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Community Development Finance

Challenges, Choices, Change

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Across the nation, community development practitioners, funders, investors, researchers and other stakeholders have recognized that the community development industry is at a crossroads. The federal government is looking at ways to consolidate and realign its community economic development programs—including the Community Development Block Grant, Community Development Financial Institutions Fund and Economic Development Administration—leaving their future funding in question.

Banking industry consolidations translate into fewer funders, and, having become more sophisticated in how they direct their community development dollars, these funders have become more selective. Meanwhile, information technology and telecommunications have reshaped the way the financial services industry identifies and grows markets. Local financial institution managers have less flexibility to customize how they meet identified community needs. Taken together, these major trends mean a more precarious environment for community development corporations and financial institutions.

This issue of Perspectives *examines the community development industry's potential for greater* ***scale, sustainability*** *and* ***impact****. We hope it inspires creative thinking about how community development practitioners in the Federal Reserve's Eleventh District can grow and become more sustainable so that they can have greater impact in their target communities and expand their reach.*

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Scale

Mark Pinsky, president and CEO of National Community Capital Association, a network of independent community development financial institutions (CDFIs), describes this as a time to "grow, change or die." Growth, or scaling up, refers to increasing the volume of community development dollars relative to the demand. Pinsky observes that the community development industry has neither a system to meet the demand nor the power to significantly influence policies that affect its constituents. He argues that to be sustainable, CDFIs must expand their sources of capital, change how they use it and help shape public policy.

The Aspen Institute's Economic Opportunities Program (EOP) suggests structured dialogue as a fundamental step in addressing the issue of achieving scale. In a recent report, EOP defines scale as that which includes "expanded volume, reach, increased efficiency resulting in sustainability, and deepened social impact."[1] Program researchers began their study with several underlying questions: Can and should we reach scale? If community impact is the goal, is building scale the only tactic for achieving it? And if the focus remains on reaching scale, does it achieve, or compromise, impact?

To answer these questions, EOP researchers looked at the business models of 10 mostly for-profit organizations that had successfully reached scale, evaluated their methodologies, and developed a list of questions for the community development industry to consider. (See the box on this page.)

The Texas Landscape

How can the Texas community development industry apply these observations to its own landscape? The Dallas Fed and nonprofit Wall Street Without Walls (WSWW) cohosted a workshop in May on how Eleventh District community development corporations (CDCs) and CDFIs can access capital markets. Using a network of Wall Street professionals, WSWW provides financial technical assistance to individual community development organizations. The workshop introduced innovations in community development finance that could increase organizations' financial stability and sustainability.

At the workshop, the Texas Association of Community Development Corporations (TACDC) presented its 2004 Accomplishments Survey, which also includes data from its 2000 and 2002 surveys. The median budget of the 100 CDCs and 15 CDFIs surveyed was almost $263,000, and their combined operating budget was approximately $75 million. These organizations produced or rehabilitated more than 7,300 housing units in 2002–03, made over 2,700 loans totaling about $34 million and constructed almost 150,000 square feet of commercial development.

Texas CDCs

Texas CDCs' focus is affordable housing. According to the TACDC surveys, in 2002–03, 11 CDCs produced 76 percent of the affordable rental units, while 33 were responsible for the rest. Seven CDCs developed 63 percent of the owner-occupied units, and 54 produced the remainder. Overall, the number of housing units Texas CDCs have established has steadily increased over the last four survey years (*Table 1*). This number is projected to grow by more than 7,000 units in 2004–05.

The industry's weakness is in commercial development. In 2004–05, CDCs plan to build or rehabilitate approximately 145,000 square feet of commercial space, 5,000 square feet less than in 2002–03. TACDC survey respondents report facing multiple barriers in pursuing commercial projects, including a lack of government funding for such develop-

Questions of Scale

Product Development and Portfolio Mix

When for-profit entities develop products, they focus on market demand and profitability, whereas community development organizations focus on need and affordability. How can CDCs and CDFIs develop a profitable portfolio mix so their organizations have financial stability and sustainability? Moreover, product profitability directly impacts subsidy levels. The community development finance field needs to conduct further research on product mix, profitability and more efficient use of subsidies.

