorporates data from Opportunity Finance Network’s quarterly “CDFI Market Conditions Report,” the CDFI Data Project, and independent research and ideas by Nancy Andrews and Paul Weech on behalf of the Federal Reserve Bank of San Francisco. In addition, it draws on scores of conversations and e-mail exchanges I have had with CDFI executives, bankers, policy makers, and financial regulators in 2008 and 2009.

3 I am reluctant to introduce another acronym into the alphabet soup that pervades this discussion, but this paper uses “CDI” for community development institutions as shorthand for an inclusive description of a broad range of entities that comprise the infrastructure of community development finance. CDIs is broader than CDFIs and includes, but is not limited to, CDFIs, state housing finance agencies, bank community development lending teams or activities, as well as community development producers and asset managers such as CDCs, for-profit affordable housing developers, and others. Because I work in and represent the CDFI industry, my CDFI-oriented perspective is unavoidable. I hope that my inclusive intent is not compromised by that perspective and that others will find sufficient value in this analysis to apply it to their work. I also hope that the term CDI does not live on; it is so broad in most uses that it blurs important distinctions.

4 At a March conference on “The Future of Finance” convened by the *Wall Street Journal* and attended by what the *Journal* described as “roughly 100 of the brightest minds in finance today,” the top policy recommendation was a return to sound underwriting fundamentals. Surprisingly, many participants seemed to be awakening to the fact that the quality of underlying assets was material to the risk in the assets they were creating, buying, and selling. That is, many people at the event seemed to have operated on the assumption that the quality of the underlying assets was not material.

who the borrowers were and what the underlying assets were worth.⁵ The “efficient market hypothesis,” now discredited, rationalized this fantasy and fueled the spread of a string of systemic failures: bubble pricing, debauched ratings incentives, unsustainable compensation incentives, inflated assessments, lack of accountability in underwriting, and statutory and regulatory laxity, to name a few. The result is that now we are working to put Humpty Dumpty back together again in a brutally difficult environment.

In this environment, CDIs face significant challenges. Pressures are building on all sides—in portfolios, practices, on balance sheets, in operations, and among customers, funders, investors, staffs, and families. Disheartening first-quarter economic data—a 6.1 percent decline in growth—assures that the pressures will get worse before they get better. If it is true, as many people assume, that CDIs experience the economy roughly two quarters after the mainstream economy does, at least the field will have some advance warning what to expect and when to expect it.

At the same time, CDIs enter this fray with significant strengths and assets, and recognize the need to step up to the challenges. In the right set of circumstances, CDIs in general, and CDFIs in particular, can help manage systemic risks and challenges, bolstering core elements of opportunity markets, and rebuilding the infrastructure when the economy recovers. But they can survive and succeed only if their peer, philanthropic, financial institution, and government partners and allies also grow stronger.

CDFIs are uniquely positioned as bulwarks against the ongoing market trouble because of their capital structures, their relatively low leverage, their market expertise and financing credibility, and their generally respected roles as financial, policy, and civic intermediaries. When the current crisis begins to resolve, CDFIs and CDIs must be ready to play a leadership role in reestablishing and rebuilding an opportunity market infrastructure.

For CDI leaders, perhaps only one thing is certain: The stunning collapse of the modern financial marketplace and its aftermath will transform the way capital flows to, around, and from opportunity markets—the people who live and work just outside the margins of conventional U.S. markets and their communities. It will change forever the daily lives of those people as well as the social fabric and civic culture of those places. It will remake permanently the roles and responsibilities of private and public institutions that serve those markets.

Stepping Up

For CDFIs and the markets they serve, this crisis can result in either significant decline in our ability to deliver capital or rapid growth in capitalization and production. It could lead to a permanently diminished role or it could make CDFIs pillars of a new financial market foundation that better serves the people and purposes that the field exists to serve. The result will depend, to a significant extent, on four factors, in probable order of urgency (but not necessarily importance):

1) How federal policymakers respond, when they respond, and how well federal agencies execute those responses. For example, the CDFI Fund will bolster many CDFIs’ balance sheets if it keeps to its schedule of disbursing both 2009 and supplemental stimulus appropriations by October 31, 2009. If it bogs down, the number of CDFIs in serious trouble or failing will increase sharply. The Neighborhood Stabilization Program may help communities devastated by foreclosures, but its value will diminish steeply if it is implemented slowly or politicized. The Capital Magnet Fund and the National Affordable Housing Trust Fund, both approved in the Housing and Economic Recovery Act (HERA) of 2009 (PL 110-289), could backstop our nation’s affordable housing production system, but Congress has not yet funded them.⁶ (The Capital Magnet Fund, much like the CDFI Fund core financing programs, is particularly valuable because it strengthens balance sheets with equity.) In addition, working through the challenges of block grant distributions for the National Affordable Housing Trust Fund could leave a trail of institutional carcasses.

⁵ Although it is sometimes hard to pin down a moment of inception, there is a good case to be made that this started in 1976 when Merrill Lynch introduced the first Money Market Account (MMA), which allowed savers to purchase full-service banking services without banks. Banks were still subject to strict caps on what they could pay depositors, but MMAs were not. Within years, MMAs set off aggressive competition for deposits (or investments). The higher rates drew consumer capital out of banks and into nonbank financial institutions, spurred the growth of mutual funds and other managers of long-term financing from individuals, and so paired investors with limited knowledge with sellers with ever more clever products. The competition for investments led to money chasing transactions, sparking decades of speculation that seems to have slowly, but inexorably spun out of control.

⁶ Both the Capital Magnet Fund and the National Affordable Housing Trust Fund received generous allocations in President Obama’s fiscal 2010 budget. Those proposed budgets are subject, of course, to Congressional action.

2) Whether CDIs and their partners—investors, funders, civic leaders, and others—join together in organized responses toward a common good or take discordant paths. For example, CDIs and the markets they serve could unwind quickly—within months—if one or a few key investors opt to exercise default provisions based on loan and investment covenants, particularly if the economy gets worse and drags asset values down further. The intertwined fortunes of many are vulnerable to the legitimate concerns of a few. This is a clear case, to borrow from Ben Franklin, where hanging together is preferable to hanging alone.

3) Whether CDIs made disciplined strategic decisions in the past and, assuming so, can maintain their strategic and management discipline during stressful periods. *Good to Great* author Jim Collins told the Opportunity Finance Network Conference in 2009 that CDFIs benefit from operating in stressed markets that require disciplined thought and action in good times, not just in bad times. This, he argued, gives CDFIs a decided advantage in turbulent conditions such as now.

4) Whether public policy responses to the current crisis target structural and systemic fixes rather than cyclical patches or one-time bandages. There is little hope for progress if comprehensive financial regulatory reform allows or encourages recidivism, and financial institutions return to the same practices and policies that created this mess. If comprehensive reform carries with it an all-inclusive financial industry obligation to support CDIs and opportunity markets, however, there is cause for hope.

The CDI industry has a measure of control over these four factors. Most likely, all four are necessary to ensure a strong opportunity finance role and response during the next decade. Other circumstances, such as the economy, are beyond the field's control.

For example, credit conditions are unlikely to get better for opportunity markets—with minimal exceptions—in the next 24 to 36 months. After that, they are likely to improve gradually and slowly. Many, if not most, conventional lenders and investors shy away from risk they do not understand, which today is almost all risk. This adds to the unknowns that the industry cannot control. In addition, the pervasive, and sometimes malicious, confusion of predatory lending with sub-prime credit has hurt opportunity markets further, reducing credit and capital supply. Informal credit and capital suppliers, particularly friends and families, are dwindling too, as net worth declined almost universally and often precipitously.

People and places that were low income or low wealth before the recession are less resilient financially and economically during the recession. They lack the ability to absorb the shocks as well as people with greater means. People of color likely will experience a disproportionate share of economic loss because they constituted a disproportionate share of financially and economically vulnerable individuals before the recession.

Philanthropy cannot stopgap all our problems. The crisis is too large, and the field, as a financing system, has outgrown in scale and scope the capacity of all but the largest institutional philanthropists. Although willing, funders have seen their giving power decline along with their net worth. With more demand and fewer resources, donors and philanthropic investors are “choosing” (that is, funding) winners (organizations and strategies they consider both vital and critical) and gently urging mergers.

During at least the next three to five years, however, these trends and issues will produce a new normal in which—if we make good decisions now—CDIs can play a critical role in ways we do not yet understand, intermediating between wholly redefined capital markets and reshaped opportunity markets. The questions for CDIs and their partners are: What is that role? How do we prepare for it? And what do we need to do now to move in the right direction?

What We Can Do?

Policy

CDIs have long played a small but important role at the fringe of federal policy. By and large, policy work has concentrated on marshaling government resources in support of their work and in support of opportunity markets.

In the current economic and policy environment, CDFIs are pursuing a focused policy agenda to weather the storm, a mid-term agenda for growth, and a broader agenda that aims at structural and systemic change. More broadly, non-CDFI CDIs do not have a well-developed platform yet, although some planks are in place, including the Neighborhood Stabilization Program, the National Affordable Housing Trust Fund, and funding in lieu of Low Income Housing Tax Credits. In related areas, the time may be ripe for asset-building policy expansion, including Children's Savings Accounts, Individual Development Accounts, and community wealth-building strategies.

CDFI federal policy objectives include:

In the near-term:

- **Bolstering CDFI balance sheets through CDFI Fund awards programs:** This may be the single most important policy objective because it: (a) adds equity directly to CDFI balance sheets; (b) is ready for quick disbursement (in two rounds in 2009: June and September); and (c) is based on a performance-based decision model that will give shape to the CDFI industry going forward.⁷
- **Supporting CDFI lending through a Capital Access Program (CAP):** The 1994 statute creating the CDFI Fund included authorization for a CAP program for CDFIs. The program has never been used, but today it would support lending by adding a layer of security for investors and CDFIs.
- **Restoring liquidity to CDFIs, in several ways:**
 - In 2008, Congress gave all CDFIs access to membership in and, potentially, liquidity from the Federal Home Loan Bank (FHLB) system. More than forty nondepository CDFIs are pursuing this possibility. The Federal Housing Finance Agency is working on regulations.⁸ Rapid implementation could address \$1 billion or more of pent-up demand for FHLB financing.
 - The Troubled Asset Relief Program (TARP) is currently an option for community development banks but not for other CDFIs. Although some restrictions on TARP funding may be a problem for some CDFIs, more public issues such as executive compensation will not be problems. The CDFI Fund's Advisory Board has recommended that the U.S. Treasury use TARP funds to make long-term, low-cost loans to CDFIs. If this is not possible, the Treasury could make equity equivalent (EQ2) investments in loan funds and some equity funds and secondary capital investments in community development credit unions.
 - The Term Asset-Backed Securities Loan Facility (TALF) program might provide liquidity to CDFIs that lend to small businesses if it gains momentum for its original purposes.
 - Congress should enact pending legislation to provide a federal guarantee to certain CDFI bond issues. This bill would authorize up to \$1 billion per year for five years in long-term debt at government-backed prices.
 - Emphasizing mission-based results under the New Markets Tax Credit program to ensure that taxpayer-supported financing is reaching the people and places that would benefit from it most.
- **Reviving the CRA:** The Community Reinvestment Act (CRA) has been moved to the sidelines as the financial markets crisis plays out, suggesting incorrectly that it is not key to economic recovery and growth. Bank regulators should ensure full compliance with the CRA as the economy recovers, and they might consider interim, emergency rules that fit the CRA to current market conditions, much as regulators tweaked and transformed policies for multiple purposes during the past year.
- **Reinforcing key partners:** CDFIs are eager to see at least five policy changes that help key partners succeed, including funding and rapid and efficient implementation of the National Affordable Housing Trust Fund; implementation of short-term remedies to the stupor affecting Low Income Housing Tax Credits; an enhanced mission screen on New Market Tax Credit allocations; and increased resources for Small Business Administration programs ranging from the micro-loan program to the 504 real estate program.

In the mid-term:

- **Increasing CDFI Fund appropriations:** CDFI Fund appropriations flowed through fiscal 2008 despite Bush Administration efforts to eliminate the Fund. This year, through direct appropriations and a supplemental economic recovery appropriation, the Fund will award nearly \$150 million, the most ever in a single year.⁹ In the current policy environment, with an administration that seems to see CDFIs as key parts of the economic solution and a Congress that has backed the CDFI industry with broad bipartisan support, there is a good chance that CDFI Fund appropriations will continue to rise, despite real constraints on fiscal policy. The CDFI Fund model, unique

7 The President's 2010 budget includes a significant (90%) increase for core CDFI Fund financial and technical assistance programs. The budget includes \$80 million more for the Capital Magnet Fund, which also would strengthen CDFI balance sheets, increasing resources that may be available for this purpose.

8 Currently scheduled for publication in the *Federal Register* in mid-May 2009.

9 This figure represents funding in 2009 under core CDFI Fund programs. Total, combined appropriations of \$207 million also fund Native CDFI programs, the Bank Enterprise Award Act, other programs and activities, and administration of the Fund.

at the federal level, is a good fit for tough times, relying on demonstrated performance, private-sector leverage, and specialized market expertise to manage risk.

- **Building on the CDFI Fund model:** Unique today for its focus on general recourse investing in qualified, special-purpose financial intermediaries, the CDFI Fund experience over 13 years makes it a good model for other programs and agencies. Adapting U.S. Department of Agriculture, Small Business Administration, and other agency lending models to the CDFI Fund model (using equity grants and investments instead of debt) could give skilled lenders and investors more flexibility to ply their trade while reducing operating costs related to managing government-restricted financing.
- **Revamping the Community Reinvestment Act:** With widespread recognition that the time is now to modernize the CRA, the impending comprehensive reform of financial institution regulation is a once-in-a-generation opportunity to also extend the CRA to all financial institutions.¹⁰ Despite pockets of resistance, there is broad general recognition that extending the CRA is all but inevitable now that federal resources have bailed out the full spectrum of financial institution types.

In the long-term:

- **Make CDFIs and CDIs core to the financial system:** CDFIs, CDIs, and opportunity markets are increasingly important to a healthy economy and a robust civic and social environment. No longer fringe players, CDFIs and CDIs are part of the broadcloth of economic and social life. To this end, investing in CDFIs, CDIs, and opportunity markets at appropriate rates and terms should be an affirmative fiduciary obligation of all financial institutions. More than thirty years ago, a similar requirement of pension funds helped the U.S. venture capital industry grow.

Performance

Much of the CDFI industry is formed around a commitment to performance that is rooted in its early reliance on investments from Nuns' retirement funds and, later, other faith-based and socially motivated investors. That particular source of capital carried two weighty responsibilities: 1) Make an impact, and 2) Do not lose the Nuns' retirement funds. Performance today carries those same responsibilities—impact and responsible stewardship.

Maintaining discipline is up to practitioners, allowing for problems caused by economic and financial industry factors.¹¹ Not all institutions will remain disciplined and, in fact, many already are facing serious challenges due to lack of discipline in the past.

The CDFI industry—and I would posit the broader CDI world—needs a strategic intervention strategy to:

- Assess the relative strengths and weaknesses of institutions in distress. Few, if any, boards, CEOs, and senior management teams have experience with the kinds of challenges they are facing today.
- Bring in vital resources for institutions that are viable. Consultant services will come from experienced industry advisors and outside experts. The key is that the intervening entity must be able to make brutally honest decisions about whether the institution can succeed.
- Wind down institutions that are not viable. The CDFI industry has experience with successful wind-downs where investors remained whole and borrowers were served. This might involve acquisitions, mergers, or thoughtful resolution of institutional assets.
- Craft, manage, and deliver public messaging. One institutional failure can harm other, healthy institutions. A single investor fleeing the market could topple scores or more CDFIs or CDIs. Communication among investors, between investors and CDFIs/CDIs, among CDFIs and CDIs, and with the general public through the media is critical in crises.

This strategic intervention strategy would benefit CDFIs, CDIs, investors, funders, Congress and the CDFI Fund, and others.

