COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS: CURRENT ISSUES AND FUTURE PROSPECTS

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ABSTRACT: *Community development financial institutions (CDFIs) help to address the financial needs of under-served, predominantly low-income communities. CDFIs include community development banks, credit unions, business and microenterprise loan funds, and venture capital funds. Although CDFIs are a rapidly growing and an increasingly important area of community economic development, they have not received proportionate attention from academic researchers. This article begins to address the gap. It outlines the history of the CDFI industry and details how CDFIs are responding to three specific development needs: basic financial services; affordable credit for home purchase, rehabilitation, and maintenance; and loan and equity capital for business development. The article then considers the strengths and limitations of CDFIs, concentrating especially on the relationship between CDFIs and conventional financial institutions. It concludes by examining the impact that these alternative financial institutions realistically can hope to achieve.*

Affordable credit, basic financial services, and investment capital are critical to the health of communities. Individuals need mortgages to purchase and maintain their homes. Developers require financing to build and rehabilitate commercial properties, community facilities, and affordable housing. Businesses need credit and equity capital in order to grow. Community residents (as well as local institutions) require safe, affordable financial accounts where they can keep and build their assets. Unfortunately, low-income communities and individuals have always had limited access to financial services, affordable credit, and investment capital. The problem has multiple causes, including historical patterns of racial and ethnic discrimination (Oliver & Shapiro, 1995; Squires & O'Connor, 2001), suburbanization and the flight

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of capital out of the inner city (Jackson, 1995; Kasarda, 1989), banks' and thrifts' concerns about profitability, and the restructuring of the financial services industry (Avery, Bostic, Calem & Cannern, 1997; Stegman, 1999). The lack of such financing has consistently hampered efforts to improve conditions in these areas.

This article looks at one response to this problem: the community development financial institution (CDFI). CDFIs have a primary mission of improving economic conditions for low-income individuals and communities. These entities provide a range of financial products and services that often are not available from more mainstream lenders and financiers. CDFIs augment their financing with a range of counseling and educational services that increase their borrowers' economic capacities and potential. There currently are more than 800 such entities throughout the country, ranging in asset size from $5,000 to more than $1 billion (CDFI Data Project, 2003). They take a variety of institutional forms, from federally regulated banks and credit unions to unregulated, nonprofit and/or for-profit loan funds and venture capital providers.

Today's CDFIs have a number of predecessors. The first minority-owned banks targetting low-income areas were established in the late 1880s (DuBois, 1907). The 1930s and 1940s saw the emergence of credit unions, many of which were in the rural south and were designed to serve African Americans who did not have access to credit (Isbister, 1991). A number of the community development corporations (CDCs) that were first created in the late 1960s and early 1970s provided financing for small businesses as part of their broader economic revitalization efforts (Halpern, 1995; Perry, 1987). (Most of the CDCs formed in the past few decades have chosen not to offer direct financing, though, electing instead to focus on real estate development and small business counseling.) The 1980s saw the emergence of a series of nonprofit loan funds that worked to promote affordable housing and small business development. Many of these organizations—including the Local Initiatives Support Corporation, the Enterprise Foundation, Boston Community Loan Fund, and the Delaware Valley Reinvestment Fund—focused in large part on helping CDCs obtain the financing and technical skills necessary to carry out their various projects (Walker, 1993).

The coalescense of these various initiatives into a recognized development finance industry did not really occur until the early 1990s and was fostered by two federal initiatives actively supported by the Clinton administration. The first involved increased enforcement of the federal Community Reinvestment Act (CRA). Enacted in 1977, the CRA mandates that banks address the credit needs of their entire service area and prohibits them from discriminating against any portion of their markets. The law went largely unenforced for much of the next 15 years, but received far greater federal attention in the early 1990s. For example, federal regulators revised the CRA in 1995 so that banks were judged more on their actual lending and investment performance in low-income and minority communities than on their marketing and outreach efforts in these areas. The changes contributed to a sharp growth in lending in these communities (see Belsky, Schill, & Yezer, 2001).

The second, related initiative involved the establishment of the Community Development Financial Institutions (CDFI) Fund in 1994. Championed by candidate Clinton and based in large part on his experiences with the Chicago-based South Shore Bank, the Fund sought to increase the availability of affordable capital in historically underserved markets. Its primary focus to date has been to foster the development of loan funds, banks, credit unions, venture capital funds and other financing entities that have as their primary mission the expansion of economic opportunities in low-income communities. The Fund certifies organizations as CDFIs, thus ensuring that they meet a certain set of institutional criteria. The Fund also provides capital to CDFIs both directly and indirectly through regulated banks and thrifts. Since its inception, the Fund has provided a total of more than $400 million in direct funding to over 250 CDFIs and has facilitated an additional $1 billion in CDFI-related investments from banks through its Bank Enterprise Award program. The Fund's efforts have significantly expanded the development finance industry, as evidenced by the fact that the more than 675 certified CDFIs currently in operation are more than double the number that existed in the mid-1990s (CDFI Data Project, 2003). Many of the certified CDFIs had been providing financial services to disadvantaged communities prior to the creation of the CDFI Fund. Others decided to expand into financial service provision in order to take advantage of the funding that the CDFI Fund offered.

To date, there has been relatively little analysis of the role and effectiveness of CDFIs. Part of the reason lies in the considerable diversity of groups that qualify as CDFIs. It is difficult (if not impossible) to make meaningful comparisons of entities as different as credit unions and venture capital funds. Even within certain categories of CDFIs (loan funds, for example), individual organizations are often engaged in a wide range of disparate activities. Some of the more sophisticated CDFIs simultaneously offer affordable housing loans, small business loans, equity capital, and financing for day care centers.