Geographic and Market Parameters

Taking a product to scale typically requires geographic or market expansion, or both. Expanding geographic and market parameters can contradict the mission of community development organizations and their funders. How can they resolve this?

Infrastructure

Going to scale requires adequate capitalization and significant investment in infrastructure and technology. Organizations can grow their products and services to scale if they develop an organizational pipeline that can deliver them across locations, departments and vendors and translate them across investment criteria. Technology, standardization of products and services, and strategic partnerships are fundamental to this pipeline. How can community development organizations collectively address infrastructure development?

Leadership

As organizations grow in size and sophistication, they require more specialized skill sets. Community development leaders need to be able to focus on managing the vision, strategy, finances and other macrolevel components of the organization as it evolves. What efforts are being made to increase leadership capacity?

—Economic Opportunities Program, Aspen Institute

Table 1 Affordable Housing in Texas

	2000	2001	2002	2003
New rental units	488	538	136	1,509
Acquired or rehabilitated rental units	775	922	1,043	1,450
New owner-occupied units	629	677	781	601
Rehabilitated owner-occupied units	403	429	139	187
TOTAL	**2,295**	**2,566**	**2,099**	**3,747**

SOURCE: "Building a Future: The Contributions of Community Development Corporations in Texas," Texas Association of Community Development Corporations, 2005.

ment, a dearth of in-house expertise in the field, and the relatively high risk of investing in this type of project versus housing and business development.

Texas CDFIs

CDFIs in Texas provide loans, investment dollars, financial products and services, technical assistance and training to low-wealth individuals and organizations. According to the CDFI Data Project's review of fiscal 2003 numbers, over half the Texas CDFI client population is female, approximately two-thirds are minority and almost 60 percent are low-income. About one-fourth of these underserved populations live in rural areas, one-fourth in urban areas with fewer than 1 million residents and the remainder in urban areas with populations over 1 million.

Historically, Texas CDFIs' greatest number of loans went to microenterprise development, but their greatest dollar volume was in existing businesses. From each organization's inception through 2001, TACDC survey respondents' investment in microenterprise accounted for 55 percent of their loans. In 2002–03, it accounted for 78 percent. TACDC reports that CDFIs expect 64 percent of their loans will be in microenterprise in 2004–05.

Table 2 presents an overview of the dollar volume and number of CDFI loans in Texas. Note that while the dollar volume of microenterprise loans has increased, the number of loans has decreased, indicating that there are fewer loan recipients getting larger loans than their predecessors.

Table 3 presents a snapshot of Texas CDCs' development budgets and CDFIs' capital budgets.

Sustainability

In anticipation of shrinking subsidies, Texas CDCs and CDFIs are starting to reexamine their business models and determine how to adjust them in order to increase their funding sources and the amount of money they receive. Wall Street Without Walls and the Capital Markets Access Program at Southern New Hampshire University's School of Community Economic Development have proposed a wide array of options to increase funding sources, profitability and sustainability. Here are some of their ideas.

Industrywide Options

- Coordinate a network of mayors, who would pool their jurisdictions' vacant lots for collateral for community development transactions. These lots would enable community developers to monetize dead assets.
- Apply as a group for foundation dollars.
- Pool resources to share outsourced services (for example, accounting, legal, development, predevelopment, servicing and technology), thereby reducing costs.
- Create a network of CDFIs that provide short-term loans to each other, thereby increasing liquidity.

Organizational Options

- Add fee-based line(s) of business.
- Determine where the organization adds the most value and narrow the focus to this product or service.
- Outsource functions that are not central to the business.

Table 2 CDFI Loans in Texas

Loan Type	Through 2001	2002	2003	2004–05
Dollar Volume				
Existing business	$66,056,504	$6,926,250	$8,260,296	$22,705,795
New business	8,703,935	401,800	1,780,461	3,124,000
Housing development	137,000	N/A	261,500	1,200,000
Mortgages	50,281,923	2,232,837	2,431,788	3,623,000
Microenterprise	20,392,898	6,296,538	6,904,516	8,142,756
TOTAL	**$145,572,260**	**$15,857,425**	**$19,638,561**	**$38,795,551**
Number of Loans				
Existing business	448	61	60	166
New business	22	6	35	89
Housing development	2	N/A	3	5
Mortgages	2,342	252	234	355
Microenterprise	3,379	997	1,259	1,070
TOTAL	**6,193**	**1,316**	**1,591**	**1,685**

NOTE: Data in the first column are from organizational inception through 2001. Data for 2004–05 are current and projected.

