

# New England Community Developments

Emerging Issues in Community Development and Consumer Affairs

## An Overview of the CDFI Industry

*by Brandy Curtis*

**T**here are an estimated 1,000 community development financial institutions (CDFIs) operating in the United States, including approximately 70 CDFIs in the six New England states. These institutions provide financial services and technical assistance to create economic opportunity for low- and moderate-income (LMI) people, often where these constituencies are not being served by mainstream financial institutions.

**CDFIs are financial institutions that have a primary mission of promoting economic growth and stability in LMI communities.**

This article, part of ongoing efforts of the Federal Reserve Bank of Boston to help raise awareness of CDFIs and to be a resource for this sector, presents an overview of the CDFI industries in the United States and New England. We identify the size of the industry and the services and products offered, and we highlight some of the effects these institutions have on LMI communities. We also take a look at the changes and challenges facing CDFIs and what they indicate for the sector's future. We conclude with exhibits that highlight the work of a CDFI in each of the New England states.

While the CDFI industry has had strong growth in recent years, it still repre-

sents a very small portion of the overall financial services sector in the United States. Moreover, the industry is at a crossroads in terms of identifying strategies for increasing overall sustainability and scale, and ultimately, impact.

### What are CDFIs?

The term CDFI can be defined in several ways. Some refer to CDFIs as specialized financial institutions that receive certification by the U.S. Department of Treasury's CDFI Fund. The CDFI Fund is a public fund created for the purpose of promoting economic revitalization and community development through investment and assistance to CDFIs. In order to be certified by the Fund, a CDFI must have community development as a primary mission; must serve an eligible target market; must be predominantly a financing entity; must provide development services (technical assistance); must be accountable to the target market; and must be a nongovernmental entity. Currently, there are 748 certified CDFIs nationwide and 64 in New England.

CDFIs can also be defined more broadly as financial institutions that have a primary mission of promoting economic growth and stability in LMI communities. In certain cases, financial institutions have not found it necessary to apply for CDFI

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Figure 1 **Number and Asset Size of CDFIs**

<b>U.S.</b>	<b>All</b>	<b>Banks</b>	<b>Loan Funds</b>	<b>Credit Unions</b>	<b>Venture Capital</b>
Number	517	53	161	284	19
Total Assets	\$18,322,322,477	\$9,771,422,000	\$3,271,918,862	\$5,102,487,005	\$176,494,610
Average Assets	\$35,439,695	\$184,366,453	\$20,322,477	\$17,966,504	\$9,289,190
<b>New England</b>					
Number	30	2	19	8	1
Total Assets	\$944,467,699	\$525,143,000	\$200,432,701	\$213,495,160	\$5,396,838
Average Assets	\$305,204,323	\$262,571,500	\$10,549,090	\$26,686,895	\$5,396,838

Source: CDP

Fund certification to carry out their community development mission.

The total number of financial institutions that have community development as their primary mission is more difficult to estimate than the number of CDFIs that are certified. According to the CDFI Data Project (CDP), an industry collaborative, there are approximately 1,000 CDFIs, certified and uncertified, operating in all 50 states, the District of Columbia, and Puerto Rico.<sup>1</sup> In 2004, the CDP collected data—including over 150 data points on operations, financing, capitalization, and impact—on 517 CDFIs nationwide and 30 CDFIs in New England.<sup>2</sup> Unless otherwise noted, the CDFI data cited in this article refer to the 2004 CDP survey data.

**There are about 1,000 community development financial institutions operating in the United States, including approximately 70 CDFIs in the six New England states.**

CDFIs can take on a wide variety of institutional forms, and some organizations use more than one. The industry classifies these different forms into four broad groups: 1) federally regulated community development banks (CDBs), which take deposits and lend to and invest in individuals and organizations, 2) federally regulated credit unions (CDCUs), which take deposits and provide retail financial services, 3) nonprofit or for-profit community loan funds (CDLFs), which aggregate and lend funds, and 4) community development venture capital funds (CDVCs), which make debt and equity investments in growing businesses.

The asset size of individual CDFIs also varies widely. Currently U.S. CDFIs range in asset size from \$29,000 to more than \$1.5 billion. In New England, they range from \$90,000 to \$479 million. While it is hard to generalize about how the average asset size varies across organizational forms, the CDP data suggest that on average community development banks represent the largest institutions and community development venture capital funds the smallest (see Figure 1). Although the size of certain CDFIs might appear quite large, the total asset size for the surveyed institutions equals just \$18 billion, a small portion of the U.S. financial-services sector as a whole.<sup>3</sup>

## The History of Community Development Finance

Community development finance has appeared in many different forms. In the late 1880s, some minority-owned banks targeted their lending to low-income areas. At the turn of the century, credit unions began to emerge, offering customers the ability to pool their money, which has had broad appeal for low-income individuals. In the 1960s and 1970s, some community development corporations (CDCs) offered financial assistance, usually to support the community development projects of other groups. In the 1980s, a series of nonprofit loan funds began providing financial support for the development of affordable housing and small businesses. As the overall number of venture capital funds multiplied in the 1990s, several were established for the specific purpose of promoting community development.