Particularly in this difficult time, the field must talk openly and honestly about merit and performance in assessing intermediaries that serve low-income and low-wealth people and places. Not all intermediaries are equally effective or valuable.

In 2005, the Bush administration proposed to consolidate all of the federal government's community development and antipoverty efforts into block grants in the "Strengthening America's Communities Initiative." Because it proposed to cut

¹⁰ See Federal Reserve Banks of Boston and San Francisco, *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act* (San Francisco and Boston: Federal Reserve Banks of Boston and San Francisco, February 2009).

¹¹ In Part 2 of this paper, Nancy Andrews details operational challenges that CDFIs are facing and some of their responses. My comments are broad and are meant as a complement to hers.

overall funding by more than one-third, severely restrict the use of funds, and end the role of most federal agencies in this work, it was known behind the scenes at the White House as the “Strangling America’s Communities Initiative.” The stated premise of the initiative was that because some community development programs worked better than others, some were very successful, and some did not work at all, it was time for a national conversation on the future of community development. Because it was such a bad idea, it was relatively easy to defeat. But because it was such a bad idea, it was also a wasted opportunity. We should have an honest, if difficult, conversation about what works and why.

Collaboration

The most vulnerable aspect of the current situation is also, possibly, its strongest attribute—the trust among a complex set of partners. The greatest systemic risk for CDIs is the potential to lose the confidence and commitment of key partners, on all sides.

Binding the field together, on the other hand, are a shared set of commitments to mission; interwoven economic interests and concerns; and institutional, professional, and personal reputations. Responding to the current crisis can unite the field or pull it apart. The field must ensure that collaboration tightens the ties that bind.

This begins from the recognition that we need each other—that CDCs and housing developers need CDFIs to pull together transactions; CDFIs need banks to participate in transactions and support CDFI financing; banks need philanthropic institutions to inject subsidy that makes the transactions work; philanthropies need government to shape policies and provide resources that leverage grants and program related investments; government needs a viable and effective delivery system to implement policy choices; and round and round.

At the core of the collaboration is a commitment to preserving assets for everyone, from end beneficiaries to developers to financiers. The field needs a balanced and sustainable set of incentives to keep everyone engaged and encouraged. Asset managers, at multiple levels, must act with discipline as well as with an eye on the bigger community development ecosystem.

In practical terms, this collaboration has at least three applications:

- 1) *The field must strengthen and create forums for open and honest communications.* The Federal Reserve’s upcoming policy discussion based on this report is a foundation for this sort of forum. My organization is advocating for a CDFI Investors’ Roundtable so that investors avoid surprising one another and CDFIs. In cases involving distressed CDIs, much like distressed mortgage borrowers, the first, and worst instinct is to avoid contact with sources of financing. CDFIs and other CDIs need to engage in tough conversations about what is working, which institutions are healthy and viable, and what policy solutions are best for the people and places the field serves—rather than what is best for a particular group. Policymakers need to know what is working and what is not. As practitioners, we do not want to surprise our policy champions with unexpected bad news. In addition, the field needs an active media and public communication strategy that is coordinated, to the best of our abilities.
- 2) *The field must find common purpose in managing stressed and distressed assets and institutions.* A series of asset or institutional failures can send waves of concern across the industry, but it is equally true that taking extraordinary measures to save assets or institutions that need to be—it sounds harsh—written off is equally damaging to our long-term viability. The current crisis will, and should, reshape the composition, structure, and practices of community development. This is one of the key transformational changes that can, over time, make money and resources flow better in opportunity markets.
- 3) *The field should create a fund or a set of funds to manage the resolution of troubled assets held by otherwise healthy organizations, healthy assets held by troubled organizations, and troubled assets held by troubled organizations.* These Resolution Funds would exist to create soft landings for investors, funders, borrowers, and others (assuming a CDFI Resolution Fund for Financial Assets would be separate from a CDC or Developer Resolution Fund for Fixed Assets). The Resolution Funds would assume or purchase assets, warehouse them, and find buyers or takers, as appropriate and as quickly as possible. The Funds would provide interim servicing capacity and would function in close coordination with the strategic intervention services described above. They would require substantial first-loss risk capital, access to revolving credit, and independent management and governance.

Reasons to Smile and Reasons to Fret

CDIs are accustomed to turbulence, the risk that comes with economic instability, and illiquidity. It is what our customers, clients, borrowers, and beneficiaries live with day in and day out. This grounds us in risk management practices that tend to defy conventional thinking. So far, in good economies and bad (but never in crisis economies), the field has managed successfully.

In this economy and financial marketplace—with current liquidity, capital, and operating challenges—almost everyone is a neophyte. The field is short on capital and powerful relationships to fall back on, dependent on partners and institutions that are less able to help than they once were, and vulnerable to steady erosion of financial, intellectual, and human assets.

The economy may continue to deteriorate, and the worst for CDIs and opportunity markets may come six to nine months after the economy bottoms out. The financial marketplace could leave the field behind as regulatory reform and financial self-interests make community development a burden and opportunity markets a luxury that banks can no longer afford to mine. Policymakers could overlook the field in pursuit of bigger infrastructure solutions to economic malaise, in compassion for individuals who benefit more immediately from direct resources and services, and in the tough triage of decreasing federal resources.

Yet we are more important than ever to economic growth, to the people and places the field serves, and to the ability of the financial marketplace to function well and to grow. It is unclear who other than us can reverse Gresham's Law and drive "bad money" out of the marketplace and ensure that "good money," rooted in prudent and responsible underwriting, takes its place.¹² CDIs seem to me to be key to President Barack Obama's statement, in his inaugural address, that: "The success of our economy has always depended not just on the size of our gross domestic product but on the reach of our prosperity; on our ability to extend opportunity to every willing heart—not out of charity, but because it is the surest route to our common good."

Issues to Consider for the Upcoming Meeting at the Federal Reserve

One purpose of the conference is to frame and support informal and formal communications and work planning as we try to manage through the crisis and its backwash. With so much happening so fast and with such significant consequences, the challenge is to narrow the set of topics sufficiently to make them manageable but to define each topic in ways that allow dynamic conversations. With those goals in mind, a few ideas seem prominent:

- Policy priorities and strategies: transitional (short-term) and transformational
- Strategic intervention planning: products and services
- Outreach and communications: managing public understanding
- Market data and market conditions: What do we know? How do we know it?
- Capital strategies: meeting needs now and for years to come
- Supporting best practices: from crisis management to viable futures

No doubt the upcoming discussion will influence, enhance, and expand this list.

Overarching these topics is the question, What will the community development finance system look like on the other side of this crisis? And in ten years?

Conclusion

The future of opportunity markets and CDIs will be extraordinary—that is, they will be different in most ways from what we have known until now. Either they will be extraordinarily bad, involving organizational failures, long-term funding and financing shortfalls for surviving CDIs, and the loss of both jobs and leaders. Or they will be extraordinarily good, involving broad recognition that CDIs play critical roles in economic growth and financial system efficacy, in fostering robust partnerships among CDIs, the private sector, and government; and in rapid increases in CDI production.

The scenario that seems least likely is that CDIs will muddle through the current quagmire and simply continue along the path that has brought them here. That outcome is only possible if policies surrounding financial services and the economy do not change in material ways.

We do not know what will happen in policy or in the financial marketplace. Like the baker in Chelm as he faced the town elders, we know for certain only that life will never be the same as it was not very long ago. Things we thought would never change, things we thought we could always trust, will never feel certain again.

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¹² Gresham's Law, articulated by Sir Thomas Gresham, states that "bad money" will always drive "good money" out of the marketplace—where "bad money" describes a material difference between the real or stated value of an asset and its trading or commodity value.

Part II: Operations

Strength in Adversity: Community Capital Faces Up to the Economic Crisis

Nancy Andrews
Low Income Investment Fund

First Responders—America's Community Development Organizations

This paper reviews the impact of the economic crisis on the community development industry. Specifically, it asks: How are Community Development Financial Institutions (CDFIs) faring? What trends are emerging? What steps are CDFIs taking to respond to the crisis? In addition, the paper offers “best practices” to help all CDFIs manage this difficult climate.¹³

CDFIs can survive this economic crisis and deepen their mission, despite the extraordinary difficulty of the current period. CDFIs are the first responders in neighborhoods across the country and for families hardest hit by the downturn. CDFIs have created an industry joined together by a common mission of providing opportunities for people and places left out of the economic mainstream. The CDFI network can create the strength for CDFIs to help one another through these times, and to ensure not only that the field survives, but that it thrives.

From a series of eleven interviews with leading CDFIs across the country, we find that the economic crisis has created the following conditions for CDFIs:

- **Heightened risk in portfolios:** The risk is evident in delinquency rates, extensions of loans, or loss reserves set asides.
- **The need for significant patience among community development partners:** More time is needed for projects to come together, and lender patience is now crucial for success in struggling neighborhoods.
- **Heightened liquidity problems:** CDFI liquidity is strained. Many leaders are worried about the availability of new capital, as well as capital renewals from their investors, both private financial institutions and philanthropic partners.
- **Severely strained housing portfolios:** For-sale housing or early stage loans with Low Income Housing Tax Credits (LIHTC) as part of the project financing plan are particularly hard-hit.
- **Increasingly fragile borrowers:** The future strength of CDFIs is bound to the future of its customers, and the trends are negative.

Description of Interviews

Among the eleven interviews, six were with national or large regional CDFIs; two were rural CDFIs; and three were small and locally targeted CDFIs. Two were in the Midwest, three were headquartered on the West Coast, and six were headquartered on the East Coast, in locations stretching from the northern to the southern tip of the Atlantic seaboard.

In all cases, the individuals interviewed were CEOs or senior members of the executive team. In most cases, the relationship with the leader and author was at least a decade long, which generated immediate rapport and a willingness to be candid. The anonymity of the respondent was assured, which added to the candid nature of responses. In all cases, we asked leaders for their judgment and a sense of trends in order of magnitude, rather than data precision. Given the history and success of these CDFI leaders, their insights are invaluable about the future of the industry and steps needed to protect the community development field during this crisis, perhaps more valuable than detailed data analysis. Indeed, in this fast-paced crisis, even three-month-old data are quickly obsolete, making data analysis less reliable by the time it is published.

¹³ While this section of the paper is focused on CDFIs, it is our hope the discussion here would be valuable to the wide range of community development finance institutions; what Mark Pinsky refers to as CDI in the preceding section.

Background

Community developers—the neighborhood builders, investors, and service providers—are on the frontlines of this crisis. They witness daily the impact of the crisis on communities, families, children, and senior citizens. They are the first to get the calls from families in trouble, or from nonprofit service organizations facing state or city funding cuts, or from neighborhood developers scrambling to keep projects alive. For more than three decades, community developers have been quiet but vibrant agents in America’s most distressed locations, mitigating the worst effects of an economy that delivered uneven benefits.

The community development finance sector, including CDFIs, community development banks, venture funds, micro funds, and community loan funds (henceforth “the sector”), are the capital side of this network of community support. The sector represents a unique part of the remarkable 30-year experiment America has undertaken in community revitalization and poverty alleviation. Coupling private-sector business discipline with social mission, community development finance organizations draw private capital into places and projects it could not otherwise reach. The sector capitalizes public subsidies, allowing low-cost housing, health care centers, and child care centers to be built, jobs to be created, and commercial enterprises to expand. The CDFI sector finances projects that are financially viable but that fall below the profit requirements of mainstream capital.

Three decades ago, CDFIs emerged from the grass-roots activism of neighborhood organizations. Initially an informal, homegrown response, CDFIs increasingly are large-scale and professionalized. The community development finance sector represents more than \$29 billion in capital today, and most of the organizations possess strong internal financial management systems, coupled with investor covenants intended to keep the sector safe and sound. Community capital organizations maintain loss reserve cushions, liquidity cushions, equity cushions, and risk rating systems. With the advent of CDFI Assessment and Rating System (CARS), the community capital industry has created a rating process intended to reward success and spread best practices. These are all signs of a vital industry that is self-reflective, self-correcting, and self-aware.

Nothing in the industry’s history—neither investor covenants nor internal models nor scenario planning—could have prepared CDFIs for the stress they now face, either in the communities they serve or within their internal operations. To make matters worse, their primary capital partner—regulated financial institutions—face unprecedented challenges and are pulling back on the throttle of their capital. The financial system can turn to the Troubled Asset Relief Program (TARP) for liquidity aid. Robert Kahn of the World Bank estimates that governments in the industrial world have invested \$9 trillion in guarantees, credit extensions, and debt purchases in efforts to put a floor under the market.¹⁴ However, the closest thing to a liquidity infusion that most CDFIs have is the small, but welcome, \$100 million emergency appropriation in the national stimulus plan.

Community organizations have faced hard times before. In the early 1970s, the Nixon administration attempted to roll back the signature efforts of the Kennedy-era War on Poverty. It disbanded the Office of Economic Opportunity (OEO) and marginalized its programs. Community activists reeled from this devastation and, in many cases, believed the end of the nation’s war on poverty was near.

However, after the first shock wave subsided, community advocacy gave rise to Community Development Corporations (CDCs), and CDCs learned how to generate fees from their activities. They created new partners with philanthropy for support. They attracted religious orders and foundations to the idea of using their capital affirmatively to create community loan funds for the special needs of neighborhoods and people overlooked by banks. In short, out of adversity, community activists hard-scrabbled their way to survival. What sprang from that early devastation is, today, the most robust system of community-based development, services, and finance in the world.

This movement created the Community Reinvestment Act and the Low Income Housing Tax Credit that together delivered billions of dollars to low-income communities. In more recent years, the field created the CDFI Fund, the New Markets Tax Credit program, and the Capital Magnet Fund. In short, the challenges in the 1970s that threatened America’s community programs made the sector stronger in the end, and it has subsequently delivered billions of dollars of capital investments to communities.

This history speaks to the spirit of communities and people motivated by a vision of self-improvement. It speaks to the creativity and drive of the professionals working in the community development field, professionals motivated by a social

¹⁴ Robert Kahn, Senior Advisor, Financial Systems Unit, Financial and Private Sector Development Vice Presidency of the World Bank, speaking at “The Financial Crisis: Global Dimensions” lecture, sponsored by American University Economics Department, Robert A. Blecker, Chair.

vision, not by profit maximization. Economic reversals spur creativity. Most important, the field is today a strong network that is mutually supporting. The sector's biggest asset is its common mission and collaborative spirit. No private-sector entity possesses this asset, nor does it have colleague organizations to lean on for support. In a very real way, the field's common mission is its greatest asset, and that mission is furthered by continued survival and success. We are not only in this together, but we are in it for each other.

Avoiding Denial—What Is the Impact on Community Finance?

Community finance organizations feel the impact of the economic downturn at multiple levels. First, the people served are disproportionately affected by hard times; they suffer more and recover more slowly than the mainstream population. Second, a large proportion of the projects CDFIs finance depend on federal, state, or local subsidies, all of which are severely strained. Third, CDFIs finance a mission-driven delivery system, often not-for-profit in both name and reality. Their borrowers operate with thin equity cushions and few shock absorbers to cushion bad times. One East Coast leader described the impact of the economic crisis on the borrower community as “teetering, undercapitalized.” Another noted that while at first, weaker entities were experiencing problems, now “even well-run borrowers are having real problems.” As a result, the community development sector can expect some serious challenges ahead. One leader estimated that if the current crisis continues for a year or more, the entire delivery system will begin to fail.

As noted above, CDFI leaders see five key trends:

- Heightened risk
- Significantly more patience required by borrowers
- Serious liquidity problems
- Hard-hit housing loans
- Increasingly fragile borrowers

Heightened Risk

In general, all CDFIs reported heightened risk in their portfolios and particularly in housing loans. It did not matter if the CDFI was national, regional, local, large, small, rural or urban—all saw heightened risk. The severity of risk varied considerably by portfolio concentration and by size. Those with high concentrations of housing, particularly homeownership projects, reported far greater risk. Eight of the ten CDFIs with sizable housing portfolios saw homeownership projects as a primary source of increased risk. In particular, respondents reported that unsubsidized homeownership loans were experiencing the greatest weakness.