SOURCE: "Building a Future: The Contributions of Community Development Corporations in Texas," Texas Association of Community Development Corporations, 2005.

Table 3 Texas CDC and CDFI Budgets, 2003

Development Capital Source	Amount	Percentage
CDC Development Budgets		
Banks	$115,975,309	42.1
Sale of Low-Income Housing Tax Credits	43,300,000	15.7
501(c)(3) bonds	42,415,866	15.4
Federal programs	34,440,806	12.5
CDC equity	11,199,530	4.1
State of Texas Housing Trust Fund	3,922,657	1.4
Local government	3,052,792	1.1
Intermediaries	2,770,000	1.0
Other	18,093,000	6.6
TOTAL	**$275,169,960**	**100**
CDFI Capital Budgets		
Bank loans, equity investment	$2,388,788	26.4
Earned income	1,905,038	21.0
Foundations	1,453,095	16.1
Federal programs (excluding CDFI Fund)	884,017	9.8
Bank grants	648,659	7.2
CDFI Fund, Treasury grants, equity investment	550,000	6.1
Noncash, in-kind contributions	387,932	4.3
Intermediaries	280,000	3.1
Other	554,498	6.1
TOTAL	**$9,052,027**	**100**

SOURCE: "Building a Future: The Contributions of Community Development Corporations in Texas," Texas Association of Community Development Corporations, 2005.

• Hire practitioners or consultants with expertise in commercial real estate finance or other relevant areas where a knowledge gap hamstrings business growth.

• Work with local governments to monetize dead assets, such as land, which CDFIs and loan funds can use as credit enhancements to make their business deals less risky.

• Access New Markets Tax Credits (NMTC).

• Work with certified capital companies (CAPCOs).

How have Texas CDCs and CDFIs reacted to these proposals? Some have questioned why community development organizations headquartered in Texas have not received more NMTCs. (Table 4 presents a snapshot of where these credits are distributed). Others have expressed interest in learning more about CAPCOs. In response to these questions, the next two sections provide overviews of these investment tools.

New Markets Tax Credits

The NMTC program is administered by the CDFI Fund and extends from 2000 to 2007. Its purpose is to attract $15 billion in investment for businesses and economic development activity in low-income communities. The program gives corporate and individual taxpayers a federal income tax credit for investing in community development entities (CDEs), which then invest in businesses in low-income areas.

The program's strength is that it provides needed gap and equity funding. To date, the CDFI Fund has awarded $8 billion in NMTCs. The fund is currently publicizing its fourth Program Notice of Allocation Availability, which invites CDEs to apply for an aggregate of $3.5 billion in NMTCs. Among the sources for more information are the CDFI Fund, New Markets Tax Credit Coalition, Novogradac & Co. and TACDC.

CDEs that want to directly apply for NMTCs should consider teaming up with appropriate partners. The partnership is most likely to succeed if it has knowledge and experience in commercial real estate investing, raising institutional investment capital, and deploying capital in low- and moderate-income areas.

If an organization does not want to directly apply for NMTCs, the alternative is to contact CDE allocatees whose service areas and activities are aligned with the organization's and request to secure credits from those allocatees. The CDFI Fund compiles a list of local, regional and national entities that have won tax credit allocations. In 2005, no Texas entities were directly allocated NMTCs. However, 10 allocatees have service areas that include Texas (*Table 5*). For allocatee activities (categorized as "Profiles"), service areas and other details, go to www.cdfifund.gov, and click on "Awardees."