Another part of the problem stems from the lack of clarity as to the organizations' role within the financial system, particularly in their relationship to mainstream lenders and investors. Are CDFIs and banks competitors, partners, or something else? Such a question is laden with ideological, political, and fiscal complexities. Furthermore, the paucity of good data on CDFIs and their impacts has limited the extent of critical analysis that can be done. Most of the available information is descriptive at best and exists only from the 1990s onward, a period marked by one of the strongest economies in national history.

In light of these challenges, this article offers a framework for beginning to understand CDFIs in a broader context of development finance. It looks at what CDFIs do, focusing on their activities and functions instead of on their institutional type. (Because so many CDFIs are now engaged in multiple activities, some of the previous ways of categorizing the groups—as business loan funds, housing loan funds, and the like—are no longer particularly helpful.) The article considers the strengths and limitations of CDFIs, concentrating especially on the relationship between CDFIs and conventional financial institutions. It then provides a way of assessing the impact that these alternative lenders can realistically hope to achieve.

BASIC FINANCIAL SERVICE PROVISION

One of the most important functions of financial institutions is the provision of services such as checking and savings accounts. These accounts are the most basic financial assets that most households own (Williams & Hudson, 1999) and when held in insured depository institutions, provide a safe place to keep money, create opportunities to build wealth, and often serve as prerequisites for obtaining other forms of credit. Households without such transaction accounts face a number of financial disadvantages. They typically have to use currency exchanges to cash checks. They also have difficulty establishing the credit history necessary to purchase a home or build other wealth. Overall, low-income households without transaction accounts are 43% less likely to have positive holdings of net financial assets, 13% less likely to own a home, and 8% less likely to own a vehicle than those with such accounts (Carney & Gale, 2001). In short, the lack of such services makes it exceedingly difficult for a community to build and maintain wealth. Unfortunately, at least 10 million US households (9.5% of the population) have no checking or savings accounts with an insured financial institution (Kennickell, Starr-McCluer, & Surette, 2000).

One response to the lack of financial service provision has been the growth of fringe banking entities (including currency exchanges, check-cashing outlets, pawnshops, and rent-to-own stores) in lower-income communities. In Chicago in the late 1990s, the ratio of fringe bankers to conventional lenders was as high as 12:1 in low-income, predominantly minority communities, compared to 1:1 for the city as a whole (Mullen, Bush, & Weinstein, 1997). These fringe bankers typically offer customers convenient locations, flexible hours, short lines, and immediate cash from paychecks (instead of having to wait for the check to clear, as is customary for most banks). While a typical check-casher may charge up to 4% of the value of a given check, it charges only $0.75 to issue a money order and also sells envelopes and stamps. In contrast, conventional credit unions and banks can charge as much as $40 for one overdraft and do not offer the same ancillary services (Caskey, 2001; Stegman, 1999).

Fringe banking fees add up quickly, however. Moderately frequent users of these institutions' services (10 or more per month) can end up paying two to three times as much as they would if they had an account at a regulated financial institution, an amount equating to a few hundred dollars over the course of a year (Mullen, Bush, & Weinstein, 1997) Even more striking is the difference in interest charges for short-term, "payday" loans. For example, a check-casher might charge a 10% fee for a two-week cash advance (or $5 on a $50 loan). Because many payday loans are rolled over or extended, the annual percentage rate serves as a better reflection of the true costs of the loan (Caskey 2001; Stegman, 1999; Woodstock Institute, 2000). A 10% fee for a two week loan translates into an annual interest rate of 1,092% (compared to a typical annual consumer loan rate of 16.5% for a credit union) (Stegman, 1999).

The desire to improve the accessibility and affordability of basic financial services in low-income communities has been a major focus of CDFIs, particularly community development banks and credit unions. The growth in the number of such institutions over the last decade has made that objective easier to reach. Community development banks increased from 27 in 1992 to 39 in 2001, with their total deposit base growing from $61.5 million to $108.1 million and their lending rising by 160% (Woodstock Institute, 2002). Similarly, the number of credit unions specifically designated as low-income by the National Credit Union Administration (NCUA) grew from 142 in 1990 to 538 in 1999, with a corresponding increase in deposits from approximately $570 million to just over $2 billion (NCUA, 1999). Not all low-income credit unions are community development credit unions, however. The former are designated by the population they serve while the latter choose their identification based on their mission of community development.

These CDFIs are working to address many of the factors that explain the persistence of a large unbanked population and the rise of fringe bankers. The majority of community development credit unions (CDCUs) and CD banks are located in low-income areas and/or serve predominantly low-income individuals. They typically provide a range of basic financial services at little or no cost to their members or customers. For example, the CDFIs' basic savings and checking accounts usually have no monthly fees and either no or very small ($5 to $10) minimum balance requirements. CDCUs and CD banks often offer certificates of deposit (CDs) that can be purchased for as little as $100. They also offer special savings vehicles such as Christmas accounts and Individual Development Accounts (IDAs). The IDA is a relatively new program in which a qualified low-income individual's deposits are matched by a donor up to a certain level and then can be withdrawn by the individual for certain uses (Boshara, Scanlon, & Page-Adams, 1998; Sherraden, 1991; Tansey, 2001). CDCUs and CD banks also are the primary CDFIs that make consumer loans to households for purposes such as purchasing an automobile, covering health care, and investing in education. Not only do these loans address critical household needs, they also help borrowers establish the positive credit history necessary to obtain a subsequent mortgage and purchase a home.