Heightened risk was evident in increased delinquency rates, or an increase in loan extensions, or increases in loan loss reserves, and occasionally in all three. Two respondents reported no loss reserve increases. The others reported some increase in reserves, generally by 25 percent to 50 percent. One CDFI with a large exposure to homeownership reported a tenfold increase in its annual provision for loan loss reserves.

The second most frequent cause of growing risk was dependency on fundraising or public subsidy (reported by five of eleven CDFIs). One CDFI reported a full stop on new loans that depended on fundraising.

Smaller CDFIs reported less portfolio deterioration than larger CDFIs. Respondents saw short-term acquisition and pre-development loans as more risky than long-term loans for projects already in service and seasoned, especially community facilities. Portfolios with greater concentrations in Low Income Housing Tax Credit (LIHTC) projects experienced greater risk. One CDFI avoided portfolio deterioration because of the absence of LIHTC-dependent projects in its portfolio. Projects in weaker markets, such as those in rural or exurban areas, were affected more than in strong markets.

Geographically, western CDFIs saw more trouble than others. Several national and regional CDFIs reported a concentration of problems in California. They reported enduring slow payment on loans and deep financial stresses on community developers. The strains in California CDFI portfolios extended beyond housing and homeownership to health care facilities, charter schools, and other community facilities. One CEO feared that the affordable housing delivery system would be permanently weakened because many community developers would not survive the current economy. Others saw the problems in California beginning to bleed over into Arizona, Washington State, and other western locations. One national CDFI reported the weakness in its portfolio was concentrated in Los Angeles, Florida, and in rural locations.

Although community facility portfolios seem to be holding steady at present, many leaders said they were waiting for “the other shoe to drop,” and foresaw trouble in this sector in the near future, as well as in their commercial portfolios. One respondent predicted the commercial and facility loans “will be the second wave.”

Need for Patience

Most CDFIs (nine of eleven respondents) called for greater patience as borrowers scrambled to put resources together to make deals work. “Everything is taking longer,” one respondent said. “Borrowers are going multiple rounds to get financing and subsidy, at the state and city level.” Some leaders reported that their delinquencies were stable because they simply extended loans, believing that the borrower would eventually work out the problems. One CDFI reported extending 80 percent of its housing loans (up from 50 percent in more normal times). Another reported that they had always experienced many extensions, but “now it is for bad reasons.” In part because of this growing need for patience as projects came together, all but a few CDFIs were anxious about investor renewals and serious liquidity issues that affected their ability to finance new requests.

Serious Liquidity Problems

Liquidity shortages were felt broadly, but large CDFIs were particularly affected. Six of eight large or rural CDFIs reported current and often severe liquidity problems, or concern about future liquidity problems. Smaller CDFIs fared better as well as those located in the Midwest. All but one CDFI expressed concern about a contracting capital environment, even if they were managing well at present. Respondents also noted the need for extensions, the lack of new capital coming into the field, and concern about capital renewals. Indeed, one CDFI leader said, “If banks don’t start lending again at reasonable rates, a lot of us will go out of business.” Another said that their capital partners were “really hunkered down. They’ve begun to understand that this is a structural adjustment and they need to figure out the new normal.”

More of the CDFIs that experienced strong growth in deployment during the past two to three years were more likely tapped out of capital than those with growth in the past year. On the other hand, CDFIs that had not expanded their lending volumes appeared to be faring better than others with respect to liquidity. In the case of faster-growing CDFIs, recent high-volume levels had consumed much of their available capital and the need to extend loans was causing a capital crunch. Nearly all CDFIs reported difficulty in getting new capital and sometimes renewed capital. Most reported “just making it,” by saying no to borrower requests. Some indicated that the liquidity problems were being offset by reduced demand. Others reported that demand had increased in recent months, largely from the contraction of lending by banks.

CDFIs reported mixed experiences with investor renewal of capital. In general, they were “holding steady” with capital levels, but new capital was virtually impossible to find. One CDFI reported negotiating with a bank for more than two years and being on the cusp of a capital commitment, only to find the bank taken over by another, and the verbal commitment nullified.

Housing Loans Are Hardest Hit

As noted above, most CDFI leaders reported that increased risk came mainly from the housing portion of their portfolios, particularly from for-sale housing. “Homeownership,” said one respondent, “is clearly most severely impacted. It is head and shoulders above the others in weakness. If ten deals are in trouble, seven will be in for sale/homeownership. However, our community facilities are fine.”

Community facilities (charter schools, child care centers, health care centers, water and sewer systems, and other community centers) seemed to be performing well, particularly if the financing was long-term and for a facility already in service. That said, a few saw future trouble in their community facilities portfolios, assuming hard times spill over into the next year. CDFIs with loans in California reported more concern about community facilities projects than others.

Three CDFIs continued to experience strong customer demand, particularly when the CDFI was involved in financing community facilities or commercial lending. As one respondent said, “There is a ton of demand right now. Our phones are ringing off the hooks.” Her organization, she said, was “moving upstream” and taking on deals previously done by banks. She worried, however, that they might become complacent and accustomed to having higher-capacity customers. “My lending team is really happy not to have to hold as many hands,” she said. “They are dancing in the aisles when they get a complete loan application.”

Most leaders, however, and particularly those concentrated in housing, had seen demand slow dramatically during the past few months largely because of the uncertainty of public support, the collapse of the LIHTC market, and state or local budget issues that made new projects too dicey to undertake. The reasons given for slower volume included:

- Housing developers remaining on the sidelines, waiting for property values to bottom out;
- Housing developers are financially weaker, because they are paying the carrying costs of unfinished projects over longer periods of time as total project financing is assembled;
- Lack of capital supply is forcing demand to contract;
- Lack of public subsidy to fund new projects;
- Homeowners remaining on the sidelines because of uncertainty over their employment future, despite the low cost of housing.

How Are CDFIs Responding?

In general, CDFIs are responding to the need for patience by extending loans (nine of eleven respondents) where an extension did not cover up a credit problem. All CDFIs but one reported notable increases in extended loans. The result is a liquidity crunch that often forces CDFIs to dial down positive responses to new requests.

CDFIs are managing heightened risk through a combination of extra vigilance toward late payments, bulking up loss reserves (nine of eleven respondents) and, in a few cases, performing stress tests on portfolios and corporate budgets. Many CDFIs are scrutinizing deals more closely, along with asset valuations, and occasionally, reappraisals of portfolio collateral. Most reported higher scrutiny of transactions at the front end, in light of the risk environment.

The most common risk management strategy is paying greater attention to late payments. CDFIs are making calls to customers within a few days of the due date, and are escalating if payments are not received. The second and third most widely used approach to mitigating risk is paying extra attention to borrowers' financial condition and scrubbing of asset valuation. CDFIs are also performing stress tests on borrower projections, looking at levels of borrower liquidity to determine size of loans, as well as imposing tighter terms and conditions.

One CDFI said they believed with enough time and with adequate patience, the problem loans would work themselves out with minor losses. Nearly all others saw growing risk in the future.

At the corporate level, several CDFI leaders mentioned they were stress-testing their budgets in every way they could think of, and continuing to "look around the corner for things I haven't thought of that could kill us."

Yes We Can! (Manage Through This)

The community development financial sector's biggest asset is its commitment to a shared vision and an industry structure that does not require competition for vitality. The economic crisis calls on this asset more than ever. The field will need the strength and insights of everyone to pull through this extraordinary time. Several leaders noted that if the crisis goes on for more than a year, it would create serious hardship for the industry. One CDFI leader said:

Philanthropy needs to hear that 2010 is a watershed year for CDFIs and other nonprofits dependent on multi-year grants. 2011 is not survivable without continuing support. We may watch the silent demise of nonprofits.

Many CDFI leaders called for new ways of communicating and sharing, for creating united fronts endorsing common positions on critical issues, especially capital requirements. To get through this crisis, the field will need to pull together more closely than in the past. The watchwords for the next several years will be: learn, share, and help.

Steps to Weather the Storm

Navigating the worst economy in a century will require that members focus on ensuring that the field is as secure as possible and able to continue to attain its goals and sustain its mission. This requires a number of proactive steps:

- 1) Batten down the hatches by:
 - a. Going to ground; forecast cash flows for the worst-case scenario,
 - b. Circling up risk through portfolio stratification,
 - c. Instituting stress tests for portfolios and organizations,
 - d. Instituting a credit review discipline
- 2) Learn new skills: workouts and foreclosures.
- 3) Remember: our borrowers, ourselves. The core of the field's mission is borrowers' well-being. Become active in policy matters that benefit borrowers and the field.
- 4) Never waste a crisis; Refresh attention on the basics of financial management: net worth, liquidity, and net operating margin.
- 5) Attend to other best practices, such as full-cost accounting, scenario planning, and multiyear forecasting.
- 6) Practice the network solution: share your way through this.

Batten Down the Hatches

During any crisis, it is important to identify one's soft underbelly and protect it, rather than waiting for problems to arise. Although some CDFIs are reporting no dramatic increases in delinquency rates, they are anticipating problems and are rescoring their portfolios, increasing their risk reserves, and scrutinizing new requests. These are perfect initial steps.

Now is the time, as well, to begin stress-testing at the organizational level. How much of a revenue decrease can the organization withstand? What would happen if grant support declined by half? What happens if ten percent of the organization's portfolio is nonperforming?

We offer four important steps to batten down the hatches in preparation for a bad storm. For smaller organizations, many of these are back-of-the-envelope calculations. Larger organizations may need to develop simple spreadsheet models. The emphasis is on simple. It is not necessary to develop comprehensive or precise information in undertaking these exercises. In this case, the perfect is very much the enemy of the good. Rather, the goal is to identify in broad strokes the magnitude of potential problems and to develop responses for the back pocket if bad news is forthcoming. In the end, the actual steps an organization takes may be quite different. But there is nothing quite as reassuring to a leader as thinking through how bad it might get, identifying the soft spots, and developing contingency plans.

Step 1: Cash, and forecast the worst-case scenario. In October 2008, the finance committee of Low Income Investment Fund (LIIF) startled both the CEO and CFO by requiring them to come to the October board meeting with a draconian scenario:

Assuming no customers repaid and no investors renewed their capital commitments, how long would we survive?

Both the CEO and CFO believed their approach to scenario planning was aptly conservative. In their hearts, they felt the finance committee was being overly dramatic. Dutifully, however, they completed the scenario.

The process was transformative. They realized, first, they had enough cash to weather a "ground zero" scenario for more than a year. On the other hand, they also realized that three large capital renewals must occur for the organization to sustain a healthy level of investment in its communities. With that, the executive team realized how dependent they were on these events and how tentative their work could become if any one event failed to materialize.

They began monitoring with great care. At their weekly executive team meetings, they looked at a multiyear forecast and began managing the lending pipeline far more deliberately. In LIIF's case, one of the three critical renewals has occurred. The remaining two are promised. Thanks to the willingness of the board to push management to "go to ground," LIIF is confident that its capital management disciplines can handle a deteriorating environment.

Not every CDFI needs to create a special forecast. For many, the assumptions are so obvious that key events are perfectly well understood. What changed within LIIF was that management foresaw the likely case and began managing more actively to deflect the worst case.

Step 2: Portfolio stratification. Portfolio stratification—examining the layers of risk within a loan portfolio—is useful in highlighting where future risk might reside. It is less useful in highlighting risk already understood. In portfolio stratification, managers create a table that stratifies outstanding capital on the basis of loan-to-value (LTV) ratios to better isolate the proportion of the portfolio with high LTVs. Such an exercise might show, for example, that 15 percent of the portfolio possesses LTVs greater than normal thresholds (say 90 percent), and ten percent carries high-risk LTVs of, say, greater than 100 percent. This makes visible the percentage of capital that could carry higher risk, even if it is currently performing well. By “circling up” the risk, a CDFI can dig into these specific transactions and get ahead of the curve by anticipating future problems.

In addition to LTV stratification, portfolios can be stratified using Debt Service Coverage ratios, second lien positions, unsecured debt or any combination of these factors.

Step 3: Stress-test the portfolio and get ahead of looming problems. CDFI directors intuitively understand that the greatest weakness in their portfolios lies in homeownership, LIHTC deals, and fundraising-dependent projects. Knowing this, it is possible to conduct stress tests of individual loans in a given soft area.

A stress test means varying the key assumptions of the loan repayment to determine how bad things can get before the repayment is threatened. For example, with LIHTC projects, the stress test would involve assuming a lower LIHTC price, say 75 cents on the dollar, rather than the original underwriting assumption of 85 cents on the dollar. What would the borrower do in this circumstance? For homeownership projects, the likely stress point is the break-even sales prices of the homes against current market trends. For small portfolios with only a handful of loans in the most susceptible categories, the stress tests can be done by simply varying critical assumptions. For larger portfolios, it may be necessary to hire consultants. Stress-testing can identify problems before they happen and provoke conversations between lender and borrower that avert the worst outcomes in a deteriorating environment.

Step 4: Credit reviews – hire a “junkyard dog.” Once every few years, it may be useful to engage an external expert to conduct a credit review. This generally involves evaluating the underwriting standards, as well as the checks and balances within a lending operation. The review identifies strengths and weaknesses of the system and how accurately current processes have been followed. In general, the outside perspective of a credit review can yield valuable insights, even if the evaluator is unfamiliar with the CDFI environment.

Frequently, a friendly bank or other CDFI capital investor is willing to deploy a credit officer to conduct pro bono portfolio reviews. If not, the expense of hiring a consultant can be controlled depending on how deep the CDFI wants the review to go. However accomplished, the key to a meaningful credit review is using external expertise and external eyes to provide insight.

Workouts and Foreclosures

For many CDFIs, loan workouts are a rare event. Although projects often hit bumps in the road, the ability to be patient and responsive to borrower requests has often been the main ingredient for a successful workout. However, conditions have changed markedly in the past twelve months. More and more hard workouts are rearing their heads.

Good workout and restructuring are specialized skills. In the best circumstances, they can be a tool to enhance borrower strength and capacity. Few CDFIs, however, can afford to bring on special asset managers. Yet all CDFI lending staff can learn the special skills of a workout situation. One of the hardest things to balance is when to exercise speedy and decisive action over simple patience. A second difficulty is how to communicate in a manner that helps the customer understand why the workout is the best course, particularly if wishful thinking is at play about the project’s future chances.

In any event, it is worth considering whether an industrywide response is warranted. This could take the form of a shared approach to workouts and restructures, or training for lending staff. At the highest level, an industry response might also include a “bad bank” where CDFIs could create liquidity from their underperforming assets while transferring them to specialized expertise to help customers get through these difficult economic times.

Our Borrowers, Ourselves

Policy matters. CDFIs are frequently lagging indicators of the overall economic environment. Although borrowers are on the frontlines, the field can be shielded from immediate impact by borrowers' coping strategies: they use their own cash to feed projects or fundraising shortfalls, they lower operating expenses to cover debt service payments, and so forth. However, if the economic downturn is both deep and protracted, these coping strategies will be temporary. Ultimately, the health of CDFIs depends on the financial health of its customers.

Many CDFIs are witnessing the deteriorating conditions of community developers and human service organizations. The withdrawal of public safety net services and the contraction of philanthropic support pose a special challenge to the CDFI agenda. Raising a strong voice to advocate for the community development agenda is more important now than ever before, and the message must be about the resources that not only benefit CDFIs, but also their customers. LIHTC, Section 8, and Community Development Block Grants are examples of programs central to the community development agenda, but less central to the CDFI advocacy agenda. More than anything else, supporting the advocacy agenda of community development will protect borrowers and the CDFI field in the coming years.