Table 4 NMTC Allocatees, by Headquarters

	1st round 2002	2nd round 2003–04	3rd round 2005
California	10	1	5
Florida	0	1	0
Illinois	4	6	2
New York	5	6	5
Texas	0	2	0
Louisiana	2	1	3
New Mexico	0	0	0
TOTAL	**21**	**17**	**15**

NOTE: First four states have demographics similar to those of the Eleventh District.

SOURCE: Community Development Financial Institutions Fund.

CAPCOs

CAPCOs are state-regulated, privately owned venture capital companies created to facilitate economic development. A state legislature passes a CAPCO Act, which establishes premium tax credits in the form of debt securities called certified capital notes. A venture capital company based in the state submits an application to become a CAPCO so that it can issue these notes. The state grants CAPCO certification if the company meets certain requirements, which include an initial capitalization of at least $500,000 and at least two money managers with significant venture capital experience.

State-licensed insurance companies purchase the certified capital notes in exchange for premium tax credits. The CAPCO uses the proceeds from these securities to invest in small businesses in low-income areas whose growth is hampered because they lack access to capital.[2]

The CAPCO acts as a traditional venture capital company by investing in qualified businesses and providing them with technical assistance. CAPCOs can invest up to 15 percent of their certified capital per qualified business. At least 30 percent of their investment must go to strategic investment businesses, which are enterprises located in low-income areas, and at least 50 percent to early stage businesses, firms that are either under 2 years old or had less than $2 million in revenue the previous fiscal year.

CAPCOs must invest at least 30 percent of their certified capital in these businesses within the first three years of certification and 50 percent of it within the first five years. Every dollar CAPCOs invest in qualified businesses earns them an equal amount in tax credits. When a CAPCO has invested all its certified capital, the state ceases to regulate the CAPCO.

Texas CAPCOs

Lawmakers passed the Texas CAPCO legislation in 2001, which established $200 million in tax credits. The credits were allocated in June 2005, creating 10 sources of investment capital. According to the Texas Treasury Safekeeping Trust Co. in the state comptroller's office, which administers the CAPCO program, these sources are Accent Texas Fund I LP, Aegis Texas Venture Fund LP, Enhanced Capital Texas Fund LP, Lonestar CAPCO Fund LLC, Republic Holdings Texas LP, Stonehenge Capital Fund Texas LP, Texas ACP I LP, Waveland NCP Texas Ventures LP, Whitecap Texas Opportunity Fund LP and Wilshire Texas Partners I LLC.

At the May Wall Street Without Walls/Dallas Fed workshop, Paul Deslongchamps, managing director and chief investment officer of Waveland Ventures LLC, explained how his firm works as a CAPCO. Waveland Ventures is a holding company whose focus is generating returns for its investors while driving economic development returns for the communities in which it invests. Waveland positions itself in what it calls "emerging domestic markets" because it believes this is where the market opportunity is: creating jobs and wealth in what have been traditionally underserved but potentially vibrant markets. The company implements this strategy by investing in these markets via state and federal incentive programs, enabling Waveland to monetize tax credits to create pools of investment capital.

In June, Waveland received Texas CAPCO certification and premium tax credits that created a $23.4 million pool of investment capital. Waveland's Texas CAPCO operates under the name Waveland NCP Texas Ventures and has offices in Austin and Dallas.

According to Deslongchamps, the value of CAPCOs is that they fill a financing gap. "Financing, especially in the $1 million to $5 million range, is very difficult to acquire. . .and it's getting worse. Angel investing typically tops out at $1 million, and the institutional venture capital firms typically don't want to deploy less than $7 million to $15 million, depending on the fund."

Table 5 2005 NMTC Allocatees Whose Service Areas Include Texas

Allocatee	Controlling Entity	Headquarters
Structured Products Group CDE LLC	GMAC Commercial Holding Corp.	Denver, CO
CSDC New Markets Fund LLC	Charter Schools Development Corp.	Washington, DC
Advantage Capital Community Dev. Fund LLC	Advantage Capital Partners	New Orleans, LA
CDF Development LLC	The Cordish Co. Inc.	Baltimore, MD
ESIC New Markets Partners LP	The Enterprise Foundation	Columbia, MD
CCG Community Partners LLC	CityScape Capital Group LLC	Princeton, NJ
Chase CDC	JPMorgan Chase & Co.	New York, NY
UA LLC	None	New York, NY
Wachovia Community Dev. Enterprises LLC	Wachovia Corp.	Charlotte, NC
Self-Help Ventures Fund	Center for Community Self-Help	Durham, NC

SOURCE: Community Development Financial Institutions Fund.