Virtually all CDCUs and CD banks spend a considerable amount of time helping their members and customers improve their credit ratings, with the goal of increasing their asset-building capacities. Much of the CDFIs' work involves counseling clients/members on ways of reducing and managing their debt and repairing their credit histories. Such efforts are particularly important given that the typical low-income household had credit card debt of nearly $1,300 in 1995, and 17% of low-income families had credit card balances that exceeded their annual income (Bird, Hagstrom, & Wild, 1997 as cited in Carney & Gale, 2001).

HOUSING FINANCE

The focus of most community development efforts (and thus the majority of development finance) has historically been the creation and/or rehabilitation of housing. The home is the primary asset for most Americans, and homeownership is a time-tested way of building individual and family wealth. Families frequently borrow against the value of their homes to finance education and small business development. Homeownership also has traditionally served as a linchpin of a broader neighborhood development strategy, as it tends to contribute to more stable residential areas (Rohe & Stewart, 1996). The development or rehabilitation of housing, be it single-family homes or multi-family rental apartments, can spur other economic activity within a community.

Single-Family Financing

As noted in the introduction, the stability of a residential area depends on the availability of affordable mortgage financing. Such credit historically has been difficult to obtain, however. For many years a number of banks redlined poorer and minority neighborhoods (see Polikoff 1978). Even now, banks struggle to manage the risks associated with lending in lower-income communities and to lower-income individuals. On average, mortgage default rates in low-income census tracts are 15% higher than in moderate-income ones and 31% higher than in middle-income ones (Capone, 2001). Low-income borrowers are more likely to default than are moderate or middle-income borrowers (Van Order & Zorn, 2001). The end result has been that lower-income markets have tended to have less access to the wide range of financing products available in other markets.

The problems caused by the inadequate availability of credit have helped mobilize local activists throughout the country and have resulted in the enactment of the CRA and other legislation designed to eliminate discriminatory lending. The activism has also resulted in the creation of specific alternative financing mechanisms. South Shore Bank was created in large part to ensure affordable mortgage financing in Chicago's South Shore neighborhood. Groups such as the Santa Cruz Community Credit Union have created special home mortgage programs for their members, augmenting their financing with extensive counseling on the nuances of buying and maintaining a home. There are now over 220 members of the Neighborhood Reinvestment Corporation's NeighborWorks network, many of which are CDFIs. Most of these groups provide mortgage financing to low-income prospective homebuyers as part of a broader community revitalization strategy. The NeighborWorks members themselves have collectively provided mortgage financing to over 60,000 low-income families in the past 10 years.

The growing emergence and activity of CDFI lenders has coincided with substantially increased lending in lower-income markets on the part of conventional financial institutions. Between 1993 and 1997 mortgage lending increased by 40% in minority neighborhoods and 31% in low-income neighborhoods in cities throughout the country (Wyly, Cooke, Hammel, Holloway, & Hudson, 2001). The actual and perceived risks of these areas had historically dissuaded lending, but the increased saturation of higher-income markets, coupled with CRA pressures, caused many lenders to re-consider the areas. As they grew to understand the markets and specialized in the nuances of lending there, they found that these communities too could be profitable. Furthermore, the strength of the national economy in the 1990s contributed to improved economic conditions in many low-income neighborhoods, including increases in residents's income levels and corresponding declines in both residents' and communities' credit risks. The reduced risk perceptions contributed to a greater willingness on the part of Fannie Mae and Freddie Mac, enterprises established by the federal government in order to create a secondary market for home mortgages, to liberalize their criteria for purchasing mortgage loans originated in these markets. This, in turn, made it easier for lenders to make and sell more of these loans (Belsky, Lambert, & von Hoffman, 2000).

Conventional lenders have increasingly adapted their products and underwriting criteria to address the needs of lower-income borrowers. For example, many lenders are allowing higher loan-to-value and other debt ratios. An increasing number of products enable borrowers to make down payments of 3% or less of the home's purchase price. In certain areas (Boston, for example), banks have even offered subordinated second mortgages in conjunction with conventional firsts so as to reduce further the amount of up-front equity a borrower must provide (Campen & Callahan, 2001).

The greater involvement of more conventional lenders in lower-income and minority markets has significantly increased the amount of available credit in these areas. It also has substantially changed the CDFIs' role in these areas. In the era of redlining and more widespread lending discrimination, CD banks and CDCUs were often the only sources of affordable mortgages for minority and low-income homebuyers. As recently as the early 1990s, CDFIs remained the principal mortgage providers for many of these purchasers. Now, however, CDFIs have become much more supplementary lenders. Most of the home purchase lending on the part of NeighborWorks members, for example, involves second (or even third) mortgages, loans subordinate to first mortgages held by more conventional financial institutions. The principal loan product of the various NeighborWorks groups is a "soft" second mortgage covering up to 30% of the value of the home and carrying a significantly below-market interest rate. The loan serves to reduce the borrower's overall interest rate, the amount of the down payment required of the borrower, and the credit risk borne by the conventional lender. In the past five years these CDFIs have added loan products to finance down payment and closing costs. Taken together, these products make homeownership much more affordable for lower-income borrowers. A growing number of CDFIs also have added home repair and maintenance loans to their stable of products. The monies are critical not only for maintaining the livability of individual homes, but also for precluding the physical decline of the neighborhood.

Extensive homebuyer education services are integral parts of CDFIs' asset-building strategies. Prospective borrowers often must attend some sort of training on the intricacies of home purchase and repair before being able to obtain a loan. Such education may involve a series of group sessions over multiple weeks (the typical NeighborWorks model) and/or one-on-one meetings with a CDFI staff member. The goal is to enable the prospective borrower to address prior credit issues and meet the CDFI's (and/or a conventional lender's) underwriting standards. Once the borrower can qualify for a loan, the CDFI usually partners with a conventional lender to provide a mortgage, with the lender issuing a first mortgage for approximately 70% of the home's value and the CDFI providing subordinate financing to cover most of the remaining property cost.