Never Waste a Crisis

Use the basics to grow stronger. It is worth repeating the basics of sound fiscal and organizational managements. There is nothing complicated or fancy about these principles. They are rooted in everyday commonsense. Ironically, several of the high-flying financial institutions that crashed in the current bust violated these fundamentals.

Only three financial management principles really matter: net worth, liquidity, and net operating income margins.

Net worth – Of the three, net worth or equity is most important. It is no accident that, among CDFIs interviewed, additional equity was the single largest desire. There are only two ways to create net worth: through annual surpluses (see net income below) by attracting equity and capital grants, that is, the Financial Assistance program from the CDFI Fund or the Capital Magnet Fund.

The net worth of an organization is what stands between it and insolvency. Equity is a built-in “endowment” that reduces the overall cost of funds, allows CDFIs flexibility in lending tools, and allows patience with our borrowers. It is a revenue source that creates long-term sustainability and the tools to accomplish the organization's mission.

Liquidity – Sufficient liquidity requires CDFIs to manage cash to ensure enough on hand to cover at least one year of upcoming liabilities (although management textbooks say the ratio should be 2:1, for CDFIs, 1:1 is a must). Keep 90 days of operating expenses in cash as well.

Net operating income – Always budget a surplus. A four percent to eight percent net operating margin has proved to be a good range. This is the cushion that allows budget estimation mistakes and revenue reversals to be absorbed without eroding net worth.

Other Best Practices

Other best practices include full-cost accounting, ongoing forecasts of annual and multiyear performance, and scenario planning. These are techniques that support financial security.

Full-cost accounting: Know when to hold 'em, know when to fold 'em. Full-cost accounting aligns the expenses attributable to an activity or program with the revenue the program generates. It requires properly allocating management and general costs (overhead). Full-cost accounting is the basis for understanding which activities cover their costs, which create surpluses, and which require discretionary resources. This allows management to make rational and deliberate decisions about which activities to expand and which to shrink.

Scenario planning. Create high-, medium-, and low-risk scenarios for each annual planning cycle. This can seem like make-work, but it is crucial. If nothing else, scenario planning forces planners to think about the assumptions beneath annual plans, and programs are stronger for it. Moreover, the financial aspect of scenario planning can reveal weaknesses and assumptions that alert management to issues they must tackle. Using worst-case scenarios in the present climate is also a cleansing experience; it forces us past our natural denial and disbelief. In the end, worst-case planning can spark new ways

of looking at an organization and point to creative solutions to existing problems. Sometimes it is helpful for an outside force—in the story above, it was LIIF’s Finance Committee—to put one through the paces.

Ongoing projections of fiscal performance. A discipline often overlooked is preparing year-end projections with each financial statement. Similarly, multiyear scenarios (three to five years) should be refreshed annually as part of the planning cycle.

The Network Solution: Sharing Our Way through This

CDFIs form a national network dedicated to a common vision of community development and poverty alleviation. On a daily basis, however, the field operates separately, with little sharing of services, operations, or expertise across organizations. This isolation causes a “hall of mirrors,” where each CDFI creates independently the systems and expertise needed to run its business. Each enterprise is largely on its own in addressing problems and challenges. The result is increased overhead and inefficiency, as numerous organizations reinvent the same wheel. The field’s survival and future health depends on greater efficiency and cost savings. It must break down the hall of mirrors and build in its place a hall of windows. In these most difficult of times, the field needs everyone’s ideas and cooperation. We even need one another’s emotional support.

CDFI leaders identified five pressing needs for the future.

- Equity support in grants or grants for loan loss reserves;
- Liquidity relief, especially reasonably priced debt;
- Workout/trouble asset expertise;
- A forum for self-help: shared information, best practices, shared services;
- Heightened focus on policy solutions.

Equity support. The top priority for CDFI leaders was the need for additional equity and protective capital during the down cycle. This could take the form of equity grants, loan loss reserve grants, possibly even equity equivalent loans. Many equity bases are stretched by credit deterioration at precisely the moment CDFIs need to be patient with customers. Additional equity would mitigate this and permit more mission-driven behavior rather than “hunkering down.” As one organization said, “there’s no sense of being a CDFI if we can’t push mission in a down time.” In this case, the example was to take advantage of low prices to buy up land-bank property. However, the same general point can be made in many program areas.

Liquidity relief. A near tie for first place was the need for additional liquidity. Although the need is for additional liquidity, many also made the point that the price must be reasonable so that CDFIs could earn a spread. The strategy for this may well be joint advocacy for additional resources for the CDFI Fund, for renewed capital commitments from banking partners and foundations, or increased capital commitments through the current regulatory reform discussions. There was interest in innovative new legislation, such as the OFN sponsored “CDFI bond” program. Likewise, several leaders reflected the concern that foundations with program related investments (PRIs) and banks with loans to CDFIs were not responding flexibly with capital renewals or extension in the face of extraordinary financial circumstances. They pointed to a need to join together to influence investors.

Workout/trouble asset relief. Several organizations asked for a centralized workout service that they could call upon in dealing with the troubled loans in their portfolios. This could take the form of a “bad bank” to purchase troubled loans and recapitalize CDFIs. A second approach would be to provide expertise that CDFIs could call upon for help with their most troubled loans.

A forum for self-help. Every organization interviewed called for additional opportunities to learn from one another. Some were hopeful things will improve soon; others felt there was more darkness to come. Nevertheless, all organizations called for increased communication and sharing of best practices, resources, and information. A few called for new models of shared services to improve operating efficiency. One leader asked for “volunteers from banks who are workout/trouble asset specialists.” Another asked for help in developing sophisticated liquidity models and processes. Most called for stronger advocacy within policy circles. In addition, a few specific ideas were put on the table:

- Greater sharing of terms and conditions offered by investors to increase transparency of capital terms within the industry;

- Shared services to help organizations improve their cost structures and grow net worth naturally;
- A “bad bank” to aid in liquidity for individual CDFIs, while placing troubled loans into professional hands;
- A federal guarantee of CDFI portfolios;
- A forum to discuss how firms are coping, what works and what doesn’t;
- A forum for seeking influence with PRI and bank investors perceived to be unresponsive to the industry in these difficult circumstances;
- A way to discuss and understand that the solutions for small CDFIs may be different from large CDFIs;
- Agreements to stand by one another when shared transactions face risk; it’s not cricket to say, “I’m first in line so good luck to you.” The field needs more of a system solution for working out troubled credits.

Policies for new resources. Central to CDFI-specific policy work are the CDFI Fund appropriations debate, funding the Capital Magnet Fund – included with an \$80 million allocation in President Obama’s budget, and funding of the New Markets Tax Credit program.

In addition, the importance of the upcoming Community Reinvestment Act debate cannot be overstated. CDFIs need to be a strong voice in this debate, advocating for increased resources for communities. In fact, the Opportunity Finance Network is developing ideas for building CDFIs directly into the fabric of regulatory reform as a “must do” for financial institutions in meeting their community reinvestment obligations.

Because the future of development finance is intimately linked to its customers, many of the policy issues affecting those customers will provide ultimate support to CDFIs. These include the Low Income Housing Tax Credit market, Section 8 subsidies, National Affordable Housing Trust Fund subsidies, Community Development Block Grant programs, and a range of education, child care, and health care operating subsidies. Providing support to CDFIs without shoring up these underlying programs will be only a temporary solution. CDFIs could lend critical support to their customers when they advocate for increased federal and local support for these safety-net programs.

Conclusion

Community development and community capital in the United States are facing heightened risk. This is most acutely felt in housing projects and the housing portion of loan portfolios, and particularly in for-sale projects. It is also felt in projects that depend on fundraising or public subsidies. Many leaders fear these problems will very shortly bleed over into community facilities and the commercial sector. CDFIs are responding by exercising patience, giving community-based developers additional time to succeed and to weather the bad economic climate. However, the credit crunch is constricting the flow of new capital coming into the community capital field and push is coming to shove. As a consequence, liquidity problems are emerging, and are most acutely felt by the larger-volume CDFIs. Anxiety is growing that investor commitment, both from banks and foundations, will not match the need of communities for patient, supportive capital. Nearly every CDFI is taking aggressive and prudent steps to shore up risk reserves, to re-score portfolio risk and to manage demand to match capital supply, assuming ongoing constraints. CDFI leaders increasingly recognize the need to pull together as an industry to find pathways through the difficult times, and to help one another navigate rocky economic times. There is also a growing sense that a common agenda must be formed to influence investors and funders in the choices they make for community development in the United States during the next few years.

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Part III – Access to Debt and Equity

Observations on the Effects of the Financial Crisis and Economic Downturn on the Community Development Finance Sector

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Overview

In the almost two years that have passed since the collapse of two Bear Stearns hedge funds in June 2007, the difficulties faced by the financial services sector have continued to dominate the attention of policymakers. Concerns have focused primarily on the troubles at the very large financial institutions and the systemic risks they pose. Policy responses have included infusions of government capital, increases in deposit insurance coverage, government-supported shotgun mergers, conservatorship for the government-sponsored enterprises, purchases of marketable securities to maintain liquidity, and guarantees against losses.

At the same time, policymakers have devoted considerably less focus on the smaller, mission-driven institutions in the financial services marketplace that provide community development finance—critical credit and investment services—to low-income borrowers and communities. These institutions include those certified by the Department of the Treasury as Community Development Financial Institutions (CDFIs), but also other financial institutions with similar missions, which are referred to here as community development institutions (CDIs).¹⁵

By definition, CDFIs and CDIs were created to meet the lending and investment needs of low-income borrowers and communities that were not well served by mainstream financial institutions. Although many of these institutions have long, meaningful histories, the rise of the community development finance movement is a more recent phenomenon.¹⁶ The industry has grown significantly in number, scale, reach, and impact since Congress created the CDFI Fund program at the Department of the Treasury in 1994. Many of the estimated 800 to 1,000 institutions that qualify as a CDFI or a CDI are adding significant value to the communities they serve.

The CDFIs and CDIs are the institutions best positioned to deliver financial services to the communities hardest hit by the economic challenges. As mission-driven organizations, the CDFIs and CDIs are keenly focused on how the downturn, with its attendant job losses, foreclosures, and bankruptcies, is affecting low-income families and low-income communities (that is, their customers and service areas). Yet an increasingly challenging economic environment is making it difficult for the community development finance industry to respond to these communities' needs. The traditional sources of funding are more constrained as funding partners deal with their own financial challenges. Less access to funds coupled with credit challenges, which are forcing the CDFIs and CDIs to extend outstanding loans and increase loan loss reserves, has meant a liquidity crunch for many institutions in the industry. These strains make it difficult to meet the demand for their investment dollars and other services. And, most in the industry expect the situation to get worse. CDFIs and CDIs are doing the necessary contingency planning and adopting other strategies to prepare for an uncertain future environment.

Given the importance of CDFIs and CDIs, policymakers should better understand the impacts of financial crisis on the health and effectiveness of these institutions. This section of the report examines the state of the community development finance sector today, and how the crisis is affecting the funding sources for CDFIs and CDIs and the projects in which they invest.

15 See, "The New Normal" by Mark Pinsky, who coined the term CDI. Like Pinsky, the author regrets introducing yet another acronym to the alphabet soup of federal program names and industry jargon included in this paper. At the risk of adding confusion, the term CDI signals the inclusion of those institutions that do not necessarily identify with the CDFI label. The labels "community development finance industry," "community development finance movement," and "community development financial institutions" include the wide variety of financial institutions serving low-income communities. Where appropriate, "CDFI" is intentionally reserved for specific institutions that identify with this term or that segment of the community development finance movement that is certified by the Treasury Department as eligible for its assistance.

16 The National Development Council, which was founded in 1969, claims it is the oldest nonprofit community development organization in the United States. The Illinois Neighborhood Development Corporation acquired South Shore National Bank in 1973 and with the acquisition launched the community development bank model.

Research Methodology and Issues

The material in this paper is derived from conversations with more than twenty-five leaders in the community development finance field. Those interviewed represent many of the most prominent community development financial institutions and some of the leading foundations, lenders, and policy advocates in the industry.¹⁷ The interviews are augmented by available studies from the Department of the Treasury, the Opportunity Finance Network (OFN) survey, several published and unpublished articles, and the other working papers and interview notes. This paper attempts to aggregate the themes that emerged in the conversations with field leaders to paint a picture of the industry today.

However, the project faced a variety of research challenges, which warrant caution in interpreting the results. Some of these challenges include the following:

- **The interview sample does not allow statistically valid generalizations about the industry.** For the most part, the people interviewed for this project represented larger, more established, nonprofit CDFIs. The information from these interviews, therefore, cannot begin to capture the extraordinary diversity of the community development finance industry. The estimated 800 to 1,000 CDFIs come in all shapes and sizes, with structures ranging from for-profit to nonprofit; from banks to credit unions to loan funds to venture capital funds to microenterprise funds. The institutions that comprise the community development finance movement range in sizes from very small and local (in 2005, the median size was \$8.3 million in assets)¹⁸ to relatively large institutions with a national presence, ranging from Self-Help, which has invested more than \$5 billion since 1980, to LISC, which has invested more than \$9 billion over the same period, to ShoreBank with more than \$2 billion in assets.¹⁹

The CDFIs and CDIs operate on a wholesale or a retail level, and their funding bases vary considerably, ranging from private financial institutions, to foundations, to other socially motivated investors. Likewise, the types of activities they invest in span a wide spectrum of the financing needs in any given community, including homeownership and rental housing; predevelopment and acquisition loans; rehabilitation, development, and construction lending; commercial real estate, health care, and mixed-used development; small business and microenterprise finance; and public facilities such as charter schools and child care centers.

As one CDFI leader said, “The CDFI is the ultimate niche business with a unique geography and mission.”

- **The situation facing the industry is dynamic and changing rapidly.** The field is in a period of great uncertainty. The environment is changing daily. Funding partners of CDFIs and CDIs are also facing an uncertain future. Applications for loan or grant renewals are in, but decisions have not been made. Other loan and grant renewals are looming on the horizon. CDFI and CDI efforts to manage their credit books reflect the stresses and uncertainties of a stressed and uncertain economy. Many entities are hopeful that extending repayment terms on their outstanding loans will allow recovery, but this strategy may only work if the downturn is not too prolonged. And, the public policy environment is volatile.
- **Available data have limitations for analyzing the current environment.** There is no single, readily available data set that captures the current conditions faced by the CDFIs and CDIs. The ideal data set, quarterly financial statements for every institution covered by this project, in a format that allows aggregation, does not exist. In 2004, the CDFI Fund launched the Community Investment Impact System that is providing some very useful information, but there is a lag in its availability and the Treasury Department limits the levels of detail released. Likewise, an ongoing survey by the OFN provides terrific insight. However, only about 118 CDFIs participated in the survey for the end of the fourth quarter of 2008, and, of these, only 35 also responded to the third quarter survey, limiting the value of any longitudinal data. Further, the survey produces an insufficient level of financial detail to precisely describe the changing environment. First quarter 2009 survey results are due out in May and may illuminate what many observers believe has been a markedly negative change in the position of CDFIs during the first quarter.

These and other data limitations mean that the information and findings in this paper are more anecdotal than dispositive, more observation than conclusion. The spirit of the paper is to generate discussion, encourage others to validate (or refute) the findings, and help guide the industry and policymakers through these uncertain times.

17 The author is grateful for the time and thoughtfulness of so many people who helped in framing this research. While many have contributed intellectually to this work, the findings and observations are my own.

18 Community Development Financial Institutions Fund, *Three-Year Trend Analysis of Community Investment Impact System Institutional Level Report Data FY 2003-2005*, Washington, DC, December 2007.

19 Data comes from the websites for these three institutions.

Sources of Funding for the Community Development Finance Industry

The CDFIs and CDIs rely on a wide variety of funding sources. Table 1 categorizes the sources of funds for the CDFIs into: 1) financial institutions and other corporations, 2) government, 3) philanthropy, and 4) internal sources. It shows the considerable differences in funding structures for depository and the non-depository CDFIs. The CDFI depositories, like non-CDFI depositories, generally accumulate funds from the deposits themselves, from shareholder equity, and from the issuance of debt into the capital markets. The non-depositories, on the other hand, rely on a more diverse funding base, with debt and social investments from the mainstream financial institutions comprising the largest shares of their resources.