Impact

Federal Reserve Board Chairman Alan Greenspan stresses that quantifying impact is crucial to the industry. At the National Community Reinvestment Coalition conference in March 2005, he said, "Measuring the results of programs . . . is essential to effectively managing scarce resources and maximizing the impact of these programs. . . . By consistently and reliably measuring outcomes, and thus helping current and prospective investors better assess their risks and predict their returns, community devel-

Q&A with the Heron Foundation's Kate Starr

The F. B. Heron Foundation was among the participants at the Wall Street Without Walls/Dallas Fed workshop in May. The 13-year-old, New York-based foundation emphasized that its funding and financing criteria are based on applicants' capacity to demonstrate impact and their ability to improve it. The Dallas Fed recently spoke with Heron Senior Program Officer Kate Starr to learn more about the foundation and its strategies.

How big is the Heron Foundation and what is its goal?
Starr: We are a medium-sized, national foundation with an annual grantmaking budget of around $10 million. Our goal is to help people help themselves through wealth-creation strategies like homeownership, enterprise development, access to capital and access to high-quality child care.

What distinguishes your grantees from their competitors?
Starr: What these organizations have in common is a track record of making meaningful changes in their communities in terms of wealth creation, such as building houses, developing commercial real estate, packaging mortgages, lending dollars, providing high-quality child care for low-income children, creating innovative programs and having a multiplier effect on their local economies.

What organizations do you fund in the Federal Reserve's Eleventh District?
Starr: Since 2003, we have partnered with Austin CDC, Avenue CDC [Houston], the CDC of Brownsville, Fifth Ward Community Redevelopment Corp. [Houston], the Interfaith Education Fund [Austin], McAllen Affordable Homes, Proyecto Azteca [San Juan, Texas], and United Cerebral Palsy of Texas' Home of Your Own Program. In November 2004, our board narrowed our reach from 26 to 12 locations, including Texas. In 2004, we had $615,000 in grants and investments to Texas grantees.

What kind of funding do you provide?
Starr: Our foundation provides general support and makes below-market and market-rate investments. The former are often called program-related investments, which include debt and equity. While Heron prices PRIs on a concessionary basis, it does give some consideration to risk. In contrast, market-rate investments are purely risk-adjusted vehicles. For example, Heron invests in inner-city community commercial real estate projects that generate rates of return that one would expect from any private equity real estate investment.

How do you demonstrate your focus on community impact?
Starr: Embedded in our grantmaking and investing culture is our dedication to measuring and demonstrating impact. Heron has supported two efforts in measuring impact to boost the community development field's ability to have and demonstrate impact: Success Measures Data System [SMDS] and the Capital Markets Access Program [CMA]. SMDS is a web-based, participatory evaluation system aimed at helping community-based organizations develop the capacity to evaluate the efficacy of their own work. According to NeighborWorks America, home to SMDS, community-based organizations and their stakeholders field-tested and designed this tool to document outcomes, measure impact and inform change. To help boost impact, the CMA program provides technical assistance to nonprofit organizations with significant economic development projects that want to position themselves to attract capital market investment. This program is important because it can help build successful community development efforts to scale.

What would you say community development funders are commonly asking themselves?
Starr: How can we support practitioners' efforts to increase impact and scale and reach more people? That's the $64,000 question.

opment organizations can attract more funding."[3] Following are examples of how practitioners are demonstrating their impact.

CARS:™ An Impact Indicator

One indicator of community developers' impact is CARS, the CDFI Assessment and Rating System. The National Community Capital Association (NCCA) launched the system in 2004 to increase the volume of capital flowing to CDFIs. CARS analyzes the impact of CDFIs and gives them a AAA, AA, A or B rating. In addition, CDFIs can receive a Policy Plus rating—for example, a AA+—by playing a leadership role and dedicating significant resources to policy change. Heading efforts to pass antipredatory lending legislation serves as an example. CARS also analyzes and rates the CDFIs' financial strength and performance on a scale of 1 to 5, 1 being the best, using a CAMEL analysis: capitalization, asset quality, management (governance, information systems, infrastructure, staff, strategy, etc.), earnings and liquidity.