CDFIs increasingly have geared their lending and counseling services toward combating the problem of predatory lending in lower-income markets. Certain sub-prime lenders such as Associates First Capital have pursued lending strategies that effectively strip homeowners of their equity. Among the more common predatory practices have been excessively high up-front loan fees, required financing of single-premium credit insurance, stiff penalties for prepaying loans, and fee-loaded mortgage refinancing. In many cases the borrower remains perpetually in debt, with monthly payments going entirely for fees and interest. CDFIs such as Self-Help have been especially active in documenting and publicizing predatory lending practices, counseling individuals on ways of avoiding such loans, and marketing their own products as much more consumer- and community-friendly alternatives (see www.responsiblelending.org).

With the expansion of loan products and services in lower-income markets, households earning 80% or more of a metropolitan area's median income can now obtain mortgage financing relatively easily. The actual income floor varies across regions; low-income indviduals have a much easier time buying homes in weaker-market cities such as Cleveland, Philadelphia, and Baltimore than in stronger-market ones such as Boston, New York, and San Francisco. A number of CDFIs and even some conventional lenders have claimed to have provided mortgages to individuals making as little as 50% of their area's median income. Boston's soft second mortgage program (operated by a consortium of area lenders) has succeeded in targeting half of its loans to individuals with incomes at or below that amount (Campen & Callahan, 2001). Approximately 49% of the mortgages that the Self-Help Venture Fund has purchased from conventional lenders has been made to individuals earning 60% or less of the median income in the area in which they live (Quercia, Stegman, Davis, & Stein, 2001).

The ultimate impacts of this expanded mortgage lending on low-income individuals and communities are not yet clear. Thousands more minorities and lower-income individuals have been able to purchase their homes in the past decade; the national homeownership rate increased by roughly 4 percentage points during the 1990s. Yet the national economic downturn of the past few years has contributed to 30-year highs in the number of mortgage defaults. It is not clear to what extent lower-income borrowers and communities have been negatively affected and whether CDFI counseling efforts have had sufficiently mitigating effects.

Multi-Family Financing

Just as CDFIs serve as intermediaries between low-income households and conventional financial markets, they often serve as a conduit between nonprofit housing developers and mainstream capital providers. CDFIs have been instrumental in the growth and maturity of the CDC industry. Most of the larger community development loan funds (LISC, the Enterprise Foundation, the Low Income Investment Fund, and The Reinvestment Fund, to name a few) have historically concentrated a large portion of their efforts on building the financial and organizational capacity of CDCs and similar nonprofits to develop affordable housing.

Virtually every housing development, particularly those serving lower-income individuals in low-income communities, requires a mix of debt and equity financing. Public and philanthropic monies can only go so far; private sector capital is essential for larger-scale development. To attract such financing, CDFIs have consistently pursued a number of strategies simultaneously. First, they have worked to make the CDCs viable borrowers in the eyes of mainstream lenders. They have helped the groups develop sound financial and accounting practices, identify and manage developers for their projects, address asset management issues, and generally become more business-like in their orientation to real estate development.

Second, the CDFIs have worked to demonstrate the financial viability of the projects themselves. For many years most bankers (as well as their regulators) were extremely hesitant to commit monies to housing projects in low-income communities; the risk of project failure was simply too great. To entice these lenders, the CDFIs had to reduce the perceived risk of the deals. They did so in many cases by providing the initial, most risky project financing. LISC, for example, was a pioneer in the creation of "pre-development" loans and recoverable grants: low- or no-interest loans to cover the various land acquisition, architectural, environmental, legal, and other up-front costs associated with preparing a site for development. Once the project was approved and the site prepared, a CDFI would often provide the CDC developer with a construction loan so that the CDC could actually build or rehabilitate the planned housing units. As the project moved along and bankers felt more comfortable about the project's likelihood of completion, they would provide the CDC with a conventional mortgage (or mortgages) collateralized by the property. The CDFI's loan then would become subordinate to the bank's.

Obtaining conventional financing for CDC housing projects solved only part of the problem, however. Then as now, such developments required a significant amount of subsidy for lower-income individuals to be able to afford the units. Without a means of reducing project costs significantly, the housing would be affordable to only a very small percentage of the individuals in need. In addition to helping the nonprofit developers identify and obtain various public and philanthropic grant monies, CDFIs such as LISC and Enterprise successfully pushed for the creation of the Low Income Housing Tax Credit (LIHTC). Since its implementation in 1986, the LIHTC has enabled taxable investors to obtain a federal tax credit for investing monies in low-income housing developments. The resulting equity has substantially reduced the costs of financing such projects and has contributed to the creation of thousands of additional housing units for lower-income families (Cummings & DiPasquale, 1999; DiPasquale & Cummings, 1992; McClure, 2000).

As CDCs have become more sophisticated and the risks of housing lending have been reduced, conventional lenders have become much more active in financing such projects. Often, the largest amount of financing in a multi-family project located in a low-income community now comes from a bank community development corporation. Wholly owned subsidiaries of conventional banks, bank CDCs focus exclusively on CRA-eligible financing activities. They have become much more prevalent since the early 1990s, as regulated lenders have sought to comply with CRA requirements and compete for the growing amount of business in what had been largely untapped lower-income markets. (The benefit of the bank CDC model is that it enables a regulated lender to meet its CRA mandates but is not subject to the same safety and soundness concerns as the bank itself.)