Table 1. Sources of CDFI Capital under Management, Weighted Averages, 2003-2005

	Depository CDFIs	Non-Depository CDFIs
Financial institutions and other corporations	15%	54%
Government	3%	16%
Philanthropic	0%	12%
Internal funds, individuals, and other	82%	18%
Total	100%	100%

Source: Community Development Financial Institutions Fund, Three Year Trend Analysis of Community Investment Impact System Institutional Level Report Data FY 2003-2005, Washington, DC, December 2007, derived from Table 3-3.

Private financial institutions and other corporate sources. The principal sources of funding for the non-depository participants in the community development finance movement are private financial institutions motivated primarily by Community Reinvestment Act (CRA) obligations. In total, private financial institutions and other corporate sources provided more than 54 percent of the capital under management by non-depository CDFIs. Depository financial institutions provided 29.4 percent of the total capital. Non-depository financial institutions—investment banks, insurance companies, and pension funds (1.9%), CDFI Intermediaries (0.9%), and other corporations (15.7%)—provided an additional 18.5 percent. The government sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—composed the rest of the capital (6.2%) from private financial institutions and corporations. In contrast, 15 percent of capital under management for the depository CDFIs came from private financial institutions or other corporate sources.

Government sources. Approximately 16 percent of the capital under management by non-depository CDFIs comes from government sources, the most prominent being the CDFI Fund. During the fourteen years since it was founded, the CDFI Fund has provided nearly \$1 billion in equity investments and grants, loans, and technical assistance funding in support of the CDFIs eligible for its programs. In addition, many CDFIs rely on federal, state, and local government as a source of capital for reinvesting, which the CDFI Fund study estimates to provide approximately five percent of total resources for non-depository CDFIs. For example, the Small Business Administration’s (SBA) Section 504 program allows CDFIs organized under this section of the law to borrow money with an SBA guarantee. In contrast, the Treasury study finds that less than three percent of the depository CDFIs’ capital comes from government sources. However, for these institutions, the ability to raise low-cost deposits from consumers and business sources relies on federal deposit insurance. In the Treasury study, deposits are included in the funds received from individuals and other sources.

Philanthropic sources. The philanthropic community provides significant levels of support for the non-depository CDFIs, nearly 12 percent of the capital under management according to the Treasury Department study. Certain large foundations, such as the Ford, MacArthur, and Heron foundations, in particular, featured prominently in conversations with the CDFIs as sources of program-related investments (PRIs). Corporate giving, particularly from companies in the financial services sector and their foundations, is another important source of funds for the non-depository CDFIs. Various religious orders are common sources, particularly those looking for investment opportunities for pension monies and operating reserves that provide a return but also reflect the social values of the investing organization. Depository CDFIs reported a minimal amount of capital from philanthropic sources.

Internal funds, individuals, and other sources. The sizable share of capital for the depository CDFIs in this category (82%) is mainly attributable to “individuals” (42% percent), the category in which the deposits are included, and “other”

(33%), an unspecified category in the data. In contrast, the bulk of the capital in this category for the non-depositories derives from “internal funds.” As financial institutions, all CDFIs and CDIs seek to make a return on their activities. The returns can come in the form of origination, development, and management fees, deal proceeds, and, most notably, from spreads on lending or investment activities. Some CDFIs and CDIs are part of larger organizations that allow them to borrow against the larger organization’s balance sheet or take advantage of revenues and proceeds from other entities in a related part of their organization. Most nonprofit CDFIs and CDIs are unable to cover their operating budgets from revenue sources and must raise funds to fill operating gaps.

Changing Economic Ties between the CDFIs, CDIs, And Their Financial Services Industry Partners

The well-publicized problems facing the nation’s largest financial institutions and the financial services sector more broadly have had a spillover effect on the terms and availability of funding for the community development finance sector. Many in the field today are focused on the changing relationship between the mainstream financial institutions and those in the community development finance field.²⁰ The data suggest that this relationship had begun to change before the meltdown in the financial markets, but the financial crisis has exacerbated the trends. Although the story is not uniformly negative, the emerging sentiment is considerable concern about the level of support from the mainstream financial services sector now and in the future.

The business models of most CDFIs and CDIs rely on low-cost, below-market-rate funding sources. Public and philanthropic funding sources are blended with private funds to provide low-cost investment capital to low-income communities and borrowers. Over the years, many mainstream financial institutions have been willing to provide funds to CDFIs and CDIs at or below the cost of funds to help fulfill their CRA obligations. Insurance companies also participated in social investment strategies in part to respond to anti-redlining lawsuits and to fend off calls for adding CRA-like obligations to their regulatory infrastructure.

In recent years, the community development finance movement has felt the effects of an increasing unwillingness of mainstream financial institutions to provide concessionary funds. The availability of these concessionary resources was often attributed to periods of relatively strong CRA enforcement; it is not too much of a stretch to characterize the last several years, even before the financial crisis, as one of relatively lax CRA enforcement.

The erosion of the concessionary relationship between the mainstream financial services industry and the CDFIs and CDIs is also a function of the growth and success of the CDFI movement. As the CDFIs and CDIs have grown, the demand for low-cost funding from mainstream financial institutions has also grown. When the volumes of concessionary lending were relatively small, the mainstream financial institutions could tolerate lower returns on community development financing in order to meet regulatory obligations. However, as the CDFIs and CDIs grew larger and the demand for low-cost funds grew larger, the levels of internal subsidy required to support these customers grew less sustainable. As one lender said, “You can do LIBOR minus 200 basis points on a \$2 million loan, but it becomes tougher within the bank on a \$10 million loan.”

That said, the financial crisis has instigated other changes in the relationships between CDFIs and their lenders. The change in the financial services landscape over the last two years has been massive, and sometimes abrupt. Self-Help’s leadership provides a dramatic example of the financial crisis’ effect on liquidity. For about five years, Self-Help had a daily repurchase agreement with a Wall Street investment house that the CDFI used to fund its mortgage portfolio. Self-Help used this overnight facility to manage its daily cash needs, which often varied by tens of millions of dollars. Although the repurchase agreement was only for a 24-hour period, the CDFI had been able to renew the trade consistently during the five-year period on the basis of what had become a routine daily phone call. The day after the fall of Lehman Brothers, the financial institution called Self-Help to inform it that the repurchase agreement had to be paid off that day. Self-Help countered with an offer to pay a temporarily higher rate or to merely reduce the size of the line, but in the end, Self-Help needed to come up with \$25 million in a matter of hours to repay the creditor. Fortunately, Self-Help was able to raise the money that morning through another wholesale creditor.

²⁰ “Mainstream financial services industry” is used throughout this paper to broadly define the non-CDFI/non-CDI financial services industry. In most instances, the term refers broadly to the various different financial services entities, such as banks, thrifts, investment banks, insurance companies, and government-sponsored enterprises that invest in, and partner with, CDFIs and CDIs. Unfortunately, as with efforts to generalize about the community development finance movement, generalizations about the mainstream financial services industry will prove inaccurate for many, if not most, of the players in this broad and diverse industry.

It is clear from the conversations with many community development finance leaders, industry observers, and lenders that the current environment is significantly altering the availability and terms of credit to CDFIs and CDIs. In this, the CDFIs and the CDIs are not alone or even necessarily singled out for unique treatment by stressed mainstream financial institutions. A May 4 front-page story in the *Wall Street Journal* documents tougher bank credit line provisions for companies such as Verizon and Hewlett-Packard. The article notes that even these strong companies must pay more for revolving lines of credit and that banks were shortening three- to five-year lines of credit to one-year terms.²¹ The next day, the *Wall Street Journal* ran an article, "Lending Practices Remain Tight," highlighting the results of the Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices. According to the report, about 40 percent of the respondents said they had tightened standards in the first quarter; 65 percent reported tightened standards for the fourth quarter of 2008 in the January survey.²²

These press reports echo the interviews with the community development finance leaders interviewed for this project. Those interviewed for this paper attributed the changing economic relationships to growing risk aversion on the part of the mainstream financial institutions, FDIC pressures on banks to tighten up credit, and the banks' desire to increase returns on the community development finance business lines to offset losses in other parts of the business. One observer opined that "many financial institutions had lost their confidence in their ability to understand and underwrite risk in general, not just for CDFIs."

Lenders are terminating or reducing lines of credit to CDFIs and CDIs, increasing the pricing on the lines, and shortening the terms of the lines. One lender confirmed that he was going through an "aggressive" review of his portfolio, terminating lines to borrowers who were in trouble and increasing prices on existing customers. He was particularly focused on raising the prices on below-market rate loans that his institution had acquired in a merger with another institution. From the CDFI side, one leader said that lines of credit renewals were coming with average price increases of "200 to 250 basis points." The OFN survey for the fourth quarter of 2008 reported that 42 percent of its respondents reported a decline in liquidity, with the most common reason cited as "bank investors not renewing loans."²³ The buzz around the industry is that liquidity has taken a dramatic turn downward in the first quarter of 2009. Most expect OFN's first-quarter survey to highlight an even greater shrinkage.

Several of the community development finance leaders interviewed had not experienced the liquidity challenges yet. Two different respondents reported they were able to raise capital in 2005 and 2006 when it was plentiful and relatively inexpensive, and these lines were still available for draws. However, each expressed concerns about upcoming renewal conversations and were anticipating price increases or losing the line.

Another CDFI leader reported that one of her lenders had asked her organization to reduce its unused line of credit. She had kept the line open because the bank had waived the fees typical in the market for unused lines of credit. For this housing-based loan fund, demand had fallen considerably, and the CDFI agreed to give up some of the line. A lender reflected the other side of the pressures: Banks are required to hold a certain amount of capital against even the unused lines. As banks move to conserve capital one of the first targets is capital that is not earning a return.

Several people interviewed observed that lenders employed renewal strategies that did not terminate the lines of credit, but seemed to reflect an ulterior motive to get the CDFI to withdraw. In testimony before Congress, Bob Davenport of the National Development Council and its Grow America Fund (GAF) described how one of his lenders, despite a successful ten-year relationship, implemented a price increase at the end of last year.²⁴ In January, the lender came back asking for two new loan covenants that GAF could not meet. GAF is a Small Business Lending Company that originates and services loans on which the SBA provides a 75 percent guarantee. Under the typical structure, a private lender will provide GAF an amount equal to the guaranteed portion of the loan, and a public entity, typically a city's economic development office, will provide the funds for the nonguaranteed portion. The lender requested that GAF cede its interest in the SBA portion of the loan (in violation of SBA rules) and asked GAF to set aside funding to ensure that the lender was paid back, despite the full guarantee on the lender's credit risk by the federal government and the federal government's ultimate responsibility to make the lender whole. GAF terminated the line with the lender, but was able to replace the line with a lender who valued the SBA guarantee.

21 Serena Ng, "Banks Get Tougher on Credit Line Provisions," *Wall Street Journal*, May 4, 2009, 1.

22 Maya Jackson Randall, "Lending Practices Remain Tight," *Wall Street Journal*, May 5, 2009, 2.

23 Opportunity Finance Network, "CDFI Market Conditions Report Fourth Quarter 2008," Philadelphia, PA, April 2009, 8.

24 Testimony of Robert W. Davenport, President of the National Development Council, before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit, March 4, 2009.

The tighter credit environment is also evident in the capital markets. The Charter School Financing Partnership that pools charter school loans for its member institutions reported that the securitization of charter school loans was dead in its tracks. Changes to the structure and its pricing were dramatic. Prior to the credit crisis, rating agencies would require a 15 percent credit enhancement on the initial loans into the pool to achieve a BBB rating for the entire transaction. The rating agencies are now requiring a 50 percent credit enhancement to achieve an AA rating, the level needed to obtain reasonable interest rates. Moreover, the interest rates spreads between BBB and AA have widened considerably, to approximately a 500 basis point difference. The new requirements are prohibitive.

One observer counseled caution in generalizing about the reaction of the mainstream financial institutions to the current economic environment. Although he agreed the relationship with large institutions was changing, based on his experience smaller community banks were more willing to work with the CDFI and work to restructure the business deals. A look at this institution's funders shows ties to dozens of national, regional, and community banking institutions.

Changing Relationships among CDFIs and CDIs and Their Partner Financial Institutions

At a fundamental level, one of the other notable effects of the turmoil in the financial services sector is the quality of the relationships between CDFIs and CDIs and their mainstream financial services partners. Certainly, one implication of the tighter credit environment is that lenders are scrutinizing CDFI and CDI loan portfolios more carefully. Lenders and CDFIs leaders alike reported much closer scrutiny of their customers' portfolios. The manifestations of this are quarterly reviews of each line of credit and a more detailed series of questions for the borrower about their businesses. One person interviewed said that he was experiencing a more rigorous enforcement of loan covenants by the banks, putting loans that were otherwise current into technical default. This presumably creates more work for the CDFI or the CDI and financial risks to the CDFIs, but also adds tension to the relationship.

Some important relationships have gone away overnight. Prominent institutions with relationships to CDFIs and CDIs—those most often mentioned are Wachovia, Washington Mutual (WaMu), National City, and Merrill Lynch—have been acquired by other financial institutions. The CDFIs and CDIs must now establish new relationships and deal with a different culture or philosophy at the acquiring institution.

In one case, the new partner expressed concerns that it is overly exposed to a single CDFI. Another CDFI leader reported that his institution still had a line with Merrill Lynch on which he was drawing funds, but he was unsure when and how to discuss the line with Bank of America when it came up for renewal. Another loan fund executive had five different relationship managers at a single financial institution over an eighteen-month period. In this case, the CDFI leader reported that at one point, her fund had discovered that the financial institution was not calculating the interest owed on the line correctly, to the detriment of the financial institution. They did not know whom to call to correct the error.

In still another case, the acquiring institution brought an entirely different business approach. Several respondents noted that the acquisition of WaMu by Chase had meant important changes in the product offerings for CDFI and CDIs. Specifically, WaMu would provide “near equity” (EQ2) investments to these customers. Chase does not. Also, it was not uncommon for WaMu to provide highly concessionary lines of credit to its CDFI and CDI customers; Chase does not provide debt financing to financial intermediaries at concessionary pricing.

Perhaps a bigger story with longer-term implications has been organizational changes at the mainstream financial institutions with respect to how they handle their CRA responsibilities. During the last several years, many of the large financial institutions reorganized their approaches to community development lending, for reasons not necessarily related to the financial meltdown. At various points in time, many larger, mainstream financial institutions managed their CRA activities through a division dedicated to community development activities. Although the specifics varied at the different institutions, the model was one in which a single, senior executive would oversee investments in community development, lending to intermediaries, tax credit investments, partnerships with nonprofits and special programs, and grant making. Often these divisions managed to a rate of return that was less than that for the rest of the financial institution.

In a trend that began before the current crisis, many banks reorganized their community development functions. The reorganizations dispersed throughout the banks many of the product lines and activities that supported the community development movement. The new executives are managing to different hurdle rates for these products, are less sensitive to the mission, and are less likely to provide concessionary terms. Expertise and institutional knowledge were lost. One CDFI leader noted that the new product line managers did not understand CDFIs and the “funky” deals that characterize community development finance. One lender interviewed for this project acknowledged the change at his institution, but described the change as positive. In the past, he said, the community development divisions were considered backwaters

in the banks, where executives and employees went to finish out their careers out of the limelight. Under new structures, the community development business is bigger, profit margins are important, and the rest of the bank takes notice. The division in which he works is now a place for an ambitious executive to build a profile and advance his or her career into other parts of the bank.