Two important initiatives in the 1990s helped to stimulate growth of the community development financing industry. The first initiative involved the establishment of the Community Development Financial Institutions Fund in 1994. The Fund is the single largest funding source for certified CDFIs and also provides technical assistance. The most significant contribution of the Fund to the CDFI industry has been equity financing, which helps CDFIs to leverage additional funding from donors and private sources. The Fund also provides a fair amount of flexibility in how the financial awards can be used, which has allowed some CDFIs to develop new products.

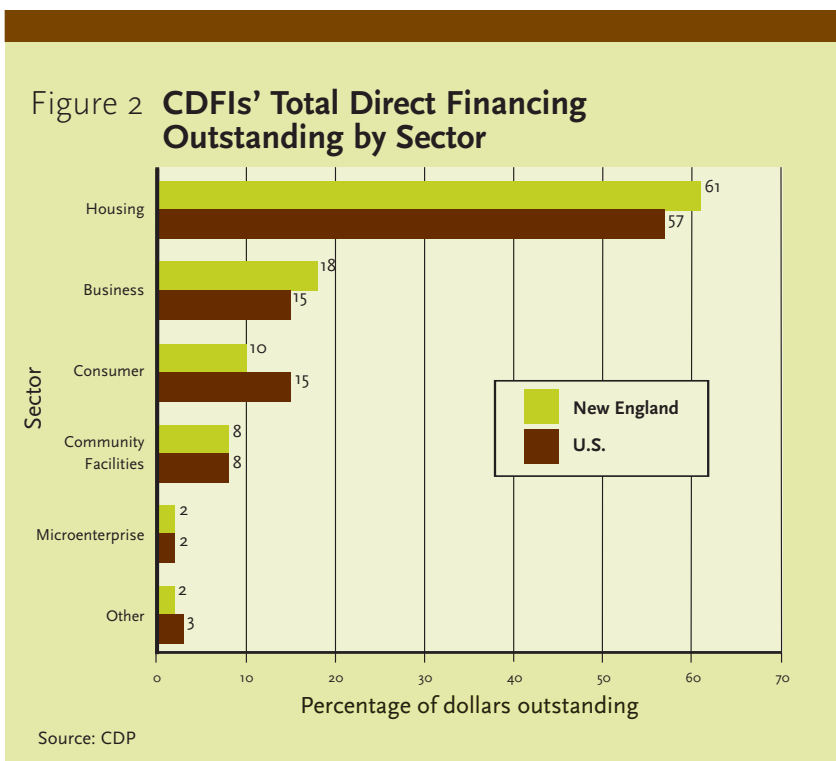
Second, federal regulators revised the Community Reinvestment Act in 1995 to judge banks and thrifts more on their actual lending than on their marketing and outreach strategies in LMI and minority communities. This change helped stimulate additional community investments from banks and thrifts.

The industry continues to change rapidly because of economic and demographic changes in the communities where CDFIs serve and because of shifts in private and public funding sources. In the last three years, fewer new CDFIs have appeared, while some existing CDFIs have consolidated. According to the Social Investment Forum, CDFIs exhibited a 19 percent increase in total asset size from 2003 to 2005.

### What Products and Services Do CDFIs Offer?

CDFIs provide financial and nonfinancial services to six categories: housing, small- and medium-sized businesses, microenterprise, community facilities, consumer financial services, and “other.” For New England and the nation as a whole, housing is by far the primary sector that CDFIs finance, constituting 61 percent and 57 percent of CDFIs’ direct financing outstanding in New England and the United States, respectively (see Figure 2). This is followed by financing for small- and medium-sized businesses, consumer financial services, and community facilities. Microenterprise and “other” are the smallest categories. Below we discuss the particular financing needs of each sector and how CDFIs work to meet these needs.

One of the unique features of CDFIs is the way they supplement their financing with a range of counseling and educational services that increase borrowers’ capacity to build wealth. Indeed, it is



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required that a CDFI provide this type of technical assistance in order to receive certification from the CDFI Fund. CDP data show that in 2004, New England CDFIs provided training to more than 700 organizations and more than 18,000 individuals through group-based training and one-on-one technical assistance.