To a certain extent CDFIs have been victims of their own success in multi-family lending. The increased involvement of conventional lenders in these deals has meant that the CDFIs are typically financing smaller, riskier portions of projects than they once were. The majority of their dollars are currently loaned out in the form of subordinated debt instruments, often to finance the earliest stages of development. Often CDFI loans are structured with interest rates at or slightly below market, with balloon repayments timed to coincide with the influx of conventional financing or tax credit equity. Such structures help reduce the overall cost to the CDC (and thus increase the home's affordability) but effectively increase the CDFIs' credit risk exposure. In addition to taking higher-risk positions in housing finance, a number of CDFIs have worked to expand their services to other areas of community development. Many of the traditional affordable housing lenders now focus as well on the financing of local facilities, such as childcare centers, health clinics, and charter schools.

BUSINESS DEBT AND EQUITY PROVISION

A healthy, growing business sector provides critical goods, services, and employment opportunities to local residents and is critical to the economic vitality of a community. Businesses, in turn, require access to debt and equity capital in order to finance the creation of new enterprises and the growth of existing ones. Without the ability to borrow funds, companies must use their own earned income to finance their growth and investments, limiting how quickly they can expand. Access to equity capital is particularly crucial for young companies, which lack the cash flows necessary for debt repayment. Equity is patient capital, which does not need to be repaid for several years.

Historically, however, access to both debt and equity capital has been very limited for ethnic minority, female, and low-income entrepreneurs, as well as for businesses located in distressed communities. The lack of debt capital for ethnic minority and female entrepreneurs often has reflected discrimination by lenders. Tougher enforcement of fair lending laws has helped to address that aspect of the problem. The lack of credit also reflects the real and perceived higher transaction costs and risks involved in doing these types of deals. Ethnic minority and women-owned businesses are generally smaller and less well capitalized than those owned by white males (a residual effect of discrimination). As a result, they have less ability to weather business downturns and are at greater risk of defaulting on a loan than larger, better-capitalized entities. Additionally, smaller businesses generally need smaller loans, which are more expensive to administer. They also may require extensive technical assistance in order to become viable borrowers. Most conventional lenders are unwilling to provide technical assistance because it too is administratively expense and may open them up to issues of lender liability should the businesses fail.

Higher transaction costs and risk also help account for the lack of equity capital in low-income communities. However, access to equity capital is problematic even in more affluent markets. Investments made by the venture capital industry, the primary source of equity capital for business, are driven overwhelmingly by their financial objective of maximizing returns for their investors. Because investment capital is limited, the industry focuses only on those markets that it perceives as the most lucrative. Companies located outside of a few major markets, in non-technology related industries, and/or with investment needs of $1 million or less, have a very difficult time attracting equity capital. Although some CD banks and CDCUs provide small business financing, most of the CDFIs business-related efforts have been through business development loan funds (BDLFs), community development venture capital funds, (CDVCs) and micro-loan funds (MLFs).

Business Development Loan Funds

Business Development Loan Funds (BDLFs) lend capital to businesses and nonprofit organizations, many of which have not been able to qualify for funding from more traditional sources, with the objective of furthering various social goals. These goals include promoting economic growth and job creation in low-income areas, stabilizing population declines in distressed communities, improving the availability and quality of community facilities in under-served markets, increasing the number of businesses owned by women and ethnic minorities, and promoting the growth of businesses that do not harm the environment (Caskey & Hollister, 2001).

BDLFs raise capital from federal and state governments, foundations, banks and financial institutions, socially conscious individuals, and religious institutions (NCCA, 2002). The capital originates in the form of grants and below-market rate loans, which BDLFs re-lend at market rates, using the difference to finance their operations. BDLFs offer a number of financial products and services, including term loans, lines of credit, loan guarantees, and debt with equity-like features. This financing is designed to support a broad range of business needs, such as facility purchase and expansion, working capital needs, and equipment purchases. While most BDLFs provide only business financing, some also finance housing and facility construction and renovation. Most of the businesses that BDLFs finance are existing operations that have the working capital to repay a loan.

BDLFs lend both independently and in conjunction with conventional lenders. Because BDLF loans tend to be riskier than those that a bank would be willing to undertake, and at times are unsecured, BDLFs also provide extensive technical assistance to their portfolio companies. The technical assistance is provided both pre- and post-investment to help potential borrowers qualify for capital and then to assist them with various aspects of operations. The type of assistance provided includes help with writing business plans, putting together marketing strategies, and developing financial systems.

Thus far, research on BDLFs has been very limited, consisting primarily of descriptive statistics (NCCA, 2002). There has not been any research that has studied the entire BDLF industry, primarily because of the large number of business development loan funds in existence and the high level of diversity among them. The diversity makes it difficult to generalize about findings from a subset of organizations, limiting the usefulness of research that examines only a few BDLFs.

Community Development Venture Capital Funds

Community development venture capital (CDVC) funds provide equity and near-equity capital to small businesses. An equity investment consists of a cash infusion into a company in exchange for partial ownership of that company, in the form of preferred or common stock. A near-equity investment consists of a loan that is convertible to equity, or a loan that nets the lender some features, such as warrants, royalties, or participation payments, which enable it to participate in the upside if the investment is successful. Both equity and near-equity investments are forms of patient capital, giving young firms the funds they need in their early years without requiring the immediate repayment of those funds, as is the case with a traditional loan.

At the end of 2000, the last year for which data is available, there were 50 CDVC providers with $300 million under management (Rubin, 2001). Their capital has come primarily from banks, foundations, and federal and state governments, which invest low-interest debt or equity in CDVC funds, usually for periods of 10 or more years (Rubin, 2001).