The Economic Crisis and Changes in Government Funding

The trends with respect to public funding streams to support the CDFIs and CDIs are a mixed story. At the federal level, the industry anxiously awaits new CDFI funding and funding for other governmental programs from the stimulus package. The community development finance industry has been encouraged by strong signs of Congressional and administration support over the last 12 months. At the same time, there are concerns that the promised new resources will not materialize in time to save many of the institutions in trouble, and that the CDFIs and CDIs will be unable to realize the full value of the new tools provided. At the state and local levels, the picture is even somewhat less encouraging, although the federal stimulus funds flowing through to these jurisdictions should help.

The federal government has signaled strong support for the community development movement. With the addition of nearly \$100 million in new funds for the CDFI Fund, the stimulus package, officially known as the American Recovery and Reinvestment Act of 2009 ("Recovery Act"), raised the 2009 program levels to \$145 million for the CDFI Fund program and the Native American CDFI Assistance program. The Recovery Act also included an additional \$3 billion in New Markets Tax Credit allocations covering both the 2008 and 2009 program years, in addition to the \$3.5 billion already provided for 2009. Further, the stimulus package provided significant levels of new funding for many of the federal programs in which CDFIs participate, including new funds for the U.S. Department of Agriculture's rural development and housing programs, the SBA, the Economic Development Administration at the Department of Commerce, and the Department of Housing and Urban Development (HUD).

The movement also had a big win in the Housing and Economic Recovery Act of 2008, which was signed into law at the end of July 2008. The act included the creation of a Capital Magnet Fund for financial intermediaries using funding based on Fannie Mae and Freddie Mac acquisitions. That legislation also directed the Federal Home Loan Banks to open up their advances to the portion of the CDFI industry that is not currently able to become members.

The industry is particularly encouraged by the new administration's 2010 budget. The budget details released May 7, 2009, call for \$243.6 million in appropriations for CDFI Fund programs, an amount more than double the FY 2009 appropriation. The request includes \$113 million for the CDFI program (for financial assistance and technical assistance), \$80 million for the Capital Magnet Fund, \$22 million for the Bank Enterprise Award program, \$10 million for the Native American CDFI Assistance program, and \$18 million for administration.

However, there is some ambiguity in all of this good news. The amount of funding provided for both the CDFI Fund and the New Markets Tax Credit program in the stimulus package were considerably less than the industry had requested. More important, the money is not yet on the streets. The CDFI Fund has promised funding announcements in July and September and made a commitment to obligate most of the money within thirty days after the announcement. CDFIs have reportedly asked for as much money as they can; the requests for funding mean that the round is oversubscribed. A significant number of CDFIs are looking for funds from this grant round to help fill in holes on their balance sheets and "break even" this year. Yet, several observers worry that given the deteriorating economic conditions the government will not get the funds out in time to save some troubled CDFIs. Of course, the inability of some marginal CDFIs to get funds in this competition will not bode well for the future of those institutions.

Moreover, other important stimulus money is not yet on the streets, although the agencies are working to get it out. HUD published the Notice of Funding Availability for Neighborhood Stabilization competitive grants on May 4 with applications due July 17, 2009. Many CDFIs and CDIs are interested in these new funds and those made available in an earlier allocation. Also on May 4, the Treasury and HUD put out guidance for the Low Income Housing Tax Credit (LIHTC) Assistance Program (TCAP). The Joint HUD/Treasury effort will provide \$5 billion to the support LIHTC deals that have stalled. Filling the gaps on these tax credit deals is of critical importance to CDFIs and CDIs who fund pre-development and acquisition loans to LIHTC nonprofit developers. HUD has also allocated the \$1 billion provided to the stalwart Community Development Block Grant (CDBG) program in the stimulus package. As a measure of the ambiguity of the "good news," one astute, long-time industry observer commented several times how stunned he was that this classic program of support for the community development movement only got \$1 billion out of a \$787 billion bill. In many past efforts to address economic challenges, CDBG had served as a flagship program for distributing federal funds.

Another source of ambiguity in the good news is the funding mechanism for the Capital Magnet Fund. That fund has the potential to become an important new tool for the community development finance movement, but its initial reliance on fees based on Fannie Mae and Freddie Mac's mortgage acquisitions makes it an unreliable source of funds given the losses at the housing GSEs. The future status and viability of these institutions is a question policymakers have only begun to consider. The community development finance industry requested resources for the Capital Magnet Fund in the stimulus package, but Congress did not respond. On the positive side, the administration has now requested \$80 million for this new program. On the negative side, the future for funding will undoubtedly be uncertain given what is likely to be an oppressive fiscal situation in the future.

Further, when we shared preliminary findings of this paper with a group of industry leaders, many did not foresee access to the Federal Home Loan Bank advances as being a meaningful step forward for the industry. Although the proposed regulations have not yet been released, the group uniformly raised concerns that most CDFIs will find the terms of participation with the Federal Home Loan Banks too onerous for the advances to prove useful.

The picture at the state and local levels is considerably more challenging. The May 13, 2009, *Wall Street Journal* reported that a Nelson A. Rockefeller Institute of Government survey of 47 states had seen a decline in first quarter 2009 tax revenues of 12.6 percent relative to the same quarter in 2008.²⁵ Corroborating information from the interview process was limited, but respondents in general supported the view that state and local government budgets were severely constrained and these funding sources would likely decrease. California and Florida stood out as places of significant concern over the declining funds for CDFIs/CDIs and their work.

The negative condition of state and local trust funds that rely on real-estate-related documents or transaction fees was another theme echoed by several respondents. Florida and the District of Columbia were singled out. Many of the nation's more than 600 housing trust funds commonly rely on mortgage-based or home-purchase-based fees as a funding source. It is not unreasonable to assume that the massive decline in for-sale housing across the nation has also constrained available housing trust fund resources in many places.

Philanthropy, the Economic Crisis, and Community Development Finance

Foundation endowments and other socially motivated investors have taken a huge hit in the economic downturn. Stock market values have dropped precipitously and other highly leveraged investment vehicles have taken a beating. According to a May 2009 survey by the Council on Foundations, foundations responded to the economy by increasing their giving, paying out \$45.6 billion in grants in 2008 compared with \$44.4 billion in 2007. Yet, the survey also highlighted the bad news in the philanthropic sector: Three out of four foundations saw their assets decline by 25 percent or more in 2008 and a majority (62%) reported they will reduce their grant-making in 2009.²⁶

In a December article in *ShelterForce*, author Rick Cohen underscores the financial services sector's role in philanthropy: "Today's financial meltdown will hit community developers where it hurts, in their financial wherewithal to respond to the challenges they face in urban and rural neighborhoods." Cohen's article is worth the read. He points out that the financial sector was a huge player in corporate giving, and he highlights how the troubles at the banks and other large financial institutions will significantly affect the community development finance movement. Financial institutions that have disappeared, such as WaMu, Wachovia, Countrywide, were providing tens of millions of dollars to institutions serving community development missions. Cohen notes, in particular, the financial troubles at the GSEs and the effects on community development:

Fannie Mae was the nation's leading corporate grant maker and one of the nation's most generous foundations overall for nonprofits in the field of housing and shelter. Between 1998 and 2004, the Fannie Mae Foundation (not counting what might have been awarded directly by the corporation outside of its foundation) handed out \$119 million in grants of \$10,000 or more for housing and shelter. For each of those years, Fannie ranked first or second in the nation among all foundations, not just corporate foundations, making grants in the housing arena, often surpassing the totals of independent foundations such as the Ford Foundation, the MacArthur Foundation, and the Lilly Endowment. Among the nation's largest 1,000 or so foundations, it accounted for just about one out of every 10 foundation dollars for nonprofits addressing housing and shelter....Between 2002 and 2006, Fannie put \$3.6 million into the Living Cities foundation consortium and millions more directly into an array of

25 Conor Dougherty, "States' Revenue Sinks Amid Income Tax Drop Off," *Wall Street Journal*, May 13, 2009, A3.

26 Council on Foundations, "Foundations Respond to the Needs of Families Even as Their Assets Have Declined: Results of a Survey by the Council on Foundations," Arlington, VA, May 6, 2009, 1.

national and regional community development intermediaries....For national grant making to housing and community development groups, the new status of the GSEs as money-losing appendages of the federal government means a disappearing philanthropic portfolio.²⁷

In interview after interview, the CDFI/CDI leaders anticipated severe tightening by the foundation community, but reports from the front have suggested that this is more of a looming threat than an immediate one. Foundations in general are still in the game, they report, but the CDFIs are girding for a more difficult conversation.

Shrinkage in the philanthropic and socially motivated investment community is likely to have a greater impact on the smaller financial institutions for which this money is a greater share of their capital under management. For the larger CDFIs and CDIs, foundation funds are only a small part of the capital structure; the vast majority of resources flow from private financial institutions.

In general, numerous individuals across the industry reported that foundations were becoming a little choosier. One CDFI executive director reported that his PRI had not been renewed, and most others reported signals from foundation partners that PRI renewals were unlikely. Another respondent said that one foundation was unable to allow a CDFI to roll over a loan; the foundation needed the cash for other commitments. The same individual reported that his CDFI asked for an extension that the foundation apologetically was unable to grant. In any other year, the funder would have approved the extension with little fuss. This is an evolving story.

Donors and recipients also report that the foundations have stepped up their management and oversight of PRI portfolios. Like the private lenders with investments in CDFIs or CDIs, foundation PRI managers are having more frequent conversations with the holders of their funds and asking tougher questions about how the CDFIs and CDIs are managing their portfolios. One foundation respondent discussed the flexibilities the foundation might employ to support these institutions with PRIs, but in the end asserted that the foundation would manage its portfolio like a private financial institution and would pull the plug to get its money back and let a CDFI/CDI fail, if necessary.

Yet foundations still differ in their approach to PRIs than private lenders regarding troubled investments. The MacArthur Foundation, with a large portfolio of CDFI-related PRIs, should announce sometime in advance of this paper's publication that it will waive one year of interest payments on its loans to CDFIs, CDIs, and housing developers, starting July 1, 2009, at a cost of about \$2 million, and it will defer for one year the payment of principal due back to it from these PRI recipients during this same period (July 2009 to June 2010). MacArthur is taking this step because it recognizes the extraordinary financial difficulty these organizations face in the ongoing upheaval in the banking sector and amid sharp declines in investor appetite for real estate-related debt and equity. The foundation hopes that this interim relief will help its borrowers maintain their operations and that it will ease the negative impact of rising loss reserves and the need for staff cuts and emergency fund-raising that most of these organizations are undertaking.

Other important changes in the relationships among the foundations to the CDFIs and CDIs were already underway prior to the financial crisis. After an evaluation of its PRI portfolio completed in 2000, the MacArthur Foundation, for example, changed its PRI philosophy with respect to the community development finance movement. In contrast to prior general support for these entities and the field overall, the foundation decided that its PRIs should be used to advance specific program areas. Two examples are its national Window of Opportunity initiative to support the preservation of affordable rental housing, and a new \$68 million foreclosure prevention and mitigation project focused on low-income neighborhoods in Chicago. Yet, perhaps also reflecting the strength of the CDFI, the foundation officer noted that many of the recipients of its PRI funding for these and other initiatives were CDFIs, a reflection of the foundation's view that these institutions were important vehicles for delivering on its programmatic objectives. Furthermore, and despite an apparent change in approach, the MacArthur Foundation continues to support the industry as a whole through the NEXT Awards for Opportunity Finance, a \$43 million partnership with OFN and the Wachovia Foundation that provides major funding each year to two outstanding CDFIs with significant potential for future growth, innovation, and policy impact.

Perhaps the most dramatic change in the PRI environment for CDFIs and CDIs is the Ford Foundation's decision to shift its PRI investments for the next two years into neighborhood stabilization activities. Ford is a major funder of PRIs, with a portfolio of about 40 CDFI/CDI investments. The foundation typically provides about eight new loans a year, with a total annual of investment of \$25 million. The investments are typically ten-year, interest-only loans, at 1 percent. This year and next, Ford will make the neighborhood stabilization effort its priority and will provide \$50 million in PRI dollars to a grant to the Neighborhood Stabilization Trust. However, as with the MacArthur Foundation story, Ford's new PRI strategy is not entirely unrelated to support for the community development finance movement. Several of the sponsor-

27 Rick Cohen, "Brave New World for Nonprofits," *Shelterforce*, December 22, 2008, 4.

ing organizations of the Neighborhood Stabilization Trust are CDFIs/CDIs, and many of the members of the sponsor organizations' networks are also CDFIs or CDIs. In addition, to a certain extent, with its change in focus to neighborhood stabilization, the Ford Foundation is responding to the priorities of many in the community development finance movement.

One CDFI leader reported that her socially motivated investors, in this case the pension funds of religious orders, had increased their investments in her loan fund. She hypothesized that, ironically, her fund's modest returns to the investors outperformed the other equity investments the pension funds had relied on for yield. These same social investors were increasing the cost of their money invested in the CDFI to offset other losses in their portfolios, but the increases were described as not onerous. At the same time, this respondent reported that one new investor, a religious order health care system, had set aside money for the loan fund, but the organization continues to delay disbursement. She too was nervous about the future. Her organization had several applications out for renewals and new money. Her relatively positive story may change over the next months.

The fourth-quarter 2008 OFN survey of the CDFIs found that many were seeking grant funding from new funders. CDFIs and CDIs, in particular, were seeking additional operating grants to cover rising costs as their credit books show signs of strain. However, it is unclear whether new funds will be forthcoming. Given the strains on funder portfolios, one industry observer felt this was not a good strategy. Most funders are stretched by their current relationships.

How the Economy Is Changing the Activities of CDFIs and CDIs

Given the troubles in the mainstream financial institutions and the disparate effects of the economic downturn on low-income communities, most observers described a market environment with rising demand for CDFI/CDI resources, although the record on this is less than uniform. Many CDFIs/CDIs, and particularly those in the small business arena such as the Grow America Fund, have reported an uptick in loan applications, which they attribute to the fall-off in lending by the mainstream financial institutions. Demand is also coming from nonprofit CDCs that are experiencing a decline in fundraising and slowing deals and who are looking for cash to keep the organization operating until their deals can close. Many are now looking to the CDFIs/CDIs for assistance and funding.

At the same time, the fourth-quarter OFN survey indicates a slowing in new lending, in part a reflection of a liquidity crunch. Although 48 percent of the OFN respondents expanded their lending in the fourth quarter of 2008, this was less than the 63 percent who reported an increase in new applications. Only 30 percent decreased their lending in the fourth quarter. In the interviews for this paper, several respondents confirmed that in the first two quarters of 2008 their institutions had strong application and lending levels, while in the second two quarters business began to slow. At the same time, some are reporting that the pipeline for 2009 is quite dead. An executive director of a nonprofit loan fund, who described the organization as a "one-trick pony" in housing, reported that its pipeline is down 41 percent for the current year.

In general, CDFIs and CDIs in the housing and real estate areas reported significant slowing in demand and increased difficulties with their deals. This is particularly true of nonprofits in the for-sale, housing/homeownership realm, which are facing borrower concerns about declining home values.

Troubles are also apparent in affordable housing development. The troubles at Fannie Mae and Freddie Mac coupled with the difficult economic climate have created a disaster for the LIHTC program. Fannie Mae and Freddie Mac, the two largest LIHTC investors, exited the markets. Prices have dropped for new credits, and many report that the more complicated deals are going begging for investors. The market is also depressed on fears that Fannie Mae and Freddie Mac will sell their investments into the market and increase oversupply even more. One housing finance expert estimated cumulative LIHTC equity deficits from 2008 and 2009 as large as \$10 billion, "virtually threatening to halt production of new affordable rental housing in parts of the country." It is unclear whether the \$2.25 billion in gap funds provided by TCAP and the provision in ARRA allowing states to exchange up to 40 percent of unusable 9 percent Tax Credits will close the holes or whether the investor market will improve enough to avoid the need for further interventions. In California, 57 out of the 75 2008 LIHTC transactions were reported to still be seeking equity investors as of April. Two CDFIs with whom I spoke participated in this market as predevelopment and acquisition lenders whose loans get repaid when the tax credit deal closes. One of these was fairly sanguine that new TCAP money in the stimulus bill to close gaps in tax credit deals would eventually get these loans paid back. The other CDFI was not so sanguine. The delays in closing were causing cash flow issues, and the respondent raised concerns that new appraisals were changing the composition of the deals and the proceeds at closing. In one example, the respondent described a deal originally appraised at \$12 million. Six months later, it appraised at \$9 million.