**Technical Assistance Provided by New England CDFIs**

	# People or organizations	# New England CDFIs reporting*
People receiving group-based training	3,214	9
People receiving one-on-one technical assistance	15,244	16
Organizations receiving training	718	13

## Housing

The stability of a neighborhood depends partially on the availability of housing finance. Such credit has historically been difficult to obtain in LMI and minority neighborhoods because of redlining and the real and perceived higher risk of lending in these neighborhoods. Some CDFIs provide loans to housing developers for acquisition, construction, renovation, working capital, and mortgage loans. CDFIs also help to reduce mainstream lenders' uncertainty by funding some of the more-risky project financing, such as land acquisition and architectural, engineering, or other predevelopment costs. Housing finance provided by CDFIs also supports the development of rental housing, transitional housing, and residential housing. Among CDFIs, community development loan funds are the primary financing source for housing development.

	Nationwide	New England	# New England CDFIs reporting
Total financing outstanding	\$1.9 billion	\$103 million	15
Housing units created or renovated	43,160	3,869	12
Mortgages closed	7,697	496	7

A growing body of evidence indicates that an absence of conventional mortgage lenders in LMI areas is increasingly filled by subprime mortgage lenders. A small number are thought to be marketing predatory loans, which have the effect of stripping borrowers' home equity. Some CDFIs work toward filling the mortgage lending gap by providing mortgages, often to those who cannot qualify for a mortgage from the mainstream financial sector. Because these borrowers are typically first-time homebuyers who need significant help with the buying process, many CDFIs offer nonfinancial services such as homebuyer education courses and counseling on how to avoid predatory lending. CDFI lending in this arena encourages involvement by conventional lenders and therefore increases the amount of available credit in underserved areas. As more conventional lenders have entered this market, CDFIs have begun focusing on supplementary financial products, such as second mortgages, loans for down payments, and home improvement loans.

## Businesses

Business provides critical goods, services, and employment opportunities to residents and local economies. Business, in turn, requires access to debt and equity capital in order to finance both new and growing enterprises. Smaller businesses generally have more difficulty accessing capital than their larger counterparts because of low levels of capitalization, lack of collateral, and shorter track records. In addition, lending to these groups is often less profitable because of the technical assistance needed and the small size of the loans. Some CDFIs help meet the needs of small businesses in LMI areas by providing loans and technical assistance.

### Small and Medium-Sized Businesses

Among CDFIs, financing for small- and medium-sized business generally comes from community development loan funds and venture capital funds. In addition to looking at returns, many CDFIs consider social benefits when making loans and investments to smaller businesses. These social benefits include promoting economic growth and job creation in LMI areas, providing services in disinvested locations, and ensuring business growth will not harm the surrounding environment. While both community development loan funds and community development venture capital funds lend to smaller businesses, the latter also provide equity capital.

	Nationwide	New England	# New England CDFIs reporting
Total financing outstanding	\$571 million	\$30 million	14
Businesses financed	1,821	143	13
Jobs created and maintained (including microenterprise)	28,330	1,675	11

### Microenterprise

The CDP defines a microenterprise as a business with five or fewer employees and a maximum loan or investment of \$35,000. CDFIs support these businesses by providing capital for start-up or expansion of a business, working capital, or equipment purchase. Most of CDFIs' microenterprise borrowers are LMI or minority and are in the early stages of business development. CDFIs offer a wide range of technical assistance for microenterprise such as entrepreneurial training, business coaching, and net-

	Nationwide	New England	# New England CDFIs reporting
Total financing outstanding	\$82 million	\$4.2 million	9
Microenterprises financed	5,052	474	8

working opportunities. Although some community development banks and credit unions provide microenterprise financing, most of the financing for these businesses comes from community development loan funds and community development venture capital funds.

### Consumer Financial Services

For a variety of reasons, many LMI customers choose not to use the retail financial services of mainstream financial institutions and turn instead to alternative financial providers such as check cashers, payday lenders, pawnshops, and rent-to-own stores. Some of the most frequently cited reasons customers choose not to use banks include the cost of bank services, “hard” barriers such as credit problems or a lack of proper ID, and “soft” barriers such as wariness of banks.<sup>5</sup> Alternative financial services typically offer customers convenient locations, flexible hours, and immediate cash. However, users of alternative banking services pay high interest rates and fees two to three times more than conventional bank-account fees. In addition, few alternative financial providers offer savings accounts, which can help consumers build wealth, or checking accounts,

	Nationwide	New England	# New England CDFIs reporting
Total financing outstanding	\$512 million	\$16.5 million	3
Pay-loan alternatives	4,361	48	1

which, together with savings accounts, can help consumers build their credit histories.