CDVCs differ from traditional sources of equity capital, such as venture capital funds and small business investment companies, in a number of important ways. Unlike traditional equity providers, which look for the promise of significant growth rates before investing in a firm, CDVCs will invest in companies that are growing at only a moderate pace, but that have the potential for significant job creation. CDVCs also differ from conventional sources of equity in their willingness to invest in companies located in rural and low-income areas (Rubin, 2001).

While traditional equity providers generally focus their investment activities on companies at particular stages of development and in specific industries, most CDVC funds invest in companies at all stages of development and in all industries. This strategy enables CDVC funds to consider the largest possible number of high-quality investments within their geographic regions. The majority of CDVC funds do target companies that will create manufacturing jobs, which typically offer higher wages and better benefits than service sector jobs. Manufacturing jobs also can employ individuals with lower education and skill levels, making such jobs an important path to greater economic opportunity (Mayer, 1998; Phillips-Fein, 1998).

As with other types of CDFIs, CDVC funds provide their portfolio companies with intensive technical assistance. Because the majority of CDVC funds are geographically restricted, they are faced with relatively few potential investment opportunities. This restricted deal flow may require the funds to invest in companies with limited management experience. As a result, the funds must play an active role in advising the companies, either directly through fund staff or indirectly through outside experts who are brought in to increase the companies' level of knowledge and market readiness (Rubin, 2001). The technical assistance significantly increases CDVC operating costs and requires the funds continually to search for new funding sources to subsidize their operations, an increasingly difficult challenge as funding becomes more sparse and the field continues to grow in numbers and size.

Like traditional venture capitalists, CDVC providers must exit their investments in order to make a profit and free up capital for new investments. The primary form of exit for both traditional venture capitalists and CDVC providers is acquisition by an external buyer. This accounted for 63% of all traditional venture capital exits in 1999 (Venture Economics, 2000) and more than half of all CDVC exits through the end of 2000 (Rubin, 2001). CDVC providers also exit approximately a third of their investments via owner and management buy-backs. Initial public offerings (IPOs), which usually are the most lucrative forms of exit for venture capitalists, have been extremely rare among CDVCs.

In general, CDVC funds tend to hold their investments for a much longer period of time than do traditional venture capitalists, tying up valuable resources and decreasing their financial returns. This reflects both the greater difficulty of exiting the types of companies in which CDVCs invest and the unwillingness of CDVC managers to force an exit that would be detrimental to the overall survivability of a company. Some CDVC managers are working to increase the number and speed of exits by creating a secondary market for CDVC investments. The economics of such a market are challenging, however, making its near-term viability questionable.

Micro-Loan Funds

Unlike BDLFs and CDVCs, which work with existing or emerging companies, micro-loan funds (MLFs) focus primarily on sole proprietorships. MLFs provide training and limited financing (loans of no more than $25,000 and often less than $5,000) to entrepreneurial individuals. MLFs are a subset of micro-enterprise programs, which work to help predominantly lower-income individuals develop their own businesses. As of 2000, there were approximately 700 micro-enterprise development programs in the United States, and these groups collectively had served more than 55,000 clients (FIELD, 2000). Less than one-fourth of these programs do enough lending to qualify as CDFIs.

The US micro-enterprise sector was modeled after the work of several prominent organizations in developing countries, particularly the Grameen Bank of Bangladesh. These organizations assist poor and primarily female clients by making small, short-term loans, often via peer or solidarity group lending (FIELD, 2000). A number of the US micro-enterprise providers initially attempted to utilize this method, but quickly discovered that the peer group approach was much more difficult to implement than they would have predicted based on experience in developing countries and that US micro-entrepreneurs were not seeking loans in large numbers. With a few exceptions, the loan volume of micro-enterprise providers was very small, regardless of the lending method they utilized. As of 1999, only 11% of all the clients served by US micro-enterprise programs were borrowers (Langer, Orwick, & Kays, 1999). Instead, the vast majority of clients sought business and financial training.

The US micro-enterprise field has evolved into a potpourri very different programs with distinct objectives and ways of defining success. Some organizations focus primarily on training with the goal of promoting self-sufficiency among their participants. Others focus more on lending and achieving economic and community development objectives. Even within the latter group, some emphasize poverty alleviation and work to assist very low-income individuals to start their own businesses. Others emphasize overall economic growth and prefer to work with micro-entrepreneurs who have been in businesses for several years or more (Else, 2000). Additionally, micro-enterprise programs may target specific groups based on their ethnicity, gender, or geographic location.

Most micro-enterprise program participants are female and ethnically minority. They also are somewhat better educated than the typical American, have often had some previous business experience, and frequently are not relying on their business as their sole source of income (Clark, Kays, Zandniapour, Soto, & Doyle, 1999). Particularly for low-income individuals, the micro-business is usually an “income-patching strategy”: a part-time endeavor geared toward generating enough money so that the individual and his or her family can make ends meet. Micro-enterprise programs often provide non-economic benefits as well, such as increased confidence, self-esteem, financial literacy, and social networks that participants may take away from micro-enterprise programs (Clark et al., 1999; Edgcomb, Klein, & Clark, 1996; Jones, 1999; Servon, 1996, 1998).

The majority of micro-businesses are small, sole proprietorships in the low-paid retail and service sectors (FIELD, 2000). The businesses typically generate a small number of jobs and offer few (if any benefits) to their employees. It is unrealistic, therefore, to view micro-enterprise as a significant economic development or anti-poverty tool. Servon (1999) argues that the micro-enterprise strategy lies somewhere between the economic development and social service worlds, and, therefore, needs a new framework for evaluating its effectiveness. Unfortunately, no one as yet has developed such a framework.