Of course, the mortgage foreclosure epidemic that has slowed housing originations has also created a huge demand in low-income communities for strategies and resources to stabilize housing prices and deal with vacant properties. Several participants in the community development finance movement have identified this as the number one issue and have shifted their business focus to this problem. One respondent described neighborhood stabilization as the “topic du jour” for the community development finance movement. The availability of neighborhood stabilization funds from HUD has also provided incentives for CDFIs and CDIs to explore this market need and opportunity.

Likewise, housing-focused CDFIs and CDIs are hoping to take advantage of large sums of money in the stimulus bill related to the “greening” and weatherization of the housing stock. The greening of the affordable housing movement began several years before the financial crisis, but the stimulus package has provided incentives for more players to explore this market.

CDFIs and CDIs working on small business lending noted that more of their borrowers were having difficulties in the downturn, but in the conversations on small business lending, the collected stories actually painted this line of business in a more positive light. With the financial crisis and the credit tightening by the large banks, more small businesses have come to the CDFIs and CDIs for credit. In general, CDFI/CDI lenders expressed concerns about having sufficient liquidity for funding the new demand. Several observers also noted that these small businesses, until now able to borrow from the mainstream banks, were generally stronger enterprises than the typical customers of CDFIs or CDIs. In some cases, these community-based lenders were optimistic that the new borrowers had the potential to strengthen their books, but they were still cautious about how to underwrite the loans in an uncertain economic climate.

Several respondents reported strong demand for financing of charter school and community facilities. One CDFI leader noted a shift in his lending business away from “for lease” commercial real estate, whose markets are quite weak, to public facilities lending. In particular, he found that these deals would continue to close because they usually included “soft debt” from a public entity or backed by the public entity in some way.

The New Markets Tax Credit (NMTC) program is an area of focus for the community development finance movement and a tool that many are using to support their missions and raise capital for their activities. One of the surprising findings of this inquiry was that the NMTC investments held up in 2008, practically matching the 2007 program levels. Participants in the market, though, are expressing some concerns. Although there has been only a modest weakening of the price of equity in the deals, down two to three basis points, the debt that allowed leverage in the deals has withdrawn considerably. There is also some emerging concern about the availability of equity at a good price for future deals. Many have watched or suffered from the dramatic changes in the LIHTC market. The additional \$3 billion provided in the stimulus package, on top of the 2009 program level of \$3.5 billion, raises concerns about an oversupply of the credits in a market in which many of the typical investors are not making a lot of income against which to apply the credits.

There are also several noteworthy stories of CDFIs and CDIs stepping up to fulfill their missions, and provide unique help to communities during the hard times. Perhaps the best example of this mission-driven act occurred during the budget stalemate in California. Unable to come up with the cash to meet its obligations, the state issued IOUs to many of the nonprofits to which it owed money. For many nonprofits, already strapped for cash, the IOUs presented a challenge in meeting their own obligations. The Low Income Investment Fund stepped up to support its customers by providing bridge loans secured by the state IOUs.

Short-Term and Long-Term Implications for Policymakers and the Industry

This inquiry has highlighted that, as with every other credit provider in the country, CDFIs and CDIs are experiencing difficulties. The economy as a whole is going through a period of deleveraging and risk reduction from the largest capital markets players to the consumer balance sheet. This period will challenge all financial institutions; if prolonged, many more will fail.

Public interventions in the financial services sector so far have been justified not by the challenges that the economy has placed on the financial institutions themselves, but by the impact that troubles in these institutions have on the real economy. This same rationale could apply to the community development finance industry. The CDFIs and CDIs present a unique and discreet case for public intervention.

Although the nature of this research makes it difficult to generalize broadly, the themes that emerged suggest several ways the public sector could support the community development finance industry through this period, and into the future.

Short-Term Options for Public Support

In the short term, the public sector must recognize the importance of the community development finance industry in serving populations underserved by the mainstream financial institutions. Many of the low-income communities served by CDFIs and CDI are hurting. In fact, the financial crisis is having a disproportionate impact on these people and their neighborhoods. The CDFIs and CDIs are uniquely designed as the delivery vehicle for credit and investment services to these communities in these times. As such, the public sector should focus on the following:

- **Implement the Recovery Act quickly.** The first and best thing the government can do is to continue to get the stimulus funding on the street as quickly as possible. It is apparent that the timing of federal money already appropriated is important for many institutions. As CDFI and CDI portfolios weaken and other investors consider renewal funds or new grant applications, the ability of these institutions to access federal grant money from the Treasury and get allocations of other stimulus funds will be important in allowing these institutions to fulfill their missions, and survive.
- **Identify additional resources to support community development finance.** The industry needs more resources, and it would benefit America's low-income communities if the industry had more resources. The funding provided in the stimulus package is likely insufficient to turn around negative developments in many communities, given the economic strains. This is particularly true if mainstream financial institutions continue to withdraw support for small businesses and local nonprofits doing community and economic development work. The policy issue lies in what form the new assistance can take.

Many voices in the community development finance movement have identified Troubled Asset Relief Program (TARP) funds as a potential source of the needed resources. The government provided TARP funds not only to mitigate systemic risk, but also to remove toxic assets from bank balances and take other steps to increase liquidity and lending across the system. Although the public attention has been on the TARP payments to the large banks and AIG, many relatively small community banks have also benefited from TARP funds.

It seems that the government's principal concern in providing CDFIs and CDIs access to the TARP funds is the lack of a regulator ensuring safety and soundness for many of these institutions. The concern is that there is no entity able to ensure that the CDFIs or CDIs have the ability to repay the funds to the Treasury and no regulator to ensure that the funds are used in a manner consistent with the law and other public policy considerations affecting TARP funds.

It may also be that CDFIs or CDIs would find the TARP requirements too onerous or that the funding terms and conditions would not work for the kinds of credits and products they support. CDFIs and CDIs should be careful what they wish for given widespread concerns among TARP recipients that the government's role in their institutions has been difficult.

The CDFI Fund has been tailored to the needs of the diverse institutions that make up the CDFI movement. The cleanest response would provide additional resources to the CDFIs through this vehicle. The administration's proposal to increase funding to \$243.6 million in the 2010 budget is very helpful and represents a strong commitment to the industry. However, policymakers should consider the more immediate needs of the CDFIs should a supplemental appropriations vehicle move through Congress.

Likewise, policymakers could consider a supplemental appropriation to the Capital Magnet Fund created in HERA. The President's 2010 budget calls for an appropriation of \$80 million for the Capital Magnet Fund, but the process means that these funds will not likely become available until next year. In the shorter term, in advance of the 2010 appropriations process, the administration, through its conservatorship control of Fannie Mae and Freddie Mac, could make the decision to fund the Capital Magnet Fund. The Treasury Department will need to accelerate its process to get the rules for this program in place.

Longer-Term, Public-Sector Support

Over the longer term, the public sector should consider the following policy options for the community development finance industry and its institutions.

- **Revise CRA and strengthen its enforcement.** The community development finance model relies on strong CRA environment. As the administration and Congress move to rewrite financial services regulations, they should give significant consideration to modernizing the act. An important rationale for creating the Community Reinvestment Act in 1977 was the *quid pro quo* for deposit insurance. It is now clear the depth to which the public sector

supports the franchises of all large financial institutions, including many financial institutions not currently subject to the CRA. Among the reforms to consider are extending the CRA's coverage to more financial institutions, such as investment banks and insurance companies; deepening the expectations for successful performance by financial institutions; assessing the entire corpus of the financial institution's business, not just for selected assessment areas; and devising an enforcement mechanism that does not rely on rare events like mergers to come into play.

- **Extend the NMTC program and make it permanent.** The New Markets Tax Credit (NMTC) has become a valuable tool in supporting the work of the community development finance movement. Policymakers should make it a permanent tool for economic and community development. At the same time, Congress and the administration should review the array of tax-advantaged investments in the tax code and rationalize the different rules and features that can cause different energy, housing, and community development credits to compete with one another in the pool of tax-advantaged investment dollars. Changes in the program design that are more advantageous to investors in one program can disadvantage other programs that rely on their tax advantages to raise capital. As an example, the government should consider making the NMTC exempt from the alternative minimum tax similar to the low-income housing and the energy tax credits.
- **Consider strengthening the regulatory infrastructure for CDFIs and CDIs.** As these institutions continue to grow in sophistication and scale, deliver increasing amounts of public program resources, and attain a place of importance in the credit needs of their communities, the public gains an increasing interest in ensuring their safety, soundness, and compliance with laws and regulations. The reluctance of the federal government to place TARP money in these institutions is indicative of a legitimate concern. A regulatory infrastructure must recognize the unique missions of these organizations, but also ensure a greater level of transparency, provide current data for evaluation purposes, and ensure certain governance standards that seem appropriate. The regulatory regime should also consider better metrics for measuring government-funded community development finance results so the public can evaluate the social return on its investments.

Implications for the Industry

It is a certainty that the economic downturn will eventually end. What is uncertain is how this economic crisis will reshape the industry. Given the industry trends and expected fallout of the financial crisis, several hypotheses emerge for where the industry will land.

- **Industry will benefit from consolidation and economies of scale.** To a certain extent, the failures of some CDFIs may benefit the industry as a whole. To the extent that the economic troubles force mergers and consolidations, the resulting larger institutions will have the opportunity to achieve economies of scale and build stronger balance sheets. With stronger balance sheets comes the ability to raise more capital and participate in developments that have a greater impact on their communities. The regulator should seek to support this natural process of creative destruction. At the same time, a thoughtful regulator must consider the effects on the delivery system for community development investments if the failing institutions are unique to a particular geography and no other institution is positioned to step up and meet the needs of that community.
- **CDFIs should continue to position themselves as the premier delivery vehicle for federal credit programs.** Those institutions that are vertically integrated provide an excellent opportunity to finally break down the silos across the many federal programs that are the tools of local community development efforts. The integrated community investment institutions have taken on not only housing, but small-business lending, commercial real estate, charter schools, and other public facilities. In some communities, the entrepreneurial CDFIs and CDIs are delivering the full range of credit programs from the federal government and other sources. It is possible that these institutions represent a route to achieve what the community development field has as yet been unable to achieve: Bring the integrated and comprehensive credit and development services to bear on the community development challenge.
- **Industry will benefit from greater transparency and regulation.** Efforts by several groups to devise systems of measuring the strengths and social impacts of the CDFIs and CDIs can only benefit the industry as a whole. This research has indicated a desire by investors in these institutions, both private companies and philanthropies, for a higher standard of care for the resources invested and a better justification for investments' social impacts in these institutions. Investors will continue to push the CDFIs and CDIs to develop quantitative metrics measuring impact and return on investment. The industry should embrace this change. The strength of the community development finance movement is its business-like approach to the social challenges it addresses.

- **Market rate environment.** It also seems clear that the longer-term trend for the industry is one in which a greater percentage of the capital it raises comes at market rates. Capital is practically unlimited if investors can get a market rate of return on their investment. CDFIs and CDIs that rely on below-market interest will likely limit their ability to grow and limit their effects on communities. Of course, the public and the philanthropic sectors that see the CDFIs and CDIs as a vehicle for delivering a social good will need to provide the subsidy dollars required if lower cost capital is the solution to affordable housing needs, entrepreneurship needs, public facilities needs, or new schools.
- **Market to the banks.** Many of the large financial institutions may have lost their ability to support community development finance in a broadly meaningful and nuanced way. As the economy emerges from the downturn and the regulatory environment accompanying the CRA returns to normal, many financial institutions will either have to rebuild the capacity to deliver services to low-income communities or they will look for strong partners to deliver these services for them. The strong CDFIs and CDIs with transparency and strong metrics for assessing community impacts per dollar invested should find themselves in a strong position to market to the banks and become even more valued as intermediaries serving these communities.

The future of community development finance is changing, for the better. Although the economic downturn is having important and mostly detrimental effects on many of these institutions, the longer-term trends suggest that the industry has become firmly rooted in the American economy and its growth trajectory will continue. The industry as a whole will benefit from the lessons of tough times and by the emergence of even stronger institutions from among those that weather the storms. Community development financial institutions are well positioned to serve as the delivery system for financial services to low-income communities in partnership with the public sector and other community-based organizations, and they are well positioned to bring meaningful change and economic development to low-income communities.

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Appendix A

Philanthropy During the Downturn

Rick Cohen
Nonprofit Quarterly

What will happen to foundation grantmaking in 2009 and 2010? The roots of the story are in the vicissitudes of the stock market, where foundations invest the bulk of their tax-exempt assets.

At 1:00 p.m. on February 23, 2009, the Dow Jones Industrial Average fell to an eleven-year low of 7,190 the lowest since October 28, 1997. By the end of the month, the market closed at 7,062.93. Compare this with the all-time high on October 9, 2007, of 14,164. In less than eighteen months, the Dow, the Dow Jones Wilshire 5000, and the Standard & Poor's 500 indices lost more than half their value. Although foundations have not lost quite as much of their assets, they have suffered serious losses of more than 20 percent of their endowments, sometimes significantly more.

Foundation grantmaking constitutes only 12.6 percent of total charitable giving, according to *Giving USA 2008*, but foundation grants are one of the few sources of discretionary capital that nonprofits might be able to use to sustain capacity and subsidize programs to weather financial storms.²⁸ The role foundations choose to play during these times will speak volumes about their commitment to people in need and to the services and advocacy organizations that serve them.

How have these important financial institutions responded to the worst recession since the 1930s? How will their strategies for navigating the next months or years of national and global economic crises alleviate or exacerbate these turbulent times for America's nonprofit sector? We examine these questions here.

Prospective Foundation Grantmaking: A Sinking Feeling

Although some foundations, such as the John D. and Catherine T. MacArthur Foundation, the Bill and Melinda Gates Foundation, and the James Irvine Foundation, have announced their intentions to exceed their 2008 grantmaking in 2009, most news reports cite grantmaking cutbacks.²⁹

But in this era of economic downturn, what will be the norm? Countercyclical increases in grantmaking? Higher payout rates (as percentages of endowments) but lower grantmaking budgets? Efforts to maintain 2008 grant levels through 2009? Or couched amid statements of concerns, reductions of unknown levels in grant budgets?

The complete answer will take time to unfold. Early data from surveys of 17 regional associations of grantmakers on foundations' response to the economic crisis are discussed below.

The Data Sources

Many foundations belong to regional associations of grantmakers, and in late 2008 or early 2009, about one-half these organizations surveyed their members about grantmaking expectations for 2009. A variety of factors, however, limits what we can learn from these reports. First, the associations did not use a uniform survey design; therefore, comparing information across them is difficult or impossible. Second, the level of detail varies in the reports. Some provide only gross, aggregate information on survey respondents, others disaggregate the information by type of funder or by regions within the state.

Further, the surveys are not random or stratified random surveys of the foundation sectors in their regions. They are

28 Foundations also receive 9.1 percent of all charitable gifts, according to *Giving USA 2008*. *Nonprofit Quarterly*'s "Illustrated Nonprofit Economy," 15 (4) (Winter 2008), indicated that in 2006, foundations received \$100 billion in interests, dividends, bequests, and individual contributions from which they made \$41 billion in philanthropic contributions but also added \$59 billion to their own assets. Given that one-third of individual charitable giving goes to religious institutions and initiatives, the \$41 billion from foundations in the form of philanthropic grantmaking is not inconsequential.