Some CDFIs try to improve the accessibility and affordability of basic financial services for LMI consumers. Community development banks and credit unions in particular provide a range of basic financial services to develop personal assets at little or no cost to their members or customers. CDFIs offering consumer financial services sometimes pro-

vide personal loans for health, education, employment, debt consolidation, transportation, and other consumer purposes. Sometimes they provide financial literacy training and programs such as individual development accounts that encourage savings. The consumer financing sector is characterized by a high number of loan transactions and relatively small dollar amounts. In New England, direct financing outstanding by CDFIs for consumer finance amounts to just 15 percent of their direct financing outstanding for housing. However, these CDFIs conduct more than twice the number of transactions for consumer finance than they do for housing.

### Community Facilities

Because public and philanthropic monies only go so far, community service providers must also turn to private-sector capital to help with the development of community facilities. CDFIs work with community groups—human- and social-service agencies, advocacy organizations, health-care providers, child-care centers, and educational providers—developing strategies to fill the gap. They help these organizations to become viable borrowers in the eyes of mainstream lenders, to develop sound financial and accounting practices, to identify and manage development issues, and generally to become more businesslike in their orientation to facilities development. In addition, many CDFIs entice mainstream lenders to commit monies to facilities projects by providing the initial, most-risky, project financing. Some CDFIs are using the CDFI Fund’s New Market Tax Credit Program to finance community facilities such as charter schools. Community facilities accounted for 8 percent of CDFI finance outstanding both regionwide and nationwide in 2004.

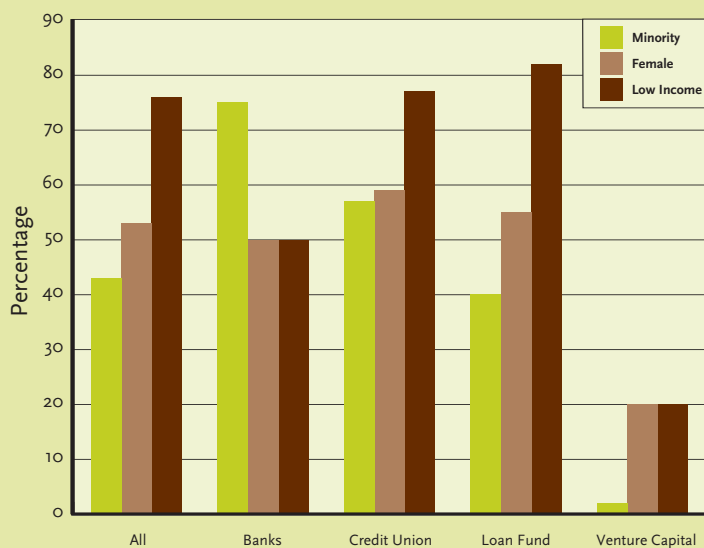
	Nationwide	New England	# New England CDFIs reporting
Total financing outstanding	\$262 million	\$13 million	9
Community organizations financed	470	35	9
Child-care slots assisted	14,446	818	3
Health-care slots assisted	245,823	1,832	4

## Clients Served by CDFIs in New England

The work of CDFIs reaches many individuals and communities in the New England region, particularly those traditionally underserved by mainstream financial institutions—LMI individuals and families, minorities, and women. Seventy-six percent of CDFIs’ clients in New England are low-income, 53 percent are female, and 43 percent are minorities (see Figure 3). Loan funds and credit unions have the highest percentages of low-income clients at 82 percent and 77 percent, respectively. CDFIs in our region are helping borrowers open their first bank accounts, are improving financial literacy, are developing affordable housing, and are providing loans to markets not typically served by mainstream financial institutions.

CDFIs serve a mix of rural and urban markets in New England, with 24 percent of CDFI clients coming from major urban areas, 45 percent from minor urban areas, and 31 percent from rural areas.

Figure 3 Consumer Profile of New England CDFIs by Institution Type



Source: CDP

## Looking Ahead

The CDFI industry is at a crossroads. A shift in available resources is pushing them to strengthen their business models. In addition, the industry has had to face the fact that they are not growing at a rate commensurate with demand. According to Mark Pinsky, president and CEO of Opportunity

Finance (formerly National Community Capital Alliance), CDFIs need to accept that they must “grow, change, or die.”