An additional problem for micro-enterprise providers is the very high administrative costs involved in this type of lending. As a result, micro-enterprise funds are dependent on ongoing operating support to a much greater degree than any other type of CDFI. Studies of micro-enterprise funds have found that their earned income covered less than 20% of their operating expenses (Edgcomb et al., 1994); and most programs were less than 10% self-sufficient (Servon, 1999).

CURRENT AND FUTURE PROSPECTS

CDFIs emerged in response to a need for accessible, affordable financial products and services. They support asset building at the household and neighborhood level through the provision of transaction accounts; capital for housing purchase, development and maintenance; and capital for business development and expansion. Their efforts, in conjunction with legislation (the Fair Housing Act, CRA, HMDA), concerted pressure from community activists, and the saturation of suburban markets, have contributed to the greater availability of conventional financing in previously underserved areas. In light of the increasingly important role that CDFIs are playing, the rest of this article discusses three critical issues affecting the potential ability of these institutions to address the capital needs of low-income communities: the strengths and limitations of CDFIs institutional diversity; the relationship between CDFIs and conventional financial institutions; and the impact that these alternative lenders can realistically hope to achieve.

Strengths and Limitations of CDFIs Institutional Diversity

Different types of CDFIs are able to carry out different functions and take on different levels of risk. Non-regulated entities, such as loan funds and venture capital providers, are free to take on as much risk as their funders and/or investors will bear. Because they are able to take on more risk, community development loan and venture funds are much more likely to finance start-up businesses, smaller nonprofit service providers, and other marginal borrowers than are federally regulated community development banks and credit unions. (Nonprofit funds typically can take on slightly more risk than their for-profit counterparts because they do not have investors that require a certain rate of return on their capital. At the same time, they cannot take on so much risk that they jeopardize their future ability to lend.)

Unlike other types of CDFIs, CDCUs and CD banks can take deposits and insure them up to $100,000 with federal guarantees. This gives them the ability to reach a much larger scale and thus provide more financing to a larger number of borrowers. However, the federal depository insurance comes with contingencies; the institutions must adhere to a range of financial safety and soundness criteria to the satisfaction of federal and/or state regulators. For example, the groups must maintain appropriate levels of liquid reserves, minimum capital/debt ratios, and acceptable levels of risk in their portfolios. These regulations can effectively limit the types and extent of activities in which the institutions can engage. For example, regulators do not permit most CDCUs to make business loans because of the higher-risk nature of such ventures. Neither banks nor credit unions can make equity investments in start-up businesses (although non-regulated bank affiliates may do so).

Federal and state evaluators generally also do not look as posititively on a CDFI's more flexible lending practices as might a socially minded investor. This has been a concern for CD banks and CDCUs, which generally show weaker financial performance than their more conventional peers. An analysis of regulated CDFI Fund awardees found that these CDFIs typically had fewer total assets, higher loan delinquency and charge-off rates, and lower returns on assets than their non-CDFI contemporaries (Rajan, 2001). South Shore Bank in Chicago, one of the oldest and most successful CDFIs, has still lagged well behind similar-sized banks on the city's south side in its profitability (Esty, 1995; Taub, 1988). While such findings are not surprising given the CDFIs' emphasis on social return and focus on lower-income, higher-risk markets and borrowers, they are not necessarily comforting for financial regulators.

Relationship Between CDFIs and Conventional Financial Institutions

One of the key questions facing community development practitioners and policy-makers is how best to continue increasing the amount of financial services available to underserved markets–what role should banks play, what role should CDFIs play, and what are the best structural and systematic mechanisms for promoting and facilitating such efforts? This is a topic that provokes a wide range of reactions from the CDFI community, reflecting a diverse set of beliefs regarding the broader question of why CDFIs exist. Some CDFI practitioners view their work as a response to the persistent failure of conventional financial institutions to address the capital needs of low-income communities. A somewhat similar view is that CDFIs are a means for communities to express their values and beliefs about local control of capital. Proponents of these views consequently see CDFIs as necessary alternatives (or even competitors) to conventional financial institutions.

Another perspective is that CDFIs are necessary supplements to the existing financial system. Such a view holds that CDFIs are intermediaries between lower-income, historically under-served communities and conventional financial markets and institutions. Many CDFIs coming from this perspective work closely with conventional financial institutions, by means of formal or informal systems of client referral and partnership lending. A subset of these CDFIs view themselves as entrepreneurs whose role is to develop new financial products and demonstrate to more mainstream institutions that investing in certain high-risk markets can be done in a way that is beneficial to the community and profitable for the lender.

Whatever their role, CDFIs alone cannot meet all of the financial service needs of lower-income communities. At the same time, most conventional financial institutions currently are not (and likely never will be) providing the more specialized and costly products and services that CDFIs currently offer (such as extensive technical assistance, micro-loans, and pre-development financing). So how can we best ensure adequate financial service provision in these markets? Is it better to develop additional means of furthering the work of CDFIs (for example, by securitizing CDFI loans and equity investments and selling them on traditional financial markets) or to provide education and incentives to enable conventional financial institutions to serve these markets, with CDFIs taking a more supportive or ancillary role?

Answering these questions is not an easy task, particularly given the limitations of existing data. It is not clear, for example, the extent to which CDFIs and banks are offering different products and services and/or serving different borrowers? Are there certain CDFI activities and markets (geographic, functional, or institutional) that conventional lenders simply cannot or are unwilling to pursue because of regulatory or transactional costs? Conversely, are there other traditional CDFI activities that banks can undertake? The growing bank involvement in affordable housing lending suggests that CDFIs' efforts can actually develop markets for conventional lenders. Finally, are there certain characteristics of CDFIs that make them intrinsically beneficial to communities, even in markets that conventional financial institutions can serve profitably?