29 John D. and Catherine T. MacArthur Foundation, "Statement of Jonathan F. Fanton Regarding MacArthur's Grantmaking in Difficult Economic Times." Press release. (Chicago: MacArthur Foundation, November 17, 2008), available at www.macfound.org/site/c.lkLXJ8MQKrH/b.4196225/apps/s/content.asp?ct=6334379; Bill and Melinda Gates Foundation, "The Economy and Our Work." Press release (Seattle: Gates Foundation, November 21, 2008), available at www.gatesfoundation.org/press-releases/Pages/statement-financial-crisis-081121.aspx; James Irvine Foundation, "Letter from the President" (San Francisco: Irving Foundation, n.d.), available at www.irvine.org/news/from-the-president/letters/2008-letters/fall-2008.

responses from those foundations that chose to respond to surveys, not structured random samples of the foundation world. Also, the responses themselves are not definitive concerning what funders will do. Many foundation executives may prefer to maintain or increase their 2008 levels of grantmaking in 2009 and say so on surveys, but they may also find that the combination of sinking investments and cautious trustees makes these hopes unrealizable.

Despite these limitations, the surveys offer important signals about how the foundation community may navigate the recession. This review focuses on two core issues:

1. Compared with 2008, what will funders do with their grantmaking budgets in 2009? Increase, decrease, or hold steady?
2. How will funders change grantmaking strategies? What will they emphasize and deemphasize?

Will Foundations Give More or Less?

Most foundations expect to give less in 2009, and few expect to give more. In all but six of 17 regions, the majority of foundations responding to the survey expect to give less. In none of these regions did more than 20 percent of funders predict that grantmaking would increase in 2009, and in most surveys, fewer than one-tenth of survey respondents predicted increases. With the exceptions of respondents in the Southeast, Illinois, and Connecticut, between 40 percent and 70 percent of respondents anticipated cuts.

Recent national surveys affirm the responses to the regional association of grantmaker surveys. According to an April 2009 study from the Foundation Center, two-thirds of the more than 1,000 foundation survey respondents “expect to reduce the number of grants they will award in 2009 and/or the size of their grants,” although the survey oddly failed to explore anticipated decreases in foundation grant budgets.³⁰ Guidestar surveyed 266 foundations on the impact of the economy during the six-month period from October 2008 to February 2009. One-third of the grantmakers reported reducing their grantmaking during the period; 32 of 249 grantmakers said that they had stopped accepting grant applications; and seven said that they had reneged on “payouts we had committed to,” apparently not following through with grants already committed.³¹ Similarly, of 2,752 public charities surveyed, 34 percent said that foundation grants were smaller, and 23 percent said they were discontinued entirely.

Surveys of foundations by interest areas are also beginning to emerge, and their results mirror regional surveys of generic foundation grantmakers. For example, the survey responses of 127 of 255 funding partners of Grantmakers in Health between November 25, 2008, and January 5, 2009, indicate that 43 percent have already decreased their grants budgets, only 30 percent will maintain their 2009 grants budgets at 2008 levels, and only 13 percent will increase the proportion of their grantmaking dedicated to core operating support.³²

How Deep Will Cuts Be?

More striking than the number of foundations that expect to shave grant budgets are those that anticipate hefty retrenchments:

- Among New Jersey respondents to the regional association of grantmakers surveys, 13.3 percent predict cutting 16 percent to 46 percent of their grant budgets.
- Among Ohio respondents, 28 percent anticipate cutting their grants by more than 10 percent.
- Among Wisconsin respondents, 11 percent anticipate “significantly decreasing” their grantmaking.
- Among Minnesota respondents, nearly 25 percent predict cutting by more than 10 percent.
- Among Connecticut respondents, 14 percent expect grantmaking cuts of 16 percent or more.
- About one-fifth of Arizona foundation respondents anticipate cutting their grant budgets by 16 percent or more.
- Among respondents to the Illinois Donors Forum, 13.5 percent predict cutting their grant budget by 20 percent or more.

30 Steven Lawrence, “Foundations Address the Impact of the Economic Crisis.” Foundation Advisory (New York: Foundation Center, April 2009), available at http://www.foundationcenter.org/gainknowledge/research/pdf/researchadvisory_economy_200904.pdf.

31 Chuck McLean and Carol Brouwer, “The Effect of the Economy on the Nonprofit Sector: October 2008–February 2009 (Washington, DC: Guidestar, 2009), available at http://www.guidestar.org/march09_npo_economic_survey.pdf.

32 Grantmakers Health, “Effects of the Economic Crisis on Health Foundations: Results of a Survey of GIH Funding Partners” (Washington, DC: Grantmakers Health, 2009), available at http://www.gih.org/usr_doc/Effects_of_Economic_Crisis_on_Health_Philanthropy_Report_Revised_Aprio_2009.pdf.

- Among metro-Washington, DC funders, 27 percent anticipate 2009 grantmaking budget reductions of more than 16 percent.
- In South Florida, 29.8 percent estimated cuts of more than 10 percent.
- Among Indiana respondents, 39 percent estimate cuts of 16 percent or more, with 13 percent cutting their grantmaking by nearly one-half or more.
- A majority of the Oregon/Southwest Washington grantmakers report moderate cuts (31 percent) or significant cuts (26 percent).
- As distressing as this picture may be, the whole scene may be worse if the numbers are skewed owing to respondent self-selection.

The Effect on Corporate Grantmakers

The effects of the economic downturn on corporate grantmakers are similar, although they must be viewed in the context of the limited reporting on corporate grantmaking. Of the \$15.7 billion in corporate giving in 2007, as reported in *Giving USA 2008*, the bulk is not from corporate foundations. Only \$4.4 billion flowed through corporate foundations, (that is, the portion that must be disclosed and reported on IRS Forms 990). The remainder came from the corporations' marketing or CEOs' offices and was exempt from disclosure.

A small number of corporations account for the majority of corporate philanthropy. For example, the Conference Board's survey of corporations and corporate foundations counted \$11 billion in philanthropic contributions made by its 197 respondents, roughly 70 percent of all corporate philanthropy in 2007.³³ The latest survey of corporations conducted by the Committee Encouraging Corporate Philanthropy examined 155 companies that accounted for \$11.6 billion in charitable contributions in 2007.³⁴

The Conference Board's 2009 Corporate Philanthropy Agenda survey (conducted from January through mid-February) paints a stark picture of the future:

- Among the 158 respondents, 45 percent have already cut their 2009 giving budgets, and 16 percent are contemplating doing so.
- 35 percent say they will make fewer grants, and 22 percent are considering doing the same.

Perhaps more than traditional private and family foundations, corporate foundations are considering shifting, or reducing, the topical areas they might address with their grantmaking. Among the respondents, 24 percent are reexamining their focus areas, and another 29 percent are considering that action. In contrast to defining their focus areas, six percent say that they have already eliminated focus areas, and 11 percent are contemplating the same.

The area of the biggest cutback in corporate philanthropy is event sponsorship, as reported by 55 percent of the Conference Board respondents. Perhaps related, the focus area most in line for cuts, according to 41 percent of respondents, is culture and the arts. Other studies, such as LBG Research Institute's survey of corporate giving plans for 2009, confirm the Conference Board findings. LBG reports nearly one-half of its corporate survey respondents indicate they will cut back on their arts and culture grantmaking.³⁵

Among Conference Board survey respondents, the area of the largest predicted growth in 2009 is the noncash expenditure of volunteerism, reported by 45 percent of the respondents. The focus area most frequently identified to grow is "environment/sustainability/climate change" (28 percent), probably for many respondents an area of corporate vulnerability warranting a corporate philanthropic response.³⁶

Although much of corporate charitable giving, for example from the pharmaceutical companies, is in-kind or products, and not cash, many corporate grantmakers, particularly banks, have been providing general operating support. For some corporate grantmakers, again the banks and the government-sponsored enterprises (GSEs) above all, their cutbacks will hit the nonprofit housing and community development field on the front lines of fighting the foreclosures, housing abandonments, and homelessness, all of which were the first wave of impacts from this economic downturn.

33 Conference Board, "Corporate Contributions Holding Steady." Press release. (New York: Conference Board, December 17, 2008), available at www.conference-board.org/utilities/pressDetail.cfm?press_ID=3542.

34 Committee Encouraging Corporate Philanthropy, "Giving in Numbers," 2008 edition (New York: CECP, 2008), available at www.corporatephilanthropy.org/pdfs/giving_in_numbers/GivinginNumbers2008.pdf.

35 LBG Research Institute, *Doing More With Less: How the Economic Downturn Will Impact Corporate Giving in 2009* (Stamford, CT: December 2008)

36 Conference Board, "Corporate Contributions Holding Steady."

How Long Will the Restricted Giving Last?

As many as six months have passed since most of these surveys were completed, and since then, even more bad news has emerged. Yet even when the surveys were conducted, there were ample hints that foundation respondents did not anticipate an economic upturn in 2009. Although, for example, only 29.3 percent of Southeastern survey respondents predicted they would reduce their grantmaking in 2009, 62.5 percent expected that 2010 grant totals would decline. Similarly, Ohio grantmakers, reportedly using twelve-quarter averaging of their assets, indicated that grantmaking in 2010 could be much worse than in 2009.

Grantmaking Strategies

Respondents typically anticipate receiving or have received more grant applications, most often via requests for general operating support. In some areas, foundations responded by increasing the proportion of their budgets devoted to flexible general operating grants. In a few cases, foundations released their grantees from program or project grant restrictions. Approximately one-half of the Ohio, Indiana, Northern California, and metro-Washington, DC respondents, and one-third of Illinois survey respondents, for example, say they will increase their general operating grantmaking.

At the same time, respondents indicate they will pull back on multiyear grantmaking. Although multiyear grants are also critical infusions for nonprofit sustainability, the impossibility of predicting future endowment values makes long-term commitments understandably difficult.

Respondents also expressed interest in encouraging their grantees to collaborate and, specifically, to merge. Three-fourths of the Michigan respondents, 71 percent of surveyed Illinois foundations, nearly 40 percent of upstate New York foundations, one-half of Ohio respondents, 56 percent of Northern California respondents, 42 percent of Arizona grantmakers, 37 percent of Connecticut respondents, and one-quarter of Southeast grantmakers suggest that they will increase focus on facilitating nonprofit mergers (in some cases, using the euphemism of “mergers and collaborations”) in 2009.

Conclusion

For many foundations, when they see their assets depleted by 20, 30, or 40 percent in one fell swoop, the first reaction is to cut back their grantmaking accordingly. It is a business-rational calculus. But what is the potential damage of this approach?

The social mission of foundations is on the docket. Will foundations focus on husbanding their assets or deploying them at the most dire time nonprofit organizations have faced since the Great Depression? Unlike many tens of thousands of nonprofit organizations, foundations are unlikely to go out of business because of the recession. Their assets may be down, but they will survive until the market rebounds, as it inevitably will. But without capital infusions for their capacity and sustainability, many nonprofit organizations will not be there on the other side to greet the foundations, and the communities they serve will be devastated by the effects of this downturn.

Counseling no need to panic, researchers from the Foundation Center and elsewhere have documented how foundations weathered the recessions of 1981–1982, 1990–1991, and 2001 to bounce back in a year or two with increased endowments and grants.³⁷ But this time, many of the nation’s most important nonprofit organizations serving and giving voice to the needs of the poor and disadvantaged may not be around to benefit from the philanthropic recovery. Unlike its predecessors of the past thirty years, this downturn might affect foundation endowments more akin to the Great Depression than to the September 11 recession, and foundations may require several years to rebuild their assets. In the interim, the cumulative work of foundations building a nonprofit infrastructure across the United States might be eviscerated unless foundations come to grips with their obligation to sustain the investments they have made in civil society.

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³⁷ See, e.g., Steven Lawrence, “Past Economic Downturns and the Outlook for Foundation Giving.” Research advisory. (New York: Foundation Center, October 2008), available at http://foundationcenter.org/gainknowledge/research/econ_outlook.html; Steven Lawrence, “A First Look at the Foundation and Corporate Response to the Economic Crisis.” Research advisory (New York: Foundation Center, January 2009), available at http://foundationcenter.org/gainknowledge/research/econ_outlook3.html; Daniel Trotta, “U.S. Charities Resisting Recession, but Hardships Ahead,” *Reuters*, February 5, 2009, available at www.reuters.com/article/lifestyleMolt/idUSTRE5147NJ20090205.

Appendix B

CDFI Market Conditions Report

First Quarter 2009

The Opportunity Finance Network CDFI Market Conditions Report is a quarterly publication based on quarterly surveys of community development financial institutions (CDFIs). This report presents the results of OFN's third consecutive CDFI Market Conditions Survey conducted in May 2009 and covering January – March 2009. One hundred and six CDFIs responded to the survey.

Key Findings

Changes between 4th Quarter 2008 and 1st Quarter 2009

Demand continues to increase for most CDFIs: 59% of respondents reported an increase in the number of financing applications received in the 1stQ09. 15% experienced an increase in applications of 50% or more.

Originations are increasing for fewer CDFIs: Equal numbers of CDFIs reported increases, decreases, and no change in the number of originations in the 1stQ09. This is a slowdown from the 4thQ08 when nearly half (48%) reported an increase in the number of originations. The reasons for originations not keeping pace with demand are evenly distributed among capital constraints, tightened lending criteria, application quality, and slower processing time due to additional due diligence or staff resources diverted to problem loans.

Delinquency is increasing for fewer CDFIs: One-third of respondents reported increased portfolio at risk (30+ days past due) in the 1stQ09. 20% experienced declines in portfolio at risk. CDFIs attributed improvements in portfolio quality to stronger collection efforts, increased borrower monitoring, and borrowers making payments on delinquent accounts.

Average portfolio at risk is falling, from 11.1% in 4thQ08 to 9.2% in 1stQ09.

Net Charge Offs were 0.4% in the 1stQ09.

Workouts and Extensions slowed in the first quarter: 42% reported a greater number of loans/investments in workout and 38% reported an increase in the number of loans granted term extensions.

Liquidity constraints have eased slightly: 51% of CDFIs reported being capital constrained.

Decrease in Capital Liquidity: 39% of CDFIs reported a decrease in capital liquidity. While this is similar to the fourth quarter, reductions were not as severe as in the fourth quarter: only 8% experienced a reduction of 50% or more compared to one-fifth in the fourth quarter.

Outlook

Respondents' outlook for the next quarter and the steps they are taking to respond are similar to the fourth quarter with the exception of a more positive outlook on portfolio quality.

Portfolio Quality: In the fourth quarter, more than half (57%) of CDFIs expected portfolio quality to deteriorate in the next quarter. The outlook has brightened considerably in the first quarter, with only half as many (24%) CDFIs expecting portfolio quality to deteriorate. While the percentage of CDFIs that expect portfolio quality to improve remained constant (25% in the first quarter versus 26% in the fourth quarter), most CDFIs (51%) expect their portfolio quality to remain the same.

Demand: 73% expect demand to increase.

Liquidity and Operating Challenges: Most CDFIs expect to experience new capital liquidity and/or operating difficulties in the next quarter. They are primarily concerned about having insufficient capital to meet growing demand, having fewer operating grants available to cover operations, and increasing loan loss reserves to cover problem loans. Similar to the fourth quarter, 36% percent of respondents expect to have a decline in unrestricted net assets (an unrestricted loss) in their current fiscal year.

CDFI Response to Liquidity and Operating Challenges: Nearly all respondents are implementing new business strategies to respond to the changing market. The most common response is increased monitoring of the loan portfolio, followed by increased emphasis on technical assistance to borrowers and adjusting risk ratings. More than in the fourth quarter, CDFIs are doing stress tests and portfolio reviews, and introducing new financing products.

The full report includes trend analyses comparing fourth and first quarter responses from 68 CDFIs that responded to both surveys. It also includes analyses by asset size, primary financing sector, and region.

This CDFI Market Conditions Report is possible thanks to the generous support of the Ford Foundation.

For more information, please visit www.opportunityfinance.net

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