As of mid-June, NCCA had rated or was in the process of rating 17 CDFIs and had a total of 20 other CDFIs in the pipeline. Austin CDC was included in the first round of selected organizations. Fourteen major investors have purchased subscriptions to CARS, which gives them the CDFIs' ratings plus a full analysis of their impact performance and financial strength and performance. Subscribers include Domini Social Investments LLC, Fannie Mae, JPMorgan Chase CDC, Merrill Lynch CDC, Trillium Asset Management, Wachovia Bank, Washington Mutual, Annie E. Casey Foundation, Calvert Foundation, Fannie Mae Foundation, F. B. Heron Foundation, Ford Foundation, The John D. and Catherine T. MacArthur Foundation, and JPMorgan Chase Foundation.

Investors can also purchase the analyses and ratings for individual CDFIs. For more information, go to www.communitycapital.org.

ACCION: An Impact Study

Leading the trend in demonstrating impact, ACCION Texas conducted a study in 2003 that quantified and qualified its impact on Texas communities and the state economy. The organization calculated that since 1994, its $22.2 million in direct lending had generated $35.5 million in economic activity (such as sales generated by borrowers' businesses) and $13.5 million in new income, $2.4 million in public-sector revenues and 604 jobs.

The qualitative effects of ACCION's lending complement these data. Borrowers report that their nonfinancial benefits include an increased ability to access credit; improved self-confidence in their roles as entrepreneurs; a growing sense of independence, financial security, empowerment and pride; stronger ties to their families and communities; increased economic literacy; and the feeling that they can enjoy the privileges and rights of being actively involved in the economy.

Since this study, ACCION Texas has disbursed an additional $15 million, for a total of more than $37 million.

Looking Ahead

How well can the community development industry meet the needs of low- and moderate-income communities in the 21st century? Frank Fernandez, Austin CDC director of programs, stresses that for community developers to succeed, they need to increase their business sophistication. Because the Texas community development industry is one generation younger than its counterparts elsewhere in the nation, it has the opportunity to avoid making the same mistakes.

Nevertheless, community development organizations at all levels of maturity and sophistication need to adjust their business models to survive and thrive in a rapidly changing marketplace. No longer can they rely on attracting a few pools of capital; diversified funding sources and vehicles are the future.

Says the NCCA's Mark Pinsky: "We have grown as a loose network of collaborative but independent organizations. To go forward, we must develop more structured networks and become more interdependent, not only with each other but with other partners in our marketplace. . . . This transformation will reshape how we work, where we get our capital, how we put capital to use; it will refine the economics of community development finance, reduce transaction costs, and increase liquidity; and, it will, I hope, alter the ways we engage in civil, political, and policy change."[4]

In 2005–06, the Aspen Institute and Federal Reserve System are hosting a series of regional conferences to promote further thinking and discussion on scale, sustainability and impact. To become updated on the industrywide conversation, go to http://innovationlabs.com/aspen. To learn about the Aspen Institute/Dallas Fed's regional 2006 conference on this topic, watch for details on the Bank's web site, www.dallasfed.org.

NOTES

[1] "New Pathways to Scale for Community Development Finance," by Gregory Ratliff and Kirsten Moy, *Profitwise News and Views*, Federal Reserve Bank of Chicago, December 2004.

[2] Qualified businesses must be "primarily engaged in. . .manufacturing, processing, or assembling products. . . conducting research and development; or. . .providing services." For the full requirements, see www.texascapital.org/CapcoRules_10_22_2004.pdf (September 2005).

[3] For the complete speech, see www.federalreserve.gov/boarddocs/speeches/2005/20050318/default.htm.

[4] "Good News," a speech at the National Community Capital Association conference in Chicago, Nov. 4, 2004, www.communitycapital.org/community_development/speeches/pinsky_speech2004.pdf.

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