The industry saw rapid growth in the size of the overall sector in the 1990s; however, the subsequent slowing of the U.S. economy and a drop in government funding for community development is requiring that CDFIs adapt their business models. Pinsky says that many CDFIs are struggling to meet these challenges and not all of them will survive. He suggests that smaller CDFIs, in particular the microlenders in rural communities, will survive because they are meeting a real need and a larger-scale operation would not work for them. He adds that the big industry leaders also should not have difficulty provided they continue to make good strategic choices. This leaves the midsize CDFIs, those with roughly \$2 million to \$50 million in assets. Pinsky says that these institutions are struggling the most but that the “CDFIs with the best chance of succeeding are those that take a brutally honest look around and make hard strategic choices.”

CDFIs are responding in several ways. Some are moving away from being vertically integrated business units that raise their own capital and do their own lending and servicing. These CDFIs have chosen to specialize, contracting out the other functions. For other CDFIs, the drive to stay competitive has led to mergers and acquisitions, as well as a push for further horizontal integration, including resource sharing.

The CDFI industry also has had to confront the fact that for all its growth, its overall impact remains small relative to the mainstream financial markets and to the needs of LMI populations. In recent years there has been a lot of talk about how the industry can reach scale, including how it can improve the flow of mainstream capital into its markets.

A number of industry initiatives have focused on increasing the impact of CDFIs by attracting additional funding to the sector. For example, in an attempt to reduce transaction costs and increase transparency for private investors, Opportunity Finance Network launched the CDFI Rating and Assessment System (CARS) in 2001. CARS provides a comprehensive analysis of nondepository CDFIs. It aides investors by rating an institution’s impact (does the organization play a leading role in policy?) as well as its financial strength and performance. Establishing a rating system for a CDFI’s role in public policy is an acknowledgment of the importance of policy to the industry. To date, 16 CDFIs

nationwide have been rated by CARS, and 14 additional ones are either in the process of being rated or are scheduled for a rating.

Several organizations have been successful in attracting additional investors to CDFIs by leveraging the secondary markets. For example, the Community Reinvestment Fund (CRF) is a non-profit that buys loans from community lenders and then pools and resells them on the secondary market. In 2004, CRA issued an \$84.6 million pool of loans to the secondary market, \$64.5 million of which received an AAA rating from Standard & Poor's. The \$84.7 million pool of loans consisted of loans made to 45 multifamily, low-income housing tax credit properties in California, Florida, Wisconsin, and Washington State.

The industry is also seeing resources directed toward research on ways to increase scale. The CDP has made a significant contribution toward promoting quantitative analysis through administering the first comprehensive survey of the CDFI industry. In addition, the Aspen Institute and the Federal Reserve System are in the middle of a two-year joint effort to increase collaboration and research on CDFI scale and sustainability. This partnership builds on the research done by Kirsten Moy and Greg Ratliff of the Aspen Institute titled "Pathways to Scale for Community Development Finance." Moy and Ratliff argue that whereas the industry has long held that growth and expanded service delivery lead to sustainability, CDFIs must not overlook cost control and increased efficiency. Otherwise, the industry will not grow in a meaningful way. Thus, the authors contend, achieving scale for the CDFI industry means expanding volume, reach, and efficiency to reach sustainability. Once they are sustainable, CDFIs will be able to attract additional investment and deepen their impact.

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## Conclusion

Self-reflection has helped the CDFI industry identify some of the challenges ahead—namely, how to make institutions sustainable in the long term and how to increase the overall scale of the industry. Individual institutions and the overall industry will have to look within themselves for ways to grow stronger, look to each other for ways to increase resource sharing, and look outward for ways to increase the flow of resources to the industry and to help shape favorable public policy. It is clear that many CDFIs improve the lives of their clients, but there is still a lot to be learned about how these institutions can effectively expand their reach.

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## Notes

<sup>1</sup>The CDP aims to ensure access and use of data to improve practice and attract resources to the CDFI field. The collaborative is composed of the following organizations: Association for Enterprise Opportunity; Aspen Institute; Coalition of Community Development Financial Institutions; Community Development Venture Capital Alliance; CFED; National Community Investment Fund; National Federation of Community Development Credit Unions; and Opportunity Finance Network (formerly known as National Community Capital Association).

<sup>2</sup>Of the 30 New England CDFIs surveyed by the CDP, nine are not certified by the CDFI Fund. Therefore, there are at least 73 CDFIs in the New England area.

<sup>3</sup>For example, the total assets of domestically chartered banks equaled \$8,180 billion at the end of May 2005 (source: Federal Reserve Board).

<sup>4</sup>Some CDFIs did not respond to certain questions on the CDP survey, either because they chose not to or because they could not get the data requested.

<sup>5</sup>See *A Financial Services Survey of Low- and Moderate-Income Households*.