It also is not possible to answer these questions without considering the broader policy and economic environments in which CDFIs operate. The most dramatic increases in financial service provision in lower-income markets occurred during the mid to late 1990s during a presidential administration that made a strong commitment to such a goal. President Clinton's support of both the CRA and the CDFI Fund was critical to the growth of the CDFI industry and to the expanded efforts by conventional lenders to serve historically under-served communities. However, conditions have changed dramatically in the last few years. The Bush administration has sharply reduced funding for the CDFI Fund and has shown no interest in supporting CRA or development finance more broadly.

The mid to late 1990s also was a period of economic prosperity and strong stock market returns. This economic prosperity greatly assisted CDFIs in raising the capital they used to fund their loans and investments and enhanced the performance of CDFI funded businesses. Ironically, the good economic conditions encouraged conventional financial institutions to enter the distressed markets that previously had been served only by CDFIs, raising questions about the proper role of CDFIs relative to such institutions. Since 2000, the US has experienced an economic slowdown that has resulted in 30-year highs in foreclosure rates and has dampened conventional lenders' enthusiasm both for direct loans in lower-income markets and for subsidized support of CDFIs. Thus, at the same time that the slowdown has made it more difficult for CDFIs to raise capital, it also has increased the need for the services that CDFIs provide.

Assessing CDFIs' Impact

Like all entities engaged in promoting social change, CDFIs struggle to identify appropriate indicators for measuring the impact of their activities. Part of the challenge lies in defining what is meant by impact. CDFIs generally have described the effects that they believe they have on their target communities in terms of specific, quantifiable measures: jobs created, housing units refurbished, mortgages provided, day care facilities developed and the like. These initial outcomes are assumed to lead to broader, longer-term impacts such as improvements in the social and economic health of a given community.

Unfortunately, such indicators can mean different things to different people. In an industry as diverse as community development finance, definitions of outcomes and methodologies for measuring and collecting outcome data vary widely. For example, the most common outcome measure for business-specific CDFIs is jobs created. There is little consistency, however, in how individual CDFIs determine what constitutes a new job, how long the job must last in order to be counted, and whether the job can be attributed to the CDFI's own actions. This lack of consistency exists not only between different types of CDFIs, but also between individual CDFIs that provide similar services.

Many community development practitioners, advocates, researchers, and policy-makers want to determine whether the specific actions of a CDFI brought about a certain outcome or if the outcome would have occurred without the CDFI's intervention. There have been few, if any, good causal studies of CDFIs. Most of the analyses end up focusing too much on the CDFIs' activities and do not adequately take into account the range of other, often more significant factors involved in creating a given outcome.

Consider a few examples. Most affordable housing developments have a number of different funding sources; a CDFI may well provide pre-development and/or gap financing. Was the CDFI's involvement critical to the deal? Yes, but each of the other capital providers could easily argue that its monies were equally essential to the deal's viability. In a different case, a CDFI makes a loan to a business to enable it to purchase a new piece of equipment. Over time the business is able to grow and hire additional workers. Part of that growth likely stems from the enhanced productivity resulting from the new equipment, and part also results from the growing market for the business's goods and strategic actions taken by the company's management and workforce. Is the CDFI, therefore, responsible for creating the new jobs? The CDFI's financing and related technical assistance likely contributed to the improved health of the company, but the direct causal connection between its activities and the growth of the company's workforce becomes increasingly vague over time.

What, therefore, is a realistic way to assess the impact of CDFIs? A positive step would be to think in terms of direct and indirect effects of a CDFI's activities. Direct effects are those that result immediately and specifically from a CDFI's financing or technical assistance (a business purchases a new piece of equipment with a CDFI's loan dollars, a family purchases a home thanks to a CDFI mortgage, etc.). Indirect effects are those that come about later as a result of factors including, but not solely related to the CDFI's activities (the new piece of equipment enables the business to expand into a new market, hire additional employees, and pay more taxes; the new homeowners help stabilize the surrounding community). Obviously, the impacts become increasingly diffused as we move further away from the original financial transaction, and measuring and attributing them accurately becomes more difficult.

It also is important to calibrate expectations of CDFI impacts more appropriately. CDFIs are, after all, relatively small in scale. They are principally financial institutions: they make loans and equity investments, collect deposits, and offer various checking and savings accounts. They augment those activities with related education and counseling activities; some CDFIs provide more extensive services than others. But the CDFIs themselves are not real estate developers or goods producers. They do not build projects or manufacture products but instead help to finance them. They are unable to affect their borrowers' markets in any significant way. The impact of any CDFI is inevitably limited relative to broader economic and political forces. Affordable homeownership ultimately depends less on the structure of the CDFI's loan than on the strength of the local housing market and the effect of national interest rates. An expansion of the Earned Income Tax Credit is likely to have a much greater impact in reducing poverty in a given community than will the efforts of even the largest and most effective CDFI.

The CDFI industry currently is at a crossroads. Since President Clinton left office, federal support for the CDFI Fund has been diminishing rapidly, greatly reducing the availability of additional capital for individual CDFIs. This problem is compounded by weaker economic conditions and a dramatic decline in the stock market, which have made it difficult for CDFIs to raise funds from banks and foundations as well. The role of CDFIs vis-à-vis banks also is unclear given banks' increased activity in a number of distressed markets that used to be the realm of CDFIs.

CDFIs appear to have succeeded in expanding financial markets to many previously un- and under-served communities. But reversing the trends of the past and continuing the improvements that have occurred in these areas requires an ongoing, concerted effort and an understanding of how to build on and further those gains. Whether such an effort will be forthcoming remains to be seen, as does the question of whether CDFIs will continue to grow and play the pivotal role that they have undertaken in helping turn around distressed communities